EMERGING MARKETS ECONOMICS LTD

STRENGTHENING INSURANCE SUPERVISION IN ARMENIA

FINAL REPORT

7 NOVEMBER 2003

Government Actuary's Department

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1 EXECUTIVE SUMMARY

In March 2003, Emerging Market Economics Ltd invited the Government Actuary's Department to submit a proposal to provide consulting services to it relating to a project on the insurance market in Armenia. This was to undertake a high level strategic review over a period of 4 weeks, with the objective of preparing in report form a medium term road map for the development of the insurance sector in Armenia, including a time bound action plan for the development of the market and the strengthening of its supervisory system. Emphasis was required to be given to identifying three particular items:

- the legislative developments needed to deliver effective market supervision;
- the needs and requirements for strengthening the structure and effectiveness of the existing insurance supervisor; and
- the policy considerations and direction for encouraging the healthy development of the insurance market.

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This report has been prepared by the consultants and comprises the final report required under the terms of reference for the project.

Section 2 describes the **background** to the project, including its terms of reference and signed contract; the consultants employed; the current legislative position in Armenia; other technical assistance that has been provided to the Ministry of Finance and Economy in the recent past; and a summary of the work undertaken on the project.

Section 3 provides a summary of the consultants' **review of** the nature and structure of **the Armenian insurance market**. This includes in section 3.11 a list of the key challenges facing the industry. In summary, these are:

- a lack of awareness of the benefits of insurance;
- low incomes and poor economic growth;
- corruption;
- a lack of mutual trust and ineffective supervision;
- a past lack of political will and coordination;
- a lack of compulsory classes;
- low levels of capital and small retentions;
- a lack of insurance and accountancy/audit professionals;
- a lack of data; and
- restricted investment opportunities.

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Recommendations for developing the insurance market, which seek to address each of the above issues, are set out in **section 6**. This section also covers the possibility of creating an insolvent insurer policyholder protection scheme, and makes some other suggestions for consideration.

Section 4 provides a summary of the consultants' **evaluation of** the constitution, organisation, staffing and supervisory systems of the **existing insurance supervisor**. It also makes detailed **recommendations as to the appropriate nature and constitution of the insurance supervisor in the future**, including its accountability to parliament, its legal relationship to ministries and other government bodies, and its source of funding; its organisational structure, including the design of supervisory systems, current staffing levels and future recruitment needs and policy; and requirements for strengthening its financial

monitoring of insurers, including its analysis and processing of financial statements submitted to it by insurers.

The primary recommendations made are:

- the establishment, no later than 31 December 2005, of an adequately resourced, independent, stand-alone insurance supervisory authority which should have responsibility for the supervision of insurance;
- the creation, as soon as possible and in any event by the time the independent insurance supervisor is established, of a policy advice unit within the Ministry of Finance and Economy, which should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry, the promotion of competition within it, the maintenance of sound principles of insurance regulation, and the promotion and delivery of public education on insurance matters;
- the insurance supervisory authority should be operationally independent in the exercising of its functions and powers but accountable for the actions it takes in fulfilling its mandate to those who delegated responsibility to it, namely the government and parliament;
- the insurance supervisory authority should prepare an annual report for the Ministry of Finance and Economy covering among other things the discharge of its functions during the year and providing statistical data on the supervised entities, which should be laid before parliament and published; and hold an annual public meeting to allow discussion of this;
- the insurance supervisory authority should be partly financed by a levy on insurers, set as a percentage of the gross premiums, excluding those relating to compulsory classes of insurance, written by the insurer; it should be required to submit to the Ministry of Finance and Economy each year a proposed total budget for the coming year (together with an estimate of the projected levies for that year) for approval, and to the extent that the levies above are inadequate to provide this budget, additional resources should be provided by the Ministry of Finance and Economy; and it should be required to prepare a set of financial statements, which should be audited by an independent auditor.
- the insurance supervisory authority should adopt the practices, including those relating to organisational structure, staffing and training, and financial monitoring of insurers set out in section 4.4.3.

Section 5 provides a summary of the consultants' **review of** all relevant insurance market **supervisory legislation**, both existing and proposed, including regulations and decrees. It also makes detailed **recommendations as to the legislative developments needed** to provide a coherent legal framework for the supervision of the insurance market, and the nature and outline content of the regulations and decrees required to strengthen market solvency including capital reserving requirements, attendant investment rules and reinsurance regulations.

The consultants' overall assessment is that the draft new Law covers satisfactorily many of the supervisory and regulatory issues which need to be addressed, but that they have some reservations over a number of aspects of this including:

- its length and relative complexity, which might prove overambitious and potentially counter-productive in encouraging development of the market;

- the very detailed nature of some of its provisions, which would be better placed in regulations;
- its provisions relating to "basic economic norms", which should be replaced by a simpler and more effective set of "minimum financial standards" (see section 5.4.2.2);
- the inclusion of certain provisions considered unrealistic and unhelpful during the next 5 years, for example that requiring every insurer (life and non-life) to have an in house actuary within 2 years (see section 5.9.9); and the exclusion of certain other provisions considered to be important, e.g. that for financial statements to be prepared in accordance with international accounting principles (see section 5.5.2.2);
- the balance drawn between penalties and sanctions on one hand and measures to encourage orderly and sustained development of the industry on the other (see section 5.6.2.2).

Recommendations made in sections 5.3 to 5.9 seek to address these points, whilst at the same time recognising the fact that the draft new Law has already received its first reading in parliament so that substantial changes to it are unlikely to be a practical option. Their emphasis is therefore on making significant but non-structural changes to the draft new Law, and outlining required regulations. Sections 5.3 to 5.8 cover respectively the important areas of licensing; prudential requirements (relating to minimum capital requirements, reserves, assets, solvency, reinsurance and premiums); financial reporting; intervention powers; transfers of business; and liquidation/winding-up. Where relevant, they recommend the nature and outline content of regulations (or other legislative provisions) that should be made in these areas. Section 5.9 covers other areas in which it is considered the draft new Law should be improved.

Section 7 provides a **summary of the recommendations** made in this report.

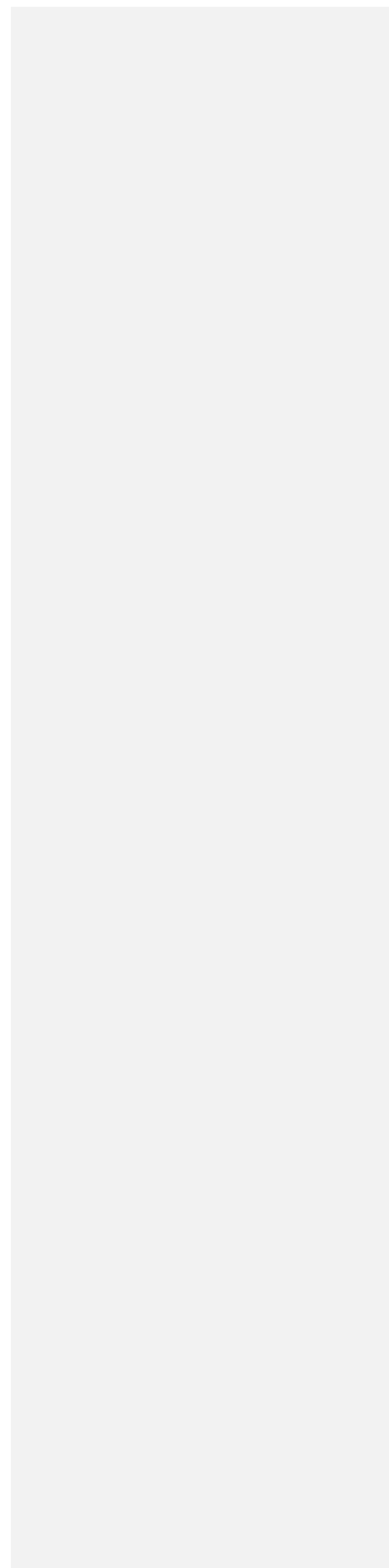
It is important to keep the recommendations made in this report in perspective. It seems inevitable that the insurance market in Armenia will remain very small for a number of years to come. Key problems like poverty, the weak state of the economy and corruption clearly go much wider than insurance, and will take time to address. They need to be tackled at a structural level by the government, and the consultants are not qualified to give expert advice in these areas.

There is no reason why the insurance industry should be singled out for harsher treatment than other areas of the financial services sector, and particularly banks. There is therefore a need for the recommendations made in the report, which in accordance with the terms of reference for the project relate only to the insurance sector, to be viewed by the government in the wider context. In some instances, recommendations which make perfect sense for the insurance industry may not do so taking a holistic point of view.

In the consultants' view, it is also important not to expect too much too soon of such a small insurance industry. There is a need to nurture this to some extent initially, and not to regulate it out of existence: development of the market and of its regulation need to go hand in hand. The recommendations made in the report therefore seek to have regard to the scale of the industry; only in areas where scale does not represent a real practical constraint are they more closely based on ideals.

As well as taking the steps described in the report, it is recommended that a further review of the Armenian insurance market is conducted after 5 years to appraise the development that has taken place by then and to make recommendations for any further structural changes to

the market and/or changes to supervisory legislation which are considered necessary at that time in the light of this.



2 REVIEW OF THE INSURANCE MARKET

2.1 Introduction

Under item 3 of the signed contract, we are required to:

- in consultation with the existing insurance supervisor and other relevant government and market bodies (as appropriate), review the nature and structure of the insurance market;
- in consultation with the existing insurance supervisor and any other relevant government and market bodies (as appropriate), review such plans, strategy papers and other related documents as have been produced and are available in Armenia;
- identify the policy considerations/direction for the encouragement of the healthy development and capacity building of the insurance market, including a survey of the capacity of insurance companies to increase the minimum capital requirements and to meet other prudential requirements;
- evaluate in outline the nature, feasibility, desirability and the supervisory implications of establishing compulsory classes of insurance;
- identify the feasibility, required structure and source of funding of an insolvent insurer policyholder protection scheme.

A summary of our review of the nature and structure of the insurance market is given in sections 3.2 to 3.11. As noted in section 2.6, much of the content of sections 3.2 to 3.10 is based on extracts from an AXCO report recently prepared by Mr Storr Venter on the Armenian insurance market. The source of the economic data used in the AXCO report was the Economist Information Unit, and, as is usual for such data, this was in some cases a year or more out of date when the report was produced. This fact should be borne in mind when reading the remainder of section 3 of this report. Our recommendations relating to minimum capital requirements are given in section 5.4. Our other findings and recommendations relating to this part of the project are set out in section 6.

2.2 Overview

The Armenian insurance market is tiny, one of the smallest in the world, with total gross written premiums of just US$4.25m in 2002.

There are currently 22 local registered insurers, of which a few are closed to new business. Some write business without any reinsurance, whilst others have only a very small retention, reinsuring the bulk of their business to the Russian or international markets. Overall, only some 7.5% of business across all classes is retained. The main classes of business written are aviation; marine cargo; travel medical; property and motor. There is very little life business. Armenia is in an earthquake region, its second city having been devastated in 1988 with thousands killed and injured, but there is very little earthquake insurance.

Since Armenia's independence in 1991 following the break up of the USSR, the market has shown very little real growth. Our perception is that this is due in part to a past lack of measures from the government to encourage this, even the simplest compulsory third party motor and workmen's liability schemes not having been implemented, but poverty also remains a very substantial problem with very few people having the disposable income to pay for insurance. The market seems likely to remain very small for years to come.

There are five registered insurance brokers with offices in the capital, Yerevan, of which two are brokering business of substance and have connections with the international markets. Other business is written by insurers either directly or through agents.

Risks situated in Armenia can only be insured by local registered insurers, but there are currently no restrictions on reinsurance placements abroad or on foreign insurers setting up locally registered insurers as wholly owned subsidiaries. There are no fixed tariffs, with insurers free to charge whatever premiums they wish. There remain no compulsory classes of insurance.

The market is highly concentrated, with just a very few risks accounting for a large proportion of the gross premiums written. These include the Armenian Airlines aviation account (by itself representing around a third of total gross premiums) and the property accounts of several large internationally owned hotels in Yerevan, of which the largest is the Hotel Armenia. Armenian Airlines has recently (March 2003) gone into liquidation and its routes taken over by Siberian Airlines, which insures abroad. Gross market premiums are therefore expected to show a substantial decline in 2003. Just 8 insurers account for some 80% of the total market gross premiums.

Insurance supervision is currently carried out by a designated department within the Ministry of Finance and Economy. The Insurance Law 1996, implemented in 1997, regulates insurance. It has three sets of associated regulations, covering licensing of insurers, licensing of brokers, and reserving and asset allocation. A minimum capital requirement is imposed of 50m AMD (= US$86k, see section 3.3.1), irrespective of the classes of business written. Retained insurance risk is subject to a maximum limit of 15 times an insurer's capital and reserves.

It is accepted internationally and by the government that corruption is a continuing problem in Armenia, and this, together with an otherwise difficult business environment, has discouraged foreign investment and establishment in the country.

2.3 Economic and demographic background

2.3.1 Economic background

From the 1960s onwards, most people in the then Soviet republic of Armenia began to enjoy a reasonable lifestyle. Improvements were made in housing, large factories were built providing full employment, and many facilities such as electricity or heating in winter were provided either free or for a nominal fee. Due to its southerly position in the USSR and resulting favourable climate, there were also large surpluses of both fruit and vegetables. Then, in 1988, the north-west of Armenia, and specifically its second city, Giumri, was devastated by a serious earthquake, which killed an estimated 30-50 thousand people. Many more tens of thousands were left homeless, and industry and commerce in the entire region were affected.

The country was only beginning to recover when the USSR collapsed in 1990, and Armenia declared its independence in 1991. The result of this was that there was no central state aid from the USSR as would formerly have been the case to rebuild the economy. Further, the collapse of the Soviet rouble and its replacement with the Armenian dram at a devalued rate destroyed the value of savings and left many people impoverished. At the same time, tensions rose with neighbouring Azerbaijan. A short but ferocious war followed over who would control the Armenian enclave of Nagorno Karabakh in Azerbaijan (this ended in 1994 only with a ceasefire, which is still the position today) further disrupting the economy and leading to an economic blockade on Armenia by neighbouring Turkey. The economy was

also affected by the collapse of the Russian economy in 1998, and by shootings in the Armenian parliament in 1999, which had a negative impact on business confidence and frightened off some potential foreign investors. Since 2000, there has been relative stability and business confidence has increased, and Armenia today shows all the typical signs of an economy in transition.

After an enormous decline in **GDP** between 1991 and 1993, reflecting a collapse in industrial output by some 60%, an ambitious IMF sponsored economic program adopted by the government in 1994 has produced an average annual GDP growth rate in real terms between 1994 and 1999 of 5.3%. The 1999 figure was an unimpressive 3.3% but this increased to 6.0% in 2000 and 9.6% in 2001. Total actual GDP in 2001 was some US$2.1bn, the main contributors to which were agriculture (25%), industry (21%), construction (11%), trade (10%) and transport and communications (7%). The part of the economy that is recovering most is agriculture (although this has long term needs for more investment and updated technology) and there are also a number of newly established small businesses, many in the services sector. Most of the large factories built during the Soviet era of central planning will never operate again.

Inflation has remained under control for the last few years, and this seems likely to continue for the foreseeable future. The period from 1996 to 1999 saw inflation averaging around 7% pa. In 1999 inflation dropped to 0.8% which was followed by a period of deflation in 2000 with the prices index reducing by 0.7%; inflation was 3.1% in 2001. The cost of many imports has lowered, however, due to the collapse of the Russian rouble: an imported Neva car, for example, still costs some 25% less than it did four years ago.

Interest rates and bond yields remain very high by western standards, largely reflecting high levels of credit risk, although these have fallen steadily in recent years as influence from Western Europe increases. A typical bank deposit rate in 2001 was around 15% and a lending rate around 27%.

Information on the level of **unemployment** in Armenia, as elsewhere in the CIS, needs to be treated with caution. International opinion is that the true level of unemployment is much greater than official statistics indicate. This is likely due to many people not bothering to claim unemployment benefit due to acute practical difficulties in registering as unemployed, and then finding that the benefit is simply never paid. Independent surveys suggest that the true unemployment rate is above 25%; official figures show unemployment below 12% and falling, due to emigration and a growth in the black economy.

Wage levels vary greatly between rural and urban areas, and between those employed in the public and private sectors. In rural areas, many families are living off the land and have only small or non-existent monthly cash incomes. Official figures indicate that the average monthly wage for public sector employees was US$43 in 2001 (up from US$24 in 1997, an increase in US$ terms of nearly 100%). Salary levels for unskilled workers are in the region of US$20-40 a month. Skilled workers can earn US$100-200 a month. Executives earn substantially more, and can have a very good lifestyle on US$600 or more a month. The average family needs around US$250 a month coming in from all its members to maintain a reasonable lifestyle. Wage inflation is not high, given the numbers of trained and educated workers looking for jobs. As is the case in other CIS countries, a small number of people earn very substantial amounts of money and have a very good standard of living, whilst the majority of the population is close to or below the poverty line.

The Armenian **currency** is the dram (AMD). The Central Bank announces on a daily basis the rate of exchange for the AMD against other currencies. Commercial banks and

moneychangers are free to offer their own rates of exchange, and during the day the rate fluctuates in accordance with market requirements. From time to time, the Central Bank intervenes to prevent wild changes in the exchange rate, but otherwise the currency floats freely. The current rate of exchange is around US$1 = 580 AMD, and this has been used for making all conversions in this report.

The AMD and US$ are freely convertible in Armenia, and both currencies are in circulation. Although insurance premiums and claims are required by law to be paid in AMD, in practice US$ are often the preferred means of payment; overseas commercial transactions are usually in US$. There is currently no **exchange control** or difficulty in transferring money abroad for reinsurance transactions. The government is concerned at the outflow of currency on such transactions, and is looking at ways of reducing premium outflow; however, it recognises that, realistically, until the local insurance industry develops, restricting the transfer of money for reinsurance purposes will be difficult to implement. The transfer of funds is through the banking system by electronic transfer; most banks have correspondent arrangements with international banks abroad and transfers are made through these.

Investment opportunities in Armenia are extremely limited. There is virtually no local equity investment, a number of the banks are not secure, and property has also been an unstable investment in the past. There are no long term government bonds issued, and the only possible safe assets are short term government bonds or investment in one of the secure local banks. Investment in local currency accounts is potentially hazardous for long term investment, due to devaluation risk. Some investment abroad by insurers is permitted, however. There is widespread suspicion of any investment in a commercial enterprise; over the last decade:

- the Soviet rouble collapsed and was replaced by the AMD at a fraction of the value of the purchasing power of the former currency;
- the Soviet Armenian Gosstrakh , which had taken people's savings for years on investment and savings policies, did not repay them as promised;
- a number of banks have collapsed, and as a result many people are unable to withdraw their investments and are still relying on the promise of future repayment.

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Most people who have any money keep their savings in cash form, or purchase gold and particularly jewellery. Security is regarded as a better option in preference to uncertain investment returns.

The **current account balance** in 2001 was negative at some US$(200m), although this is offset to some extent by international aid. **Foreign exchange reserves** in 2001 were some US$320m.

2.3.2 Demographic background

Official statistics on **population** in Armenia need to be treated with caution. Recent independent studies have shown that the number of people emigrating to seek employment and better living conditions abroad is much higher than had been previously thought. In recent years, there have been considerable numbers of immigrants to Western Europe, and there are also around 1m Armenians working in Russia. These considerably affect the official statistics, particularly as in the case of Armenians working in Russia there are no visa requirements.

The latest census, which was held in 2001, is thought by independent analysts to have disclosed that the total population was at or below 2m. However, it appears that these figures

were not published and inflated estimates issued instead. Even these, though, show a decline in population to around 3.0m in that year, a 20% fall compared with the official statistic for 2000 of 3.8m, this figure having been relatively stable since 1994. The UN estimates that the population will continue to decline. Some two thirds of the population are urban dwellers, with Yerevan having an official population of around 1m.

Over the four years 1994 to 1998, the **percentage** of the total population **aged over 65** increased steadily from 7.7% to 8.6%. The reason for this increase is not that the elderly are living longer – during this period the healthcare system collapsed, living conditions declined and the social services ceased to function, all post independence effects with the government unable to fund them – but rather that the young have emigrated in substantial numbers. This trend continues, with the current percentage aged over 65 being around 10%.

The **birth and death rates** in 2001 were 8.4 and 6.3 respectively. Current **life expectancy** is around 70.5 years for males and 74.5 year for females. The major **causes of death** for both sexes are heart disease and cancer.

2.4 Market size and penetration

The Armenian insurance market is tiny, with total gross written premiums of just US$4.25m in 2002. This figure is up from US$3.7m in 2001 and US$2.4m in 2000, but almost all of this increase is attributable not to organic growth but to increased premiums charged by international reinsurers, largely in the aftermath of 11/9/01 but also because rates were previously at a low point in the insurance cycle. A breakdown of the premiums by class of business is not published by the insurance supervisor, and is unavailable.

Poverty remains a considerable problem in Armenia and this is limiting the growth in the market. There is also widespread ignorance of insurance, and an apparent lack of impetus until recently from the government to develop the market. In neighbouring Georgia, which has a similar sized economy and has introduced compulsory third party motor insurance and fire insurance, gross premiums in 2001 were approximately US$12m, indicating the potential for growth. There should also be scope for product development, particularly of low cost schemes.

Gross written premiums in 2001 amounted to just 0.17% of GDP and US$1.85 per capita (based on a likely total population figure of around 2.0m, see section 3.3.2).

2.5 Market participants

2.5.1 Overview

Reflecting the tiny size of the insurance market, all of the insurers which operate in Armenia are of modest size. A few have almost certainly operated fraudulent schemes, at least in the past. Others rely on single large accounts from connected businesses. Slowly, though, the market is starting to evolve and become more professional, and there are the beginnings of real insurers. It is still early days, however, and for some years to come it seems inevitable that the market will be characterised by undercapitalised insurers with very limited ability to carry risk, and correspondingly low retentions.

2.5.2 Background

In the USSR, insurance was nationalised with two state run insurers in operation: Ingosstrakh, which covered international risks such as exports abroad, and Gosstrakh, which covered domestic risks. Deregulation of insurance began under perestroika, and in 1989 the

establishment of insurance co-operatives was permitted, which were subsequently converted into joint stock companies following further legislative changes.

Development was slower in Armenia than in Russia, and it was not until after its independence in 1991 that the first private insurers were established in Armenia. Simultaneously, the Gosstrakh system began to be split up into individual insurers; Armenian Gosstrakh continued to operate for a while, but then had its operations suspended for a time due to substantial losses that had accumulated. It has recently been sold to Rosno, a Russian insurer, so the Armenian insurance market is now completely privatised with no state run insurers.

2.5.3 Current insurers

There are 22 local registered insurers currently operating in Armenia, of which 18 are actively writing business. 13 of these are closed joint stock companies (and as such are subject to restrictions on the number of shareholders and over transfer of shares from one shareholder to another). Only one company is foreign owned, this being London Yerevan Insurance, which is a member of the UK Londongate group of companies.

The following are amongst the largest insurers, measured in terms of gross written premiums:

Grand Insurance Company. This company has only been established for a couple of years. It is believed to have had annual gross premium income of around US$1.3m, making it the largest insurer in premium terms, its main source of income relating to the Armenian Airlines account (albeit that this is fronted through brokers to the international market). Armenian Airlines has recently (March 2003) gone into liquidation, however, and its routes taken over by Siberian Airlines, which insures abroad. The company's premium income is therefore expected to fall dramatically in 2003. Informed market opinion is that the propriety of the Armenian Airlines account was in doubt.

London Yerevan Insurance. This UK owned company is a member of the Londongate group of companies. Although first registered in 1998, it only started to write business in early 2000. The company has paid up share capital of 63m AMD (US$109k) and writes both non-life and short-term life insurance. In 2001, it had gross written premiums of US$225k. It reinsures mainly to the London market, and particularly to Lloyd's, using Londongate facilities there. It is probably the leading insurer in terms of activity.

Alliance Insurance Company. This company is connected with the Multi group of companies, and writes the aviation account for Armavir Air. With the growth of this airline and the liquidation of Armenian Airlines, it seems likely to have the largest airline account in the future.

SIL Insurance Company. This company is a member of the SIL group of companies and has close connections with Armeconombank, a member of the same group, with whom it shares offices. It writes a mainly motor orientated account, with some property, marine cargo and liability business. It has paid up share capital of 50m AMD (US$86k) and had gross written premiums of US$193k in 2002.

Efes Insurance Company. This company is the highest capitalised in the market, with paid up share capital of 250m AMD (US$431k). It writes a broad non-life account, and has just obtained a licence to write life business. In 2001, its gross premium income totalled just over US$700k.

None of the local insurers operate on a multinational basis. The local business and taxation ethos is not conducive towards this: double taxation agreements have only been concluded

with a limited number of countries, and generally there are a number of disincentives operating against the establishment of multinationals in Armenia.

Several foreign multinationals operate in Armenia, and manage their insurance requirements through international brokers. In order to comply with Armenian insurance law, the local insurance risk is written through a local insurer and then reinsured back to the international markets. Local retentions are tiny, and where possible, international brokers prefer to avoid the local insurer taking any share of the risk. Insurers such as London Yerevan and Efes are usually used for such **fronting** operations.

Armenia is not a centre for captives as generally understood. However, as is common in a number of CIS countries, several insurers have been established in recent years by local industrial and commercial groups exclusively to meet their insurance needs. Such insurance in Armenia is apparently often unnecessary, and used as a device to reduce profits in the other group companies for tax reasons. The insurance market is still in its infancy, and at the present time it is difficult to see the development of a real captive market in Armenia, due not only to the small size of the market but also the lack of insurance personnel, communications and suitable tax legislation.

Lloyd's is not licensed to transact insurance in Armenia as a direct writer.

There are no local registered reinsurance companies in Armenia. One or two of the larger and more professional insurers offer limited reinsurance/coinsurance on a facultative basis. There are no market pools.

Two UK controlled local insurers, HSBC Insurance and London Guarantee Insurance, have closed since 2001, in both cases due to (at best) suspect claims. HSBC suffered a massive claim on a chemist warehouse, which burnt down in suspicious circumstances at a time when it had a substantial loan outstanding. London Guarantee also suffered a large dubious claim on a chemist warehouse, and also on a motor policy.

2.5.4 Brokers

There are five registered brokers in Armenia but currently only two of these, Prime Insurance Brokers and Resolution Consultants, are brokering significant amounts of business. Prime Insurance Brokers have a close relationship with Aon in London and are slowly developing business with local insurers on a coinsurance basis.

HSBC, which used to operate as a broker, have now closed their operation in Armenia. Armen Grigoryan, Inbrokar and Andrey Karapetyan, who were previously licensed but dormant, have had their licences as brokers withdrawn.

2.5.5 Industry associations

The Insurers Association of Armenia was formed in March 2002 by 8 local insurers, and has since expanded. It now has a total of 23 members from 10 insurers, which cover around 85% of the market. Its president is Mr Levon Altunyan, who is also the CEO of Efes. The association is concerned principally with the development of the insurance market, and holds meetings every three months. It does not undertake any training activities at present. The association replaced a former Armenian Insurance Association, which was run by the insurance supervisor.

There is no currently no insurance brokers' association in Armenia.

2.5.6 Other

There are no other market participants such as underwriting agencies, risk retention groups, etc. There is also a lack of local professional surveyors (we understand that a few exist) and loss adjustors in Armenia.

2.6 Classes of business

2.6.1 Overview

The main classes of insurance written in Armenia are aviation; marine cargo; travel medical; property and motor. There is very little life business. Armenia is in an earthquake region, its second city having been devastated in 1988 with thousands killed and injured, but there is very little earthquake insurance.

Other natural hazards are relatively minor. Although there is a considerable winter snowfall, this melts in such a way as to provide water throughout the year without creating exposure to flooding. Most of Armenia is over 1,000m above sea level, which counters its southerly latitude. Winters are short but cold, and in mountainous areas several metres of snow occur on a regular basis. However, the country is generally well prepared for such conditions, and they do not usually lead to incidents which could give rise to frost insurance claims. Hail is an irregular problem in spring and every three or four years fruit crops are destroyed by it across the whole country. There is currently no crop insurance, despite interest in it, the main difficulty being writing this class with affordable premiums.

There are no compulsory classes of insurance.

2.6.2 Aviation

Armenian Airlines, the national carrier and owned by the state, has recently (March 2003) gone into liquidation and its routes taken over by Siberian Airlines, which insures abroad. Grand Insurance, the local insurer which used to insure the **airline**, is therefore expected to suffer a dramatic fall in its gross premium income in 2003. Informed market opinion is that the propriety of the Armenian Airlines account was in doubt, however, the airline having apparently been plagued with corruption and over-manning. It operated a fleet of ageing Russian aircraft, most fifteen or more years old. It also leased a single airbus, which was used for flying to European destinations, until 2001 but this was returned to its lessors in that year and substituted by a new Russian Tupolev loaned on a short term basis from Russia. The hulls of the Russian fleet were not insured, despite the older Tupolevs having a poor safety record.

Armavia, a privately owned local carrier, has been set up and is flying at present with one airbus and several smaller aircraft. Two more airbuses are due to be delivered, and it seems likely that this company is now set to become the national carrier. This airline is insured by Alliance Insurance. Flights to Western Europe are required by law to have liability insurance as a condition of over flying and landing. Armavia has liability coverage in accordance with these requirements, and also conventions on passenger liability.

British Airways, KLM, Austrian Airlines and Aeroflot are the main foreign carriers flying into Yerevan. There are also regular flights to other CIS countries and to the Middle East from Zvartnots airport in Yerevan, using Armenian Airlines, Syrian Air or Aeroflot. The airport and other facilities are not currently insured. Internal flights and flights to CIS countries are often not insured or are covered by dubious arrangements.

Aviation business is brokered by international brokers without the intervention of local brokers. Willis was the broker for the airbus that was leased to Armenian Airlines. The risks are 100% reinsured through international brokers to the London aviation market. Premium rates and conditions are set by the reinsurers in line with leasing requirements established by the lessors of the airbuses. Russian hulls are not generally insured, and there may well be no liability cover on domestic or CIS flights.

There have been no insured losses of any substance. In 1998, a small aircraft taking off from the domestic airport in Yerevan hit a jeep, and several people were killed. Since the premium had not been paid under the policy, no claim was paid.

Armenia has no **space** programmes and consequently there is no insurance in that class in the country.

2.6.3 Marine cargo

In the USSR, cargo insurance was only written for foreign trade transactions, and was an Ingosstrakh monopoly. Since independence in 1991, though, marine cargo has developed into a relatively important sector of the Armenian insurance market. The country is completely landlocked, and all imports and exports have to come through Iran or Georgia. Most imports are on a CIF (cost, insurance and freight) basis and are therefore not insured in Armenia. Such exports from Armenia as are insured are generally placed with one of the local insurers. This market is slowly growing, but many exports are still uninsured.

Major imports are foodstuffs, manufactured goods, machinery and equipment. Exports include wine and spirits and fresh fruit and vegetables. There is a growing jewellery market associated with the import of precious stones which are then re-exported after being polished or mounted in jewellery.

The major insurers of this class are probably London Yerevan and Prime Insurance.

Insurers who write this class rely on London market clauses and offer both the all risks “A” wording and the more restrictive “B” and “C” wordings. The local market is still in its infancy as regards carriers’ liability and freight forwarders’ liability, and these covers are not purchased. In the event of loss, carriers would expect the goods’ owners to have taken out appropriate insurance. There is no local tariff for business, and insurers charge what they deem is an appropriate rate for each risk. Premium rates are to some extent driven by reinsurers, some of which have provided insurers with tables of varying detail with suggested rates for business. The following is a rough guide as to rates charged:

- marine cargo ICC “A”: 0.5% to 0.8%;
- marine cargo ICC “C”: 0.3% to 0.5%;
- land transit in Armenia: 0.2% to 0.35%;
- land transit in trans-Caucasus: 0.2% to 0.5%;
- land transit in CIS: 0.35% to 0.65%;
- air transit from airport to airport: 0.22%;
- air transit only: 0.17%.

Most business is written directly or through agents; brokers would not normally be involved in placing this class. The majority of cargo business is reinsured at Lloyd’s or with continental insurers such as Zurich Re.

There have been no major losses in this class. However, there are problems with theft, which although often small can be sufficient to cause problems to insurers and impact on the rates charged for land transit and the deductibles that are applied.

Marine liability insurance is completely unknown in Armenia. Only the most basic of risks are being insured at present, and it seems unlikely that there will be a marine liability market for the foreseeable future.

Marine hull insurance is also not found in Armenia. The country is completely landlocked and has no merchant shipping. Lake Sevan, which is one of the largest inland lakes in Europe, has a number of pleasure craft of varying size but these are currently uninsured.

Armenia derives its energy from a number of sources. The country has one nuclear power plant which dates from Soviet times, and which is of the same pattern as the Chernobyl nuclear reactor. This plant is due to be phased out over the next ten years. The country also has several dry oil burning plants, which depend on the importation of oil from Russia. There are also numerous hydro stations of varying size, several of which depend on water from Lake Sevan or from dammed up sources. Armenia is an exporter of electricity to neighbouring Georgia. Armenia has no oil or gas reserves, so these all have to be imported. Oil is imported through Georgia and Iran both for industry and as petrol for domestic consumption. Gas is imported both for industry and domestic consumption from Turkmenistan under a barter arrangement. Armenian exports, principally of marble, pay for the purchase of gas. There is no **energy** sector in the Armenian insurance market at present. All plant is currently uninsured, both for liability and property.

2.6.4 Travel medical

Although in premium income terms it is very small, this is an important class in Armenia since most European embassies require evidence of a travel medical policy before a visa will be issued.

Some companies issue policies without reinsurance and without the backing of an international assistance company. It appears that this class has also been prone to the issue of fraudulent policies and that there have been numerous scams as policyholders are more concerned to satisfy visa requirements rather than with the cover actually granted.

Annual covers are rarely if ever issued. Most policies are single trip, covering two or three weeks. Cover is usually offered in bands of US$10-50k and is normally for travel medical only. Policies are usually issued for Western Europe only or worldwide including the US. Premium rates are around US$1 per day of cover; those for US cover are slightly more expensive. Group discounts are available, but these are not normal in Armenia due to the lack of group travel.

Almost all of the local insurers write this class of business.

Business is written either directly or through agents. Several insurers have ticket booths outside embassies in Yerevan. Some smaller insurers write this business without reinsurance; the more professional ones write it with the support of professional travel reinsurance under specific treaties which provide international assistance as part of the cover. Reinsurance is available from both the Russian and international markets. Experience has generally been good with few claims due to lack of claims experience on the part of the insuring public.

2.6.5 Property

2.6.5.1 Overview

Property insurance is still in its infancy in Armenia. Very little is written other than for major commercial risks, usually with an international connection. The majority of commercial

property and all government risks are still uninsured. International aid agencies, embassies and other international operations are the only bodies that routinely insure their property.

No figures by class of business are published by the insurance supervisor, so it is difficult to guess the size of the property account. There are several large risks such as the Hotel Armenia in Yerevan, and in a tiny market these have a significant and disproportionate impact on the whole account.

Whilst there has been very little organic growth in the account in the last couple of years, property premiums have increased substantially as international reinsurance premiums have hardened, driving up local premium rates by as much as 50%.

Major insurers for this class are London Yerevan, Efes and Prime Insurance.

2.6.5.2 Level of hazard

There are several **fire** brigades situated throughout Yerevan and the other major towns. Equipment dates from Soviet times (pre 1991), however, and their ability to deal with fires in high-rise blocks of apartments (up to ten stories or more) is questionable. In summer, there are water shortages and a lack of water pressure in Yerevan and elsewhere. There is also a shortage of hydrants and where they exist, they are poorly maintained and unreliable. Outside cities, there is no effective fire cover.

Sprinkler systems are virtually unknown in Yerevan, other than in a few of the leading hotels that are owned and managed by international operators. In other commercial buildings, fire prevention equipment usually consists of dry or wet risers, which are infrequently inspected and poorly maintained. They are often missing hose reels, stuffed with rubbish, or have mounts that have been vandalised. Other than in modern, internationally managed premises, there are very few fire extinguishers and where they exist are water extinguishers, often many years old, not maintained and of doubtful efficiency.

Standards of housekeeping and fire prevention awareness are poor by western standards, but the position is redeemed in part by the use of massive construction in almost all buildings: civil, commercial and residential. Partitions are of stone block and ceilings are generally of reinforced concrete. There is very little use of wood or other combustible material for partitions. Roofs are usually corrugated iron sheet on a timber frame. As new construction materials are imported, however, so building methods are gradually changing towards the styles seen in Western Europe.

Most insured have very little money to spend on risk improvement, and unless these can be implemented without expenditure, they are unlikely to be agreed.

Due to the general shortage of finance, locally managed enterprises can present a **moral hazard**: there is a temptation to insure property, which in the present economic climate has no easily realisable value locally, and then arrange a claim. Great care therefore needs to be exercised in insuring locally owned premises, and factories in particular, to ensure that viable industrial activity is being carried on there and that they are not a potential **arson** risk.

The Soviet norms and regulations on construction have been revised and updated since independence in 1991 to take account of developments in building practices. The relevant government department monitors construction quality and site practices, and has the power to order cessation of operations if regulations are infringed. A special set of regulations covers earthquake resistance and construction. Officially, such regulations are strictly enforced and complied with, but the apparent reality is that this is not always the case: unfamiliar or substandard materials may be used by local contractors in breach of manufacturers'

instructions. There is also evidence that building regulations were also often not fully complied with during the Soviet period. International operators are much more safety conscious and concerned with risk management, but they are a minority. There is no local association of risk managers.

Burglary rates throughout Armenia are low by western standards.

2.6.5.3 Household

Most families in Armenia own the properties they live in. Owner occupation is high due to the government handing over properties to the occupiers when communism collapsed. It is not unusual in the extended family system that operates in Armenia for families to own several homes, often a flat in the city and a house in the country. Wealthier families tend as a matter of course to have a country house for weekends and holidays in the summer.

The market is tiny, with virtually no households insured. Only foreign residents and international organisations tend to insure their houses as a matter of course. The position shows very little sign of changing at present, not least due to the lack of finance on the part of the general population.

Policies would usually be fire and additional standard perils following international wordings on an indemnity basis. New for old is not offered, and policies do not include any extras such as third party liability. **Earthquake** is normally rated separately and offered as an additional cover where required.

Premium rates for fire and perils policies using international wordings are in the region of 0.4% for buildings and a minimum of 0.7% for contents. Depending on the contents insured, rates can be as high as 1% to 2% for standard contents cover. Deductibles are much higher than they would be in Western Europe, and there is usually a separate deductible for earthquake, which would often be in the region of US$2-5k. There is no regional rating structure, the same rates generally applying across the country; in practice, very little business is written outside Yerevan.

Business is conducted directly or through agents; it would not generally be brokered. Some insurers write this business without reinsurance, whilst others who have quota share facilities place the business to these. The business would not generally be written on a facultative or excess of loss basis; a few very high sums insured might be, as special acceptances. There have not so far been any losses of consequence.

2.6.5.4 Industrial and commercial

Very little commercial property insurance is written other than for major risks, usually with an international connection. The majority of commercial property and all government risks are still uninsured. International aid agencies, embassies and other international operations are the only bodies that routinely insure their property.

Over the last couple of years premiums in the commercial property account have increased substantially due to the international reinsurance premiums hardening and these increases being passed on to the direct market. The market has shown very little sign of organic growth and this seems likely to continue in the future.

Policies would usually be fire and additional standard perils on a replacement basis using translations of international wordings. Earthquake is normally rated separately and offered as an additional cover where required. Third party liability coverage is not generally included in standard covers. Only one or two of the very largest risks have tailor made policies offering a

much wider range of covers, using the services of international brokers. Loss of profits cover is available from one or two of the leading insurers. Cover is very rarely provided, however, due to the difficulty in ascertaining real profit levels. Where it is provided, it would normally be for 12 months and be limited to readily ascertainable losses arising out of the insured event.

Premium rates for fire and perils on buildings range from 0.25% for first class international risks to 0.4% to 0.7% for small locally owned commercial risks. Contents rates are higher, with a minimum of 0.7%. Depending on the contents insured, rates can be as high as 1% to 2% for standard contents cover. **Earthquake** is always rated separately, typically at a rate of 0.125%. Deductibles are usually in the range of US$1k for property, even on small commercial risks, and between US$2-5k for earthquake.

The local market is unable to write any but the smallest risks without reinsurance protection. With only modest levels of paid up capital, insurers have no capacity to underwrite risks, and many of them act as little more than fronting operations for international operators, living off the commissions generated. Most of the business and commercial enterprises are situated in Yerevan. Large insurable but currently uninsured risks there include a nuclear power station just outside the city, Zvartnots airport; two brandy factories and the Yerevan brewery. Other large risks include all government buildings, all of which are uninsured, and commercial premises in the centre of the city, most of which are uninsured. The largest insured risks are the internationally owned Armenia, Yerevan and Congress hotels.

Some large risks are brokered; local brokers are active in the class and seek to act for clients in this area given the commissions that may be earned. Some international risks are fronted through insurers, with the international broker setting the terms and wordings and simply paying a fronting fee. Other business is conducted directly or through agents.

Most insured large industrial and commercial risks are reinsured, with insurers such as Munich Re, or into the London market. The largest risks are fronted through local insurers by international brokers and reinsured to the international markets. Other large risks are reinsured using facultative placements or with insurers such as Munich Re who offer some insurers limited facilities on a prior notification basis. Those insurers which have such quota share facilities place smaller risks to these.

Overall losses have been few, probably due to the lack of insurance. The two largest single insured losses have both been chemist warehouses, one insured by HSBC Insurance where the claim was in the region of US$300k and the other insured with London Guarantee Insurance, which was around US$50k. Both of these insurers have now closed their offices in Armenia.

2.6.5.5 Agriculture

In the USSR, one of the main classes of business insured by the state domestic insurer Gosstrakh was agricultural insurance on the collective farms. At the time of the break up of the USSR, Gosstrakh was split up into individual insurers, and at the same time the collective farms in Armenia were privatised. Armenian Gosstrakh ceased to operate for a while, having lost its former base of income from the state collectives. In 1999, the government established the State Agricultural Insurance Company as a government department. This collected some 16m AMD (US$30k) in premiums but then paid out the same amount in claims the same year; it was closed in 2000.

Currently only one local insurer, Nairy'96, is involved in the insurance of a few cows. Otherwise, no agricultural risks are insured. There is, however, considerable interest in

developing this class of business, given Armenia's agricultural base: subject to its long term needs for more investment and updated technology being met, agriculture could be very successful and the export of agricultural products an important export. The lack of cover despite this interest is mainly due to the difficulty in writing this class with affordable premiums, a reflection of the following problems in particular:

- there are considerable variations in rainfall and/or temperature at important times in the agricultural cycle; roughly one year in five there is a total failure of major crops due to rainfall variations, late frosts etc;
- hail is also an intermittent problem, and can cause considerable damage to the apricot and peach crops in particular;
- controls over livestock are not up to western standards and conditions in which they are kept are often less than would normally be acceptable, greatly increasing the risk of disease;
- farmers, the potential purchasers of the insurance, are among the poorest in the country, and most do not have sufficient income to pay for insurance.

2.6.6 Motor

There is currently no compulsory third party motor insurance in Armenia, and very few motor vehicles are insured. In the event of an accident, the driver who is at fault will pay compensation to the injured party by private agreement. This is increasingly a problem given the number of new high value vehicles on the road, with people unable to pay sometimes coming under personal threat. A small number of generally high value vehicles are comprehensively insured under "casco" policies. The number of insured vehicles has been slowly increasing over the last couple of years, but the account is still tiny.

There is a road traffic act, and a driving test, which covers basic driving ability, but many drivers apparently simply choose to pay a bribe and obtain their licence without a driving test. Road conditions and driving standards are poor. In the absence of compulsory insurance there is no bad risk pool.

There is no green card scheme and Armenia is not a member of the green card bureau. Prime Insurance was offering green cards issued by a reputable Austrian insurer but these transpired to be fraudulent and the company was warned against continuing with this practice.

Casco covers are available, together with third party liability. Premiums are based on the type of car, and its value. Casco covers are rated at 4% to 6% of the value of the vehicle and have substantial theft excesses. High value vehicles must be garaged at night, and be alarmed. Third party liability covers are offered for limits of US$10-100k. Occasionally, covers of up to US$1m are asked for by international organisations operating in Armenia, but these are unusual. Neither a bonus or malus scale is currently applied to either type of cover, due to the very small number of vehicles insured.

Most insurers write this class of business. London Yerevan, Efes and SIL Insurance are all actively developing this class and are amongst the market leaders.

Motor insurance is generally sold either direct through insurer offices, or through agents. One or two fleets may be brokered locally. Most insurers who write this business do so by way of quota share reinsurance treaties. Some smaller insurers may write it without reinsurance. Very expensive vehicles may be dealt with by special acceptances.

So far, there have been very few insured losses, and experience has generally been good. As in other CIS countries, theft is a problem, particularly for high value imported vehicles. Repair costs for Russian made vehicles are extremely low by western standards. Spares are readily obtainable and very cheap. Labour costs are also very low (no more than US$2 per hour and often less). By comparison, obtaining spares for imported vehicles is often difficult. Spare parts may have to be specially imported, and there are few garages capable of carrying out complicated repairs using the correct equipment. Very few if any cases reach court, and there is no increase in likely court awards.

Buses, trucks and taxis are currently uninsured. There are very few fleets of vehicles in the country, and almost all of these are currently uninsured. The only insured fleets, which are very small, are those belonging to international organisations.

2.6.7 Other general business classes

2.6.7.1 Construction and machinery breakdown

Following the conflict with Azerbaijan and the imposition of an international trade embargo, the **construction** industry in Armenia collapsed completely. Buildings were left partially completed and machinery left unused and unattended on site. In the late 1990s, work on some projects began again, and these are now being completed. Slowly, the partly finished sites in the centre of the city are being completed, but there is still some way to go.

Locally funded projects are rarely if ever insured. There are one or two major projects which have been funded by international aid agencies and constructed by international contractors. These have usually been insured abroad, without use of local insurers. More recently, several large hotel complexes have been built in Yerevan and these have been fronted through local insurers. International contractors and local subcontractors have been responsible for these projects. Current major projects include: Armenia hotel reconstruction; British Embassy (insured abroad by French contractors); American Embassy; refurbishment of road system in central Yerevan (not insured).

Construction is generally a good risk given the good soil conditions and building methods used in Armenia. The main risk comes from the completion or refurbishment of old structures where many hidden problems may be encountered, particularly in construction dating from the 1960s onwards when building standards in the USSR declined.

Where policies have been issued, they follow international wordings, including advance loss of profits and maintenance periods, tailor made to each risk. Contractors' plant is usually covered under the policy. Hotels that have been refurbished have tended to opt for high levels of personal liability cover since they have remained open during the refurbishment and a number of their guests are American. Rates are in the region of 0.25% to 1.25% with deductibles of US$1-2k. Higher deductibles may be applied in respect of earthquake coverage.

London Yerevan and Efes are the leaders in this class of insurance.

Some larger risks might be brokered. International risks would be fronted through local insurers, with the international broker setting the terms and wordings and simply paying a fronting fee. Reinsurance would be on facultative basis to the London market or specialist reinsurers such as Munich Re. There have been no known losses, insured or otherwise.

There is only a tiny market for **machinery breakdown** at present, with only a few policies being issued. This is unlikely to change in the foreseeable future. The lack of business is due both to a lack of insurance awareness and the inability of most local companies to pay

premiums. Where machinery breakdown is insured, it is covered under a separate policy using Munich Re wordings.

2.6.7.2 Workmen's compensation and employers' liability

In the USSR, the state owned all the large enterprises and provided for the needs of individuals, including the provision of disability pensions. These covered both temporary and permanent disability, and there was therefore no need for either workmen's compensation or employers' liability insurance. Since independence in 1991, the state has continued to provide disability pensions for both temporary and permanent disability, albeit at a much reduced level. Employees injured at work are able to claim incapacity benefits under social security legislation and, in theory, could pursue a claim against their employer in the courts. In practice, however, such claims are unknown.

Workmen's compensation and employers' liability covers are still not written in Armenia, and enterprises wishing to insure their staff take out personal accident insurance instead, which is readily available from most insurers, although demand is minimal and generally limited to international employers. Such insurance covers death, temporary and permanent disability.

Expatriates working in Armenia are provided with a full range of benefits as part of their employment packages. There are no details of the covers provided, but these would be comparable with those offered to expatriates working anywhere abroad. Whilst expatriates pay social security taxes, and in theory are able to claim for periods of incapacity, given the level of benefits (under US$10 a month) and the difficulties in claiming, they are unlikely to do so.

2.6.7.3 Liability

In the USSR, the state owned all the large enterprises, and provided for the needs of individuals, including the provision of disability pensions. There was no concept of insurance against third party liabilities.

Since independence in 1991, there has been very little development in the **general third party liability** market. This remains tiny, and has grown very little over the last few years. There is no legal requirement to insure against third party liability, and there has been little or no penetration into locally owned enterprises, which either do not have the money to pay premiums or do not see the benefit of insuring this class. Demand for it is limited to a few foreign investors and to embassies and international organisations.

Cover is available both from the more professional local insurers and those which have a foreign shareholding. International policy wordings are used. Most covers are on a "claims made" basis, with cover available up to US$100k. It is not unusual for policies to be written with lower limits; often these are as low as US$5k. Where specifically requested, higher limits are available with reinsurance on a facultative basis being provided in these cases. Policies often include a jurisdiction clause, limiting awards to those made under the legal system of Armenia. Premium rates are usually in the region 0.2% to 0.3% of the limit of liability, with a typical deductible of US$250-500.

Most of the larger companies write this business, but the market is tiny. Market leaders include Efes, London Yerevan and Prime Insurance.

Larger risks could be brokered locally. The small number of international risks led by international brokers would be fronted through local insurers, with the broker setting the terms and wordings and simply paying a fronting fee. Other business is sold directly, or

through agents. Reinsurance is mainly on a facultative basis for larger risks, with lower sums insured placed through treaties. Some small risks are retained by those insurers who do not have treaties.

There have been no losses of any significance, and such business as has been written has been very profitable. Claims consciousness is very low in Armenia. Court awards are tiny by western standards (generally no more than a few US$k), and most people prefer to avoid involvement with the courts if at all possible: independent analysis has shown that bribery and corruption exist throughout the system, and plaintiffs are unlikely to be successful in actions against government or influential individuals. In order to claim compensation, plaintiffs must be able to show that they have suffered loss as provided for under the legal framework, which currently means loss directly and clearly due to either bodily injury or loss or damage to property. Strict liability is completely unknown in Armenia, as are punitive damages and damages for loss of office or racial or sexual discrimination. Damages are assessed on loss of earnings, with the usual maximum amount payable being 2-3 years' average earnings. Structured settlements are unknown, as is the concept of providing in the long term for plaintiffs.

There is currently no concept of claiming against the manufacturer of a defective product in Armenia, and consequently no **products liability** insurance is written at present. Armenia exports some goods to other countries, and as other covers develop manufacturers of goods may begin to show an interest in this cover. However, this seems unlikely to happen in the near future. Most exports are to Russia or other CIS countries, but those to Europe are increasing and for specialist items, particularly food and drink, those to the US are also significant. **Products guarantee** insurance is completely unknown in Armenia, and there is unlikely to be a market for this for the foreseeable future.

Professional indemnity insurance is not compulsory, and is currently not generally written, in Armenia, with only a handful of policies issued to the larger western managed companies such as accountancy firms: these companies demonstrate their professionalism by having such cover and advertise this fact. The World Bank requires professional indemnity insurance for some of the companies that it uses on its fund disbursement programmes, but business is currently limited to a handful of policies. The only policies currently issued are for accountants and software companies. By western standards, limits are low, generally being in the region US$50-250k. Mica Insurance is the leading insurer for this class of business.

Directors' and officers' liability insurance is not currently available in Armenia, and it is unlikely that this will change for some considerable time.

Despite pollution and environmental damage being a very serious problem – reflecting both the obvious immediate problem and the insidious unknown problem that may only be encountered many years afterwards, as unknown pollution surfaces - no **pollution and environmental liability** insurance is currently written in Armenia. In the USSR, Armenia was a centre of manufacturing industry, producing textiles, computer equipment, machinery and bottled fruit. There was, and still is, also mining of gold, copper and aluminium. Mining was carried on without regard to the pollution or environmental damage caused. In some cases, this was so bad as to almost amount to deliberate destruction of the environment. One of the side effects of the collapse of the USSR was the ending of industrial pollution due to the closure of many of the factories. As the Armenian economy gradually recovers, however, pollution is slowly increasing again due to the use of old and inefficient plant. Pollution in the cities is a severe problem due to fumes from vehicles: there are no controls over exhaust fumes from vehicles or limits restricting pollution by industrial operations. There is no green

movement in Armenia and very little concern over the state of the environment. Dumping of pollutants is a continuing problem.

2.6.7.4 Personal accident

There is very little demand for personal accident cover in Armenia, particularly since when provided as a employee benefit it is regarded as income and taxable as such, and at the same time it is not allowable as a valid expense on the part of the employer. One or two of the local insurers offer coupon type personal accident cover with low levels of benefit for journeys on train or aeroplane. The more professional insurers, particularly those with an international shareholding, offer western style cover both for individuals and groups. It is also available under motor "casco" policies providing death and disablement benefits to both driver and passengers in motor vehicles.

Policy wordings used by the more professional insurers follow western patterns with cover available for both death and temporary and permanent disablement. Cover is available for both individuals and groups. Local covers offering death benefits with low levels of cover (a few hundred US$) are also available. Western type policies offer cover in units of US$1k on a 24 hour basis for US$7-10 per unit per year. Discounts are available for group schemes. Local covers are available at rates of around US$5-10.

London Yerevan, Efes and Nairy '96 are the leading insurers in this market.

Most business is written either directly or through agents. Cover is available from the smaller insurers through ticket booths at airports and the railway station in Yerevan. Some of the smaller local insurers write this class without reinsurance; the larger and more professional ones reinsure it through treaties to the international markets. The results from what little business has been written are believed to have been good.

2.6.7.5 Credit

As in other CIS countries, there is a demand for **credit** insurance in Armenia – the banks want this to enable them to increase their lending by taking account of the credit insurance in their financial reporting to the Central Bank – but very little business in this class is currently written. The problem is that the banks are seeking to transfer what are banking risks to insurers without being prepared to pay a realistic premium for the risk transference. Credit is a very difficult market in Armenia because:

- the economy is not in a strong condition;
- potential clients have no credit history; and
- ascertaining the true worth of a potential insured is difficult.

There is no demand for **mortgage indemnity** insurance in Armenia. This is because most properties are purchased for cash, the concept of long term loans for property purchase being unknown. Even if there were, it would be difficult to market due to the adverse conditions which exist: employment security is poor, and few people have ascertainable work records.

2.6.7.6 Miscellaneous

Armenian Cash in Transit Company is the local carrier for 60% to 70% of all cash transferred around the country. Alliance Insurance insures this company; there is no information available as to whether this risk is reinsured. This appears to be the only **cash in transit** risk in Armenia.

There are two banks that are covered by bankers' blanket bonds, these being HSBC and Greek Commercial Bank. Both these risks are written using international wordings and reinsured in the international market with specialist reinsurers.

Legal expenses cover is completely unknown in Armenia, and for the foreseeable future there is unlikely to be a market for this class of business.

Contingency business is not written in Armenia.

The market for white goods and electrical equipment is very small. Consequently, there is no demand for **extended warranty** insurance.

The only insurer to transact any **livestock** insurance is Nairy'96, which insures a small portfolio of cows. The rate charged for insuring these is 2.5% of their value.

Kidnap and ransom insurance is not written in Armenia. There would in any case be very little if any demand for it, as such crimes are virtually unknown.

E-risks insurance is completely unknown in Armenia.

2.6.8 Life business

Two local insurers, London Yerevan and Efes, have recently entered the life market, writing simple **western style term assurances** with sums assured up to a maximum of US$130k. Efes offers critical illness and personal accident covers as riders to its life policies, the former being for up to 50% of the sum assured.

Guarantee Insurance, based in Armenia's second city, Giumri, in the north west of the country, writes short term **Soviet style term assurances**, i.e. with terms of no more than one or two years, small sums assured (generally no more than a few hundred US$) and repayment of the premium if the life assured survives to the end of the term.

A number of insurers write low cost local medical covers, but the market is still tiny with most enquiries coming from embassies, aid organisations and foreign enterprises.

Life premiums account for only a tiny fraction of gross market premiums, and probably total less than US$50k a year.

The state is a pension provider, but state pensions are a fraction of the amount needed to survive on. Despite this, there is currently no private pensions business written in Armenia. The main factors inhibiting its growth are the lack of finance to pay for pensions, the high level of unemployment and the absence of suitable assets to invest in. It seems likely that this will remain the position for years to come.

The state is also a provider of healthcare, but the system is starved of money and de-facto privatisation has taken place, in the sense that in most cases treatment has to be paid for one way or another: otherwise medication, dressings and treatments are simply not available. Despite this, there is only a tiny market for private healthcare products, provided for by one or two of the leading insurers. There are proposals to introduce a mandatory medical insurance scheme funded by a 3% contribution from the social security fund. This fund will, at best, only be able to provide the most basic level of funded healthcare, and local insurers are not involved with it. Most people do not have the finance to pay for insurance, and it will be many years before the healthcare market is anything but very small.

Credit life cover is available from London Yerevan and Efes, with reinsurance in the London and European markets. No **endowments** have so far been issued in Armenia, the main difficulties being the lack of suitable long term investments to provide the return element and overcoming a reluctance to invest in the long term in corporate enterprises when historically

such investments have often been used to defraud the populace. No **unit-linked** policies are currently issued for the same reasons. There are also no **whole life** policies or **annuities** issued at present.

There is no information available on premium rates. Medical underwriting is limited to a very few policies with high sums assured; in these cases, insurers obtain a basic medical examination report from a medical attendant of their choice. Whilst current prevalence rates are very low, HIV/AIDS is also spreading rapidly through the region – the rates of new infection are amongst the highest in the world – which will have implications for the future.

Life policies are written directly or through agents; they are not generally brokered. All policies are short term annual covers renewable for a period of years, and commission is payable at each renewal. The amounts of commission paid to agents are not disclosed. With low overheads, the business is generally profitable.

Guarantee Insurance does not reinsure any of its life business. London Yerevan and Efes reinsure their life business to the international market through proportional treaty arrangements. The amount of business written is too small to warrant the use of excess of loss or other non-proportional reinsurance. Local retentions are modest.

2.7 Distribution

Distribution is primarily direct through **company employees**, who use their connections to obtain business and are paid on a salary and commission basis, or through **agents**, who are paid a commission only basis.

Agents act only for one insurer; the concept of a professional multi agent appointment is unknown. Agents tend to deal with personal lines and smaller commercial risks. At present, agents do not have to be licensed with the insurance supervisor, and as a result there is no record of the number of them operating in Armenia. Registration of agents may be required in the future.

Brokers do not currently have a major role in the market. However, their presence is increasing, particularly in respect of the larger commercial risks on which they focus their attention, as there is a perceived need on the part of clients in this area for professional advice. Brokers must be licensed by the insurance supervisor. However, they are not required to have professional liability insurance cover, and monies are not required to be held in a trust account.

Internet selling is completely unknown in Armenia. Internet usage is limited to a small number of computer literate individuals, and this form of distribution is not likely to develop for a considerable period of time.

There are no direct marketing organisations operating in Armenia. Telesales, direct mail and other similar selling operations are completely unknown. There is unlikely to be much development of this type of selling in the short term since the majority of the population has no money for insurance, and postal services are unreliable.

There are no genuine strategic alliances in operation. Car dealers have arrangements to offer insurance to clients who purchase new cars, particularly where payment is dependent on a bank loan, but the amount of such business is very small.

There is no control over **commissions** and these are freely negotiated between the intermediary and the company. Since most business is reinsured to the international markets, commission rates tend to be a percentage of the reinsurance commission but commissions

equivalent to around 10% of premiums are typical. There are rebates of commission to clients.

2.8 Reinsurance

The largest local risks are all reinsured 100% to the international markets, with the result that the majority of business is reinsured abroad. No reinsurance statistics are published by the insurance supervisor.

Most of the local insurers have established relationships with large international reinsurers, and tend to place all their cessions with these (none of these reinsurers appears to have a material shareholding in any of the insurers).

Ingosstrakh, the former Soviet state run insurer covering international risks, still operates in Moscow but now as a private insurer, and offers reinsurance of a wide range of risks throughout the CIS on a commercial basis.

The two active brokers in the market, Prime Insurance Brokers and Resolution Consultants, can also offer reinsurance facilities. Their focus is on the larger local accounts, and particularly property; most other local accounts are too small for them to get involved in. International insurance and reinsurance brokers make regular visits to Armenia.

There are no local registered reinsurance companies in Armenia. One or two of the larger and more professional insurers offer limited reinsurance/coinsurance on a facultative basis. The market for this is very small, and limited to a few small to medium sized local risks. The relative lack of local reinsurance is mainly due to a lack of experience in the market in the writing of reinsurance, and the modest capitalisation of the local insurers and their resulting inability to accept inwards reinsurance, at least on an excess of loss basis.

There are no restrictions on reinsurance placements, nor any deposit requirements. There is a 5% reinsurance tax on reinsurances ceded abroad, which is usually paid by the reinsurer.

The larger and more professional insurers either have quota share treaties that provide them with an automatic facility into which to place risks, or arrangements with companies such as Munich Re for the placement of risks on a prior notification basis. This latter arrangement amounts to a semi automatic facility for pre agreed classes of business and within certain limits. Retentions are modest. The majority of business is reinsured either to the London market through brokers; to the European markets and companies such as Munich Re; or to the Russian market, which is still more competitive than the traditional international markets.

Facultative reinsurance is used for risks that exceed local insurers’ retentions under their treaties, and is almost exclusively on a proportional basis. A very small amount of facultative business is placed locally, but the majority is placed to the international markets, or to the Russian market.

Catastrophe reinsurance is not currently used in Armenia. This is because local insurers do not have sufficient retained risk to warrant protection with catastrophe reinsurance. There are no reinsurance/catastrophe pools.

Financial reinsurance and other forms of alternative risk transfer are completely unknown in Armenia.

Treaty reinsurance commissions are usually on a sliding scale based upon the profitability of the business ceded. Commission rates are usually in the range 20% to 40%. There is also usually provision for profit commission in addition. Business reinsured on a facultative basis to the international markets is placed by an international reinsurance broker, and the usual

international rates for facultative placements apply. Commissions for this type of business are usually in the range 10% to 20%. No information is available on the levels of commission for local facultative placements. Fronting commission is typically in the range 5% to 7.5%.

2.9 Supervision and control

Insurance supervision is currently carried out by a designated department within the Ministry of Finance and Economy. The Insurance Law 1996, implemented in 1997, regulates insurance. It has three sets of associated regulations, covering licensing of insurers, licensing of brokers, and reserving and asset allocation. A minimum capital requirement is imposed of 50m AMD (US$86k), irrespective of the classes of business written. Retained insurance risk is subject to a maximum limit of 15 times an insurer's capital and reserves.

Insurers must be either open joint stock companies (no shareholding restrictions) or a closed joint stock companies (restrictions on number of shareholders and over transfer of shares from one shareholder to another). Risks situated in Armenia can only be insured by local registered insurers, but there are currently no restrictions on reinsurance placements abroad or on foreign insurers setting up locally registered insurers as wholly owned subsidiaries. There are no fixed tariffs, with insurers free to charge whatever premiums they wish. There are no compulsory classes of insurance. There is no policyholders' protection fund, or independent dispute resolution mechanism in Armenia (disputes being settled on the basis of the legal form of the contract in the courts).

Substantive changes to existing insurance legislation are proposed, and a draft new Law, prepared by the insurance supervisor, has already received its first reading in parliament. Extensive comments on the draft new Law (and to a lesser extent also the existing Law) are contained in sections 4 (with respect to the insurance supervisor) and 5 (more generally) of this report.

2.10 Operating performance

Most insurers in the market are still retaining very little business for their own account and ceding the rest to reinsurers abroad. Commission rates for business vary from 10% to 20% on facultative business and 20% to 40% for treaty business. Insurers are making profits out of the business at these levels, since overheads are low by western standards. It is not possible to determine exactly what expense ratios are. Loss ratios across all classes average around just 30%. The average net annual profit before tax of the largest insurers is estimated to be some US$45k.

The level of paid up share capital of insurers is generally modest and in many cases no greater than the required minimum of 50m AMD (see section 3.9). This severely restricts the amount of risk that can be retained, but there have been no insolvencies among insurers to date. A number have closed down, but their affairs have been run off in an orderly fashion.

2.11 Key challenges facing the industry

2.11.1 Lack of awareness of the benefits of insurance

There is widespread ignorance among the public in Armenia of the benefits of insurance, quite apart from its lack of affordability (see section 3.11.2) and a lack of public trust in insurers (see section 3.11.4).

This is largely a legacy of the fact that in the USSR, the state provided for the needs of individuals, including the provision of disability pensions. This meant that there was no need

for employers' liability insurance, for example. The concept of risk management by firms was completely unknown, with hazards treated as part of the normal operating procedures for a business. For individuals too, hazards were treated as a part of everyday life, with motor accidents, for example, resulting in the driver at fault paying compensation to the injured party by private agreement. This remains the culture and practice for most individuals and local firms in Armenia today.

It is not uncommon for the benefits of obtaining insurance to protect against financial loss not to be understood in countries in transition like Armenia, and for this to be perceived more as a luxury than a need, even though the protection offered could well be the difference between being able to meet one's obligations and becoming bankrupt. However, the government in Armenia appears to have thus far shown little appetite for educating the public about insurance, which is in contrast to a number of other CIS countries, most notably Russia. The extent of the lack of awareness of insurance is illustrated by a recent survey conducted by Ermed Insurance, in which only 7% of respondents said they understood what health insurance was and wanted it.

The relative lack of insurance is of concern not only from the point of view of stifling development of the insurance industry but also because of the economic inefficiency and unnecessary social hardship that this creates. With the number of high value vehicles now on the road, for example, private settlements for accidents are becoming increasingly problematic with people unable to pay sometimes coming under personal threat (see section 3.6.6). On a wider scale, the effects on the economy of the lack of earthquake cover when the north west of Armenia was devastated by an earthquake in 1988 were catastrophic (see section 3.3.1) and the same could happen again.

2.11.2 Low incomes and poor economic growth

Whilst it is possible to identify a number of insurance products that the public in Armenia really need, the extremely low levels of per capita income and widespread poverty (see section 3.3.1) mean that affordability of insurance is a critical problem, with very few people having the disposable income to pay for it, and it seems inevitable that this will remain the position for years to come. However, the position is similar in a number of other CIS countries which despite this have larger insurance markets.

2.11.3 Lack of mutual trust and ineffective supervision

Another serious difficulty, wider than corruption though sometimes linked to it, is that of a lack of mutual trust between the public, insurers and the insurance supervisor.

There is widespread suspicion among the **public of** any investment in a commercial enterprise, including **insurers**. This is largely the result of bitter experience; over the last decade:

- the Soviet rouble collapsed and was replaced by the AMD at a fraction of the value of the purchasing power of the former currency;
- the Soviet Armenian Gosstrakh , which had taken people's savings for years on investment and savings policies, did not repay them as promised;
- a number of banks have collapsed; as a result, many people are unable to withdraw their investments and are still relying on the promise of future repayment.

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As a consequence, most people who have any money keep their savings in cash form, or purchase gold and particularly jewellery. Security is regarded as a better option in preference to uncertain investment returns.

The Armenian insurance market is also plagued by various **scams** and false schemes purporting to be insurance, which have contributed to the public's suspicion of insurers. Examples of these reported to us in our work on the project include:

- policies apparently backed by reinsurance but where this does not in fact exist or is effected with a fraudulent reinsurer;

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- false or reissued policies, in particular travel medical policies issued as 30 day contracts but in fact providing cover for only 3 days, which are then cancelled and their policy numbers reused, sufficient genuine policies being issued by the insurer to keep its reinsurer in the dark;
- whole accounts widely considered to be fraudulent or of dubious propriety written by certain insurers;
- policies issued by insurers established by local industrial and commercial groups exclusively to meet their insurance needs, which are in fact unnecessary and used as a device to reduce profits in other group companies for tax reasons.

It was suggested to us that the insurance supervisor and the market generally is aware of the main insurers involved in such scams, variants of which are also found in other CIS countries.

There is also **public** distrust **of** the **insurance supervisor**, which is perceived as lacking independence, potentially corrupt, and ineffective in preventing the above scams.

Insurers have distrust **of** the **insurance supervisor** due to their perceiving it as lacking independence, potentially being corrupt, and lacking the resources and skills it needs to understand insurance and supervise this effectively. They also have distrust **of** the **public**, due to engineered or invalid claims made by policyholders.

For its part, the **insurance supervisor** has distrust **of** the **insurers**, largely as a result of the above scams, and also to a lesser extent **of** the **public**, due to policyholders sometimes being known parties to these (this is particularly true of the travel medical example above, where the insured is generally interested in the policy only as a means of obtaining an exit visa).

The above perceived shortcomings of the insurance supervisor are, in our view, at least partly valid. This currently appears to be under-resourced, and to lack staff with adequate knowledge of insurance. It has also had a succession of heads, which has compromised its continuity of approach and sense of purpose; its present head was appointed in December 2002. It is now a department within the Ministry of Finance and Economy, having recently been downgraded from a "head department" with a greater degree of autonomy. We regard this change as having been a retrograde step, resulting in a lowering of its status and a reduction in the level of motivation of the people who work in it, who see it as a stepping stone to better positions within the government. The Deputy Minister in the Ministry of Finance and Economy, who has responsibility for the insurance supervision department, was appointed in 2001.

2.11.4 Past lack of political will and coordination

Since 1995, there has been little organic growth in the insurance market in Armenia. This is in contrast to a number of other CIS countries, and appears to have been due in part to a lack

of commitment from the government until the last couple of years (the passing of the Law on Licensing and the Law on Legal Acts have represented significant progress since 2001) to develop and reform the market, and take concrete measures to effect and encourage this. This apparently reflected a lack of will rather than delays in process.

A number of recommendations for the development of the market have been made by various parties, including Mr Storr Venter, dating back to 1996-7, which have yet to be implemented. For example, even the simplest of compulsory third party motor schemes has not yet been introduced, largely due to the existing insurance supervisor lacking the necessary skills and resources to make this a viable option.

The perception of the insurance industry is that the government has yet to fully understand the role of insurance and its strategic importance. For example, the industry perceives the Ministry of Health, in particular, as remaining sceptical of its motives.

Other areas where progress has been disappointing are the lack of realistic moves towards introducing privately funded pensions, despite a USAID project which has recommended them, and the very limited extent to which the insurance industry has so far been involved in the provision of private healthcare.

There is also a perception amongst the insurance industry that there has until the last couple of years (there has been significant progress recently, including the creation of a database to facilitate greater coordination between, and less overlap of, development projects funded by different donor organisations) a lack of coordination both between government ministries and technical advisors. For example, PADCO (the USAID Armenia Social Transition Program) has fairly recently recommended the introduction of a mandatory medical insurance fund, financed by a 3% insurance tax on employed persons, to provide medical benefits on a nationwide basis. However, we understand that the World Bank is opposed to this scheme, which it seems inevitable will at best only be able to provide the most basic level of funded healthcare, and will not involve any of the local insurers.

The insurers are of the view that this fund, which will be the responsibility of the Ministry of Health, will not be successful, as being a state fund it will be easy for the government to take money out of / not pay money into it (as has apparently been the experience with similar schemes in Georgia and Kazakhstan) whereas if they had been involved they could have worked together to improve service standards, and that their exclusion from the scheme was desired by the Ministry of Health.

2.11.5 No compulsory classes

Another significant factor which has restricted the size and growth of the insurance market is that there are currently still no compulsory classes of insurance in Armenia. Experience elsewhere has shown that compulsory classes can initially represent an important segment of an immature insurance market before slowly declining later on as other, voluntary classes develop.

The government has been considering the introduction of compulsory third party motor insurance, at least for bodily injury, since 1998 but no date for this has yet been fixed. Proposals have also been made in the past for compulsory insurance for people injured at work but again this has not been progressed.

This contrasts with the position in a number of other CIS countries. In Georgia, there is compulsory third party motor insurance for bodily injury and compulsory property insurance for fire and major perils for commercial premises. Azerbaijan, Uzbekistan, Kazakhstan and Turkmenistan have all introduced compulsory third party motor insurance along similar lines

to Georgia. Azerbaijan is also considering the introduction of compulsory environmental liability insurance. In all these countries, compulsory classes account for a substantial proportion of overall premium income, and total gross market premiums are some US$12m in Georgia and US$40m in Azerbaijan compared with just some US$4m in Armenia (see section 3.4).

2.11.6 Low levels of capital and small retentions

Most insurers in the Armenian insurance market are still retaining very little business for their own account and ceding the rest to reinsurers abroad. This reflects a lack of capacity in the market: the level of paid up share capital of insurers is generally modest, and in many cases no greater than the minimum required under the existing Law of 50m AMD (= $86k, see sections 3.3.1 and 3.9).

With low associated expenses and modest loss ratios, most business in the market is currently profitable (see section 3.10). This makes increased retentions attractive in principle, but these carry with them the associated need to increase levels of paid up share capital. A few insurers are understood to be seriously considering taking this step, but they appear to be in a small minority. We presume this is because they are able to make profits reinsuring the business, and because they currently lack technical expertise in pricing and risk management.

2.11.7 Lack of insurance and accountancy/audit professionals

There is a current lack of professionals trained in insurance and related matters, such as accounting and actuarial, in the insurance market in Armenia. This applies to the insurers and the insurance supervisor alike. Already a problem, this will become an increasingly serious issue as the hoped for increase in market activity materialises, and is one which threatens the healthy development of the market.

Professional skills that are, and will increasingly be, needed but which are currently not available or in short supply include:

- accounting, for the preparation of accounts by insurers (which should be required to accord with international accounting standards, see section 5.5) and their analysis by the insurance supervisor;
- auditing, for certification of accounts produced by insurers;
- specialist underwriting and knowledge of reinsurance practices, to fully understand non-life insurance, and actuarial, in order that life insurance products in particular are priced appropriately, reflecting the risk being underwritten;
- surveying and asset valuation, particularly for property, to quantify the level of risk for property insurance and to ensure that assets are valued appropriately in the balance sheet;
- loss evaluation, to assess the extent of insured damage to property; and
- investment management, to manage the assets held by insurers.

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This situation is currently mitigated to some extent by the market's very heavily reliance on reinsurance (see section 3.2) with the result that expertise is provided by international reinsurers. However, not all insurers make use of reinsurance, and as the hoped for development of the market materialises, cessions should also begin to decrease.

2.11.8 Lack of data

Good quality data relating to financial loss is required by insurers in order that they can price their products appropriately, reflecting the risk being underwritten. It is also required for the development of new products, and for reserving.

The main source of such data is the insurer's own claims experience and that of other insurers in the market. However, on occasions such data needs to be supplemented by data from other sources, e.g. national statistics on population for pricing life products.

At present, the amount and quality of such data in Armenia is very low. This is partly due to the small size and immaturity of the market and the consequent relative lack of past claims experience, but also to a lack of collation and publication of relevant data on an industry wide basis, and to national statistics being unreliable (see section 3.3).

The absence of such data gives rise to the following negatives:

- insurers being put off entering the market, constraining its growth;
- over-pricing, with insurers incorporating high margins into their products, against the interests of policyholders;
- under-pricing, creating a capital risk for insurers if they sell a lot of business on these terms (it is not the case that insurers should never under-price, there being a sound tradition of "buying your experience" by entering a market and gaining data from direct claims experience; however, this approach should be used only by insurers with adequate financial resources to support a loss if one occurs, and the current generally low levels of capital in the country (see section 3.11.7) make this very dangerous in Armenia at present);
- constraint of product development and innovation, against the interests of policyholders; and
- compromised reserving, making insurance supervision more difficult and creating a capital risk for insurers whose reserves are inadequate.

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This situation is currently mitigated to some extent by the market's very heavily reliance on reinsurance (see section 3.2) with the result that the pricing of products is largely driven by international reinsurers. However, not all insurers make use of reinsurance, and as the hoped for development of the market materialises, cessions should also begin to decrease.

2.11.9 Restricted investment opportunities

Investment opportunities in Armenia are currently extremely limited. There is virtually no local equity investment, a number of the banks are not secure, and property has also been an unstable investment in the past. There are no long term government bonds issued, and the only possible safe assets are short term government bonds or investment in one of the secure local banks.

Investment in local currency accounts is potentially hazardous for long term investment, due to devaluation risk. However, some investment abroad by insurers is permitted.

These conditions clearly give rise to issues of credit risk, liquidity risk and currency risk, particularly where investment is over the longer term. As a result, they are especially problematic for life business and will stymie its development. Because of the lack of alternative investments, holdings of property are also probably higher than they would otherwise be, and this asset gives rise to particular valuation problems (see section 5.4).

3 STRUCTURE OF INSURANCE REGULATION AND SUPERVISION

3.1 Introduction

Under item 2 of the signed contract, we are required to:

- in consultation with the existing insurance supervisory authority and other relevant government and market bodies (as appropriate), evaluate the constitution, organisation, staffing and supervisory systems of the supervisory authority;
- review the recommendations made by a USAID funded technical advisor in late 2002, paying close regard to the need for the framework legislation to be sufficiently flexible to provide for the development of detailed regulations as the insurance market evolves;
- make recommendations as to the appropriate nature and constitution of the insurance supervisory authority including its accountability to parliament, its legal relationship to ministries and other government bodies, and its source of funding;
- identify the need and requirements for strengthening the organisational structure of the insurance supervisory authority including the design of supervisory systems, current staffing levels and future recruitment needs and policy;
- identify the requirements for strengthening the insurance supervisory authority's financial monitoring systems for insurers including the adequacy of insurer reporting requirements and the analysis and processing of insurer returns.

Our analysis and recommendations on this part of the project are included in sections 4.2 to 4.4. Further comments on the USAID recommendations are included in sections 2.3 and 5. Further comments on financial reporting are included in section 5.5.

3.2 Existing and proposed legislative requirements

3.2.1 Draft new Law

The Articles of the draft new Law which are most directly relevant to the structure and organisation of insurance supervision are Articles 1, 37, 38, 44 to 51 and 53.

Article 1(2) states that the **main objective of the Law** is "to ensure the protection of interests of the insured…the development, reliability and normal operation of the insurance system, and to create equal conditions of economic competition for the activity of insurers".

Article 37(1) states that the **purpose of supervision** over insurance and brokerage activity is to ensure compliance with the requirements of the Law and other relevant legislation and "the protection of interests of the insured…insurers…brokers…other interested parties and the state".

Article 37(2) provides for the government to empower **"the state authorized body"** to "license, regulate and supervise insurance and brokerage activity" and "to develop state policy in the insurance industry".

Article 37(3) specifies the main **responsibilities** of the state authorized body. These include:

- the licensing of insurers and brokers, and the maintenance of a state register of licences;
- the "adoption of legal acts regulating insurance and brokerage activity" and the "definition of methodological documents (instructions)" as envisaged by relevant legislation and within the framework of its powers;

- conducting qualification examinations and issuing qualification certificates to managers and other specialists to define their qualification and professional adequacy as defined by the Law;
- supervision over insurance and brokerage activity, including ensuring compliance with all requirements imposed by relevant legislation and associated regulations;
- supervision of all types of compulsory insurance;
- publishing regulations relating to the licensing and "surveillance" processes for insurers and brokers, and the relationships between the parties entering into "insurance relations".

Article 37(4) specifies the **powers** which the state authorized body has. These include:

- receiving from insurers and brokers information legally required to be submitted, including reports and other documents providing information about their activity and financial status;
- carrying out inspections at insurers and brokers, and surveys of the insured to check the validity and adequate payment of claims;
- applying sanctions against insurers and brokers and their officials in the event of violations of relevant legislation;
- bringing an action to protect the interests of the state in the event of violations of relevant legislation by insurers and brokers;
- applying sanctions and bringing an action against persons carrying out non-licensed insurance or brokerage;
- executing other actions and functions envisaged by relevant legislation;
- at any time, making enquiries of insurers and brokers where sufficient, reasonable grounds exist to believe that the interests of the insured may be at risk.

Article 37(5) requires the state authorized body to prepare, within 6 months of the end of each financial year, an **annual report** describing the measures it has taken aimed at meeting its responsibilities and containing available statistical data not classified as commercially secret under relevant legislation.

Article 37(6) allows the state supervised body to **exchange information** with other insurance supervisory authorities as envisaged under international agreements.

Article 38 prohibits officials in the state authorized body from disclosing or using for their own purposes information classified as **commercially secret**.

Articles 44 to 50 expand upon the sanctions that the state authorized body can apply to insurers and brokers and on what grounds. **Article 44** lists the **types of sanctions** which can be applied, which include written warnings, penalties, suspension of licence and filing an application to the court for termination of licence. **Article 45** specifies the **grounds** on which sanctions can be taken. **Articles 46 to 48** cover the **procedures** to be followed for applying penalties against **individuals**, issuing **warnings to firms** and applying **penalties against firms** respectively. **Articles 49 and 50** cover the **procedures** to be followed for **suspending** and applying to the court for **termination** of a **licence** respectively.

Article 51 provides for **appeals** to be made to the court against decisions made by the state authorized body in relation to the issuance and suspension of licences.

Article 53 provides for **disputes** connected with insurance to be settled by the state authorized body through discussion; however its decision is not binding, with all parties to the dispute able to apply to the court in the case that agreement cannot be reached.

3.2.2 Existing Law

The Articles of the existing Law which are most directly relevant to the structure and organisation of insurance supervision are **Articles 29, 31 and 32**.

Article 29(1) states that the purpose of supervision over insurance activity is to ensure compliance with the requirements of the Law, the development of insurance business and the protection of interests of the insured, other concerned persons and the country.

Article 29(2) provides for insurance supervision to be carried out by a "state administrative body authorised by the government".

Article 29(3) specifies the main responsibilities of the state authorized administrative body. These include:

- the licensing of insurers, and the maintenance of a state register of insurers and brokers;
- the "development of normative and methodological documents" for insurance activity as envisaged by relevant legislation;
- supervision over the security of solvency of insurers.

Article 29(4) specifies the powers which the state authorized administrative body has. These include:

- receiving from insurers statements and other documents providing information about their activity and financial condition;
- carrying out inspections at insurers;
- warning insurers in the event of violations of relevant legislation, and if they do not respond appropriately, cancelling or limiting the operation of their licence until the shortcomings are eliminated or a decision is taken to annul the licence;
- applying to the court against persons carrying out non-licensed insurance.

Article 29(5) provides for an appeal to be made to the court against a decision made by the state authorized administrative body to refuse to issue a licence.

Article 31 prohibits officials in the state authorized administrative body from disclosing or using for their own purposes information classified as commercially secret.

Article 32 provides a general right for an appeal to be made to the court against actions taken by the state authorized administrative body.

The state authorized administrative body is currently constituted as a department within the Ministry of Finance and Economy.

3.3 High level analysis

3.3.1 Principles

The primary task of the insurance supervisory authority should be to maintain an efficient, fair, safe and stable insurance market for the benefit and protection of policyholders. It should maintain public confidence in the market and reduce the scope for financial crime. It should provide an appropriate level of protection for consumers, but at the same time

recognise their own responsibilities, and those of insurers. It should be efficient in its use of resources, and not stifle competition in the market.

The supervisory authority should be organised so that it is able to carry out these tasks at all times both successfully and efficiently. In particular, the supervisory authority should:

- be operationally independent, but accountable to government, parliament, the insurance industry and the public in the exercising of its functions and powers;
- have adequate powers, legal protection and financial resources to perform its functions and exercise its powers;
- adopt a clear, transparent and consistent regulatory and supervisory process;
- clearly define the responsibility for decision making; and
- hire, train and maintain sufficient skilled, motivated staff with high professional standards who follow the appropriate standards of confidentiality.

A clear statement of the ultimate objectives of insurance supervision identifies the mandate and extent of responsibilities of the supervisory authority. Specifying these key elements in legislation gives them particular prominence and prevents ad hoc or frequent changes to them, which could result in the public's perception of the supervision process being in a state of flux. It also ensures that they are accessible to the public and other interested parties. This enhances transparency by enabling the public to form expectations about insurance supervision and its operations, and to assess the performance of the supervisory authority in achieving its objectives by comparing these to actual outcomes. In this way, the supervisory authority is held accountable to the public. To maintain adequate flexibility to deal with different circumstances, however, and recognising that the objectives of the supervisory authority are likely to need to evolve (and where there are several objectives, the emphasis and priority given to these may need to change over time), it is prudent to avoid being overly specific in defining the objectives in legislation.

The supervisory authority must be fully empowered to achieve its objectives. It is therefore important that the legislation addresses the following essential elements relating to it: its legal basis, independence and accountability, powers, financial resources, human resources, legal protection and confidentiality. Independence, accountability, transparency and integrity interact and reinforce each other. Transparency is a vehicle for safeguarding independence, a key instrument in making accountability work, and also helps to establish and safeguard integrity.

Legal protection for the staff of the supervisory authority, as well as clear rules for the appointment and removal of its head, should be publicly disclosed to support both their independence and their integrity. The supervisory authority should be operationally independent from external political or commercial interference in the exercise of its functions and powers. Independence enhances the credibility and effectiveness of the supervisory process. The existence of an appeals mechanism to the courts helps ensure that regulatory and supervisory decisions are made consistently and are well reasoned.

The supervisory authority should be accountable for the actions it takes in fulfilling its mandate to those who delegated responsibility to it – namely the government and parliament – as well as to those it supervises and the public. It should provide the rationale for decisions it takes. Proper accountability requires a combination of approaches, such as governmental and parliamentary oversight, strict procedural requirements and disclosure. The decisions of the supervisory authority should be subject to substantive judicial review where such action

does not endanger the protection of policyholders. The supervisory authority should establish internal procedures for ensuring the meeting of its objectives and compliance with legislation.

3.3.2 Separation of supervision and policy advice

Experience in a wide range of jurisdictions has shown that it is desirable for the government to have a source of policy advice on insurance issues separate from the insurance supervisory authority. The primary reason for this is to minimize the risk of regulatory capture, which occurs when the supervisory authority puts the interests of itself or the insurance industry ahead of the interest of policyholders. For example, there is a potential risk that the supervisory authority may tolerate, or worse encourage, anti-competitive behaviour, as this will decrease the risk of insurers failing and leaving policyholders with unpaid claims, which would result in criticism of it. There may also be potential conflicts of interest in such areas as consideration of the introduction of compulsory insurance, which because it is not voluntary is subject to weaker competitive pressures.

Such a separation of functions allows the insurance supervisory authority to focus on supervision, and specifically minimising the risk of financial loss to policyholders by rigorously enforcing prudential requirements and intervening in the affairs of insurers where necessary and appropriate, whilst responsibility for advising the government on policy on insurance issues generally, including the development of the insurance industry and the promotion of competition within it, rests with the separate source of policy advice.

In this way, and coupled with requirements for close high-level consultation with the source of policy advice and oversight by the government, the insurance supervisory authority is better able to carry out, and be seen by the public to carry out, its mandate to protect policyholders, free from interference from the government and the insurance industry. At the same time, the separate source of policy advice is better able to take a holistic view, taking into account not only supervisory issues but also the development of the insurance market and competition within it, and wider micro- and macro-economic trends. It is also able to advise the government on the performance of the supervisory authority by monitoring and reporting on how well it is meeting its objectives, thereby increasing confidence that regulatory capture is not occurring. In performing these tasks, it should liaise as appropriate with other branches of the government and other relevant parties.

3.3.3 Application to Armenia

The above principles hold in any jurisdiction. However, they are especially important in Armenia, where there is a critical need for businesses and individuals to have more confidence in the future that they will be treated fairly by insurers, and in particular that valid claims against them will be met (see section 3.11.4). The public does not have adequate information and/or the capacity to process it to assess the soundness of insurers, and therefore looks to the supervisory authority to ensure that these are able to meet their obligations, and behave in an open and honest fashion.

Given that the Armenian economy remains in transition and per capita income levels remain very low (see section 3.3.1), it is also important that the insurance industry is as competitive as possible to minimize cost and maximize affordability of insurance products.

The above are both pre-requisites for demand for insurance to increase, thereby allowing development of the insurance market. A third is increased awareness of the benefits of insurance in reducing financial risk, which is currently very low (see section 3.11.1). This is also an area in which the government, acting on policy advice, can and should play an

important part, free from the self interest that insurers risk being perceived by the public as having in promoting greater use of insurance.

As reflected in the above comments, the optimum structure would be for the existing insurance supervisory authority, which is a department within the Ministry of Finance and Economy, to be transferred to an adequately resourced, independent body. It is recognised, however, that it may not be feasible to implement this change straight away, or even before the effective date of the new Law. We do not regard this as a critical problem, a continuation of the existing structure being acceptable in the short term, but the new Law should provide for this transfer to take place within a specified period. We also regard it as important that the general policy advice role currently performed by the insurance supervisory authority be extracted and instead placed with a separate policy advice unit within the Ministry of Finance and Economy. This change should take place straight away and in any event before the effective date of the new Law.

3.3.4 IAIS principles

In making the recommendations in section 4.4, we have paid close regard to the draft document issued by the IAIS in January 2003 containing proposed revisions to its Insurance Core Principles (ICPs), and specifically to ICPs 2, 3 and 4, which are directly concerned with the insurance supervisory authority. A copy of these is included in **Annex 6** to this report, and their content has been broadly summarised in the comments made in section 4.3.1.

Whilst they adhere more closely to these ICPs than do the corresponding parts of the existing Law, as summarised in section 4.2.2, the parts of the draft new Law relating to the structure and organisation of insurance supervision, as summarised in section 4.2.1, still fall short of full compliance with these ICPs in a number of areas.

The recommendations in section 4.4 aim to rectify these shortcomings, our view being that it is important that the new Law should adhere fully to these ICPs. This reflects the opportunity presented by the current strategic review of the insurance supervisory authority, and our view that compliance with these ICPs is not constrained by the prevailing conditions in the insurance market, and in particular the very small scale of its operations (see section 3), in the same way that development of other parts of the new Law, including prudential requirements, and of the market itself necessarily are (see sections 5.2 and 6.2).

3.3.5 Hogan report recommendations

The main recommendations made in the Hogan report (see section 2.3) relating to the structure of the insurance supervisor may be summarised as follows:

- the priority over the medium term is the relocation of the existing supervisory authority either as a stand alone independent body or as a designated division of a consolidated financial services authority;
- in the meantime, significant legislative provisions should be put in place to boost the power, authority and effectiveness of the existing supervisory authority and ease its transition to an independent body, although it is acknowledged that the development of a strong supervisory authority will take some time;
- the supervisory authority should have appropriate regulatory, supervisory and developmental powers; its regulatory powers should include that to make regulations, subject to any restrictions imposed by the Civil Code; its supervisory powers should include requiring authorisation and regular financial reporting, the ability to make on-site

inspections and the power to impose penalties and sanctions for legislative violations; its developmental powers should include that to promote insurance;

- the supervisory authority should have obligations to gather data and statistics, publish an annual report, and maintain essential registers;
- there should be a dedicated chapter in the new Law on the supervisory authority, which should specify its name, location, powers and responsibilities.

We concur with these recommendations, which have largely been reflected in the draft new Law as it now stands (see section 4.2.1), subject to:

- the establishment of an independent supervisory authority taking place in the fairly near future; and
- our comments in section 4.3.2 regarding the desirability of a separate source of policy advice to the government on insurance matters.

The recommendations in section 4.4 are consistent with these comments.

3.4 Detailed analysis and recommendations

3.4.1 Legislation: draft new Law

1. Whilst this is perhaps implied by Article 1(2), the supervisory objectives defined in Article 37(1) make no direct reference to the maintenance of an efficient, fair, safe and stable insurance market. Such a reference should be added.
2. It is unclear that protection of interests of insurers and brokers in particular, and perhaps also of other interested parties and the state, should appear in the supervisory objectives defined in Article 37(1), as these interests may often conflict with those of policyholders. Reference to these parties should be deleted.
3. Given their particular significance in Armenia (see section 4.3.3), reducing financial crime and promoting public awareness of insurance should be added to the supervisory objectives defined in Article 37(1).
4. Article 37(2) provides for a single “state authorized body” with responsibility for both the supervision of insurance and development of state policy on insurance. These two roles should be separated.

   The draft new Law should be amended to provide for a **policy advice unit** within the Ministry of Finance and Economy which should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry, the promotion of competition within it, the maintenance of sound principles of insurance regulation, and the promotion and delivery of public education on insurance matters. This unit should be established as soon as possible and in any event by the time of the establishment of the independent insurance supervisory authority referred to below.

   The draft new Law should be further amended to provide for the establishment, no later than 31 December 2005, of an adequately resourced, **independent, stand-alone insurance supervisory authority** which should have responsibility for the supervision of insurance. This structure should ensure that the supervisory authority and its staff are free from undue political, governmental and industry interference in carrying out its supervisory responsibilities. Because of the current need and desire to focus particular attention on the insurance industry, and the severe problems faced by the banking and

money market sectors, this is also, in our view, preferable to merging the authority with the Central Bank and/or Securities and Exchange Commission to form a unified financial services regulator, although this alternative structure may become more suitable in the long term. Before the establishment of the independent body, supervision of insurance should be carried out by the existing insurance supervision unit within the Ministry of Finance and Economy.

Each of the policy advice unit; the independent, stand-alone insurance supervisory authority to be established; and the interim insurance supervision unit should be identified by name in the new Law. References in the draft new Law to the "state authorized body" should be amended to refer to the body having responsibility for the supervision of insurance. In particular, the power in Article 37(3) to make regulations should rest with this body.

5. The insurance supervisory authority should have the power to issue and enforce regulations by administrative means, i.e. without the need to change the Law. Article 37(3), item 2 appears to provide such a power. However, the scope of this item is not entirely clear, and a check should therefore be made as to whether this is sufficiently wide, and if not this should be rectified.
6. The Law should grant the insurance supervisory authority sufficient powers for the effective discharge of its supervisory responsibilities. Articles 37(4) and 44 to 51 grant the supervisory authority quite wide-ranging powers which may be considered sufficient. However, consideration should be given to whether some of or all of the additional powers described in section 5.6.2.2 should be incorporated into the new Law, and also to whether some of the existing powers are unduly onerous and should be deleted as discussed in that section.
7. The governance structure of the insurance supervisory authority should be clearly defined, with explicit regulations regarding the appointment and dismissal of senior personnel. This issue is not covered by the draft new Law. This should be amended to include a brief reference to this issue, and appropriate regulations put in place under Article 37(3), item 2. See section 4.4.2.1.
8. The following institutional relationships should be clearly defined and transparent:
   - the insurance supervisory authority's relationship with the government, including the range of issues on which, and the form in which, the authority must inform or consult the relevant ministry or seek ministerial approval;
   - the insurance supervisory authority's relationship with parliament, including the procedures by which the authority will be held to account for the use of the powers delegated to it by parliament;
   - the insurance supervisory authority's relationship with the judiciary, and particularly the manner in which the authority could be subject to judicial review or other appeals mechanisms. The appeals mechanisms should be clearly specified and balanced to preserve independence and effectiveness of supervisory action.

   Apart from Article 51 covering appeals against decisions taken by the insurance supervisory authority relating to the issuance and suspension of licences, these issues are not covered by the draft new Law. This should be amended to touch on these issues, and appropriate internal procedures put in place by the supervisory authority to cover them in detail. See section 4.4.2.2. The scope of Article 51 should be broadened to provide for

appeals to the court against decisions taken by the supervisory authority generally (the existing Law has such a provision in its Article 32).

9. The insurance supervisory authority should be financed in a manner that does not undermine its independence from political, governmental or industry bodies. It should have budgetary independence, with a sufficient budget to enable it to conduct effective supervision. It should be able to attract and retain skilled staff, provide training, and have adequate supervisory infrastructure and tools. It should also have the authority to hire, contract or retain the services of external specialists through contracts or outsourcing arrangements if necessary. Those specialists should be subject to the same confidentiality and code of conduct requirements as the staff of the supervisory authority (see point 14 below).

   The means by which the supervisory authority will be funded is not covered by the draft new Law. This should be amended to cover this issue. Part financing the supervisory authority by means of a levy on insurers is recommended as a way of increasing is accountability. See section 4.4.2.3. The power of the supervisory authority to hire specialists needs to be addressed in the draft new Law, and should be added to Article 37(4).

10. The insurance supervisory authority should have clear, transparent processes and procedures for making supervisory decisions. Supervisory decisions should be demonstrably consistent. The rules and procedures of the supervisory authority should be published and updated regularly. These issues are not covered by the draft new Law and generally need not be, but appropriate internal procedures should be put in place by the supervisory authority to cover them. See section 4.4.2.4. The requirement for publication of such procedures needs to be addressed in the draft new Law, and should be added to Article 37.

11. Internal governance procedures to ensure the integrity of operations and prevent the abuse of discretion, including internal audit arrangements, should be put in place and publicly disclosed. The requirements set out in Article 37(3), item 6 and Article 37(5) relating to the publication of regulations and the preparation of an annual report should encourage the integrity of operations, but appropriate internal procedures should be put in place by the supervisory authority to cover these issues. See section 4.4.2.4. The requirement for publication of such procedures needs to be addressed in the draft new Law, and should be added to Article 37.

12. All relevant changes to insurance regulations and supervisory practices should be subject to prior consultations with the market participants, except in urgent cases. This requirement is not covered by the draft new Law, and should be added to Article 37.

13. The insurance supervisory authority should have the power to take immediate action when necessary, such as in an emergency situation, and its decision-making lines should be structured so that this can be achieved in practice. It should have open decision-making procedures, which should be tempered only by publicly disclosed confidentiality requirements applying in situations where confidentiality is required by law or necessary for sound regulatory practice or effective communication with other regulators. Nothing in Articles 37(4) or 44 to 51 appears to prevent immediate action being taken, but a check should be made as to whether this is correct, and if not this should be rectified. Appropriate internal procedures should be put in place by the supervisory authority to give effect to these requirements. See section 4.4.2.4.

14. The insurance supervisory authority and its staff should observe the highest professional standards, and the staff should have the appropriate levels of skills and experience. The supervisory authority and its staff should also observe the highest standards of integrity, and the staff should be subject to conflict of interest rules such as prohibition on dealing in the shares of, and other investment in, the companies they supervise. The supervisory authority should establish and enforce a code of conduct which applies to all staff members. These issues are not covered by the draft new Law. This should be amended to touch on these issues, and appropriate internal procedures put in place by the supervisory authority to cover them in detail. See section 4.4.2.1.

15. Legal protection should be provided to the insurance supervisory authority and its staff against lawsuits for actions taken in good faith while discharging their duties, and adequate protection should also be provided to these parties against the costs of defending their actions while discharging their duties. These requirements are not covered by the draft new Law, and this should be amended to include them.

16. Other than when required by a court or mandated by a legislative body, the insurance supervisory authority should deny demands for confidential information in its possession. Article 38 does not seem to give scope for release of confidential information in any circumstances, including those referred to above, and should be amended to rectify this. The basis on which information is classified as commercially secret is also not stated in Article 38, and this should be amended to require this basis to be disclosed publicly.

17. The insurance supervisory authority should ensure that existing or potential policyholders are kept informed of its role in the industry. It should publish a regular report, at least annually, explaining the actions taken during the relevant period in relation to its goals and objectives, giving information about the financial situation of the supervised entities, commenting on the conditions for effective insurance supervision and the use of financial resources, and presenting general observations on the insurance market.

    Article 37(3), item 6 and particularly Article 37(5) provide for these requirements to be met. However, consideration should be given to extending the latter to explicitly include the items listed above.

    Whilst this is implied by its reference to the fostering of transparency and growth of the insurance industry, Article 37(5) does not state explicitly that the annual report must be published, and this should be rectified. We further recommend that the annual report should be prepared for the Ministry of Finance and Economy, which should have responsibility for presenting it to parliament.

    We recommend that it should be a requirement for the supervisory authority to hold an annual public meeting for the purpose of consideration of the annual report, providing for a general discussion of its contents and a reasonable opportunity for those attending the meeting to put questions to the supervisory authority about the way it discharged, or failed to discharge, its functions during the period to which the report relates.

    The supervisory authority should also have the power and responsibility to release to the public directly such other reports or information as it considers necessary for the purposes of increasing public awareness of insurance, describing its role in ensuring the safety of insurance products in particular and providing relevant statistical data for the public and the insurance industry, and have the power to collect such data.

    Amendments to Article 37 should be made to reflect the above comments, and internal procedures put in place by the supervisory authority to ensure that the requirements listed above are met. See section 4.4.2.2.

18. The insurance supervisory authority should consult and co-operate with stakeholders within and without the civil service on matters relating to the sound operation of insurers and brokers. It should also participate in international insurance supervisory bodies, and specifically the IAIS. These rights and requirements are not covered by the draft new Law, and should be added to Article 37.
19. Consideration should be given to whether the wording of Article 37(4)(b) is sufficiently wide to permit the broadening of scope of on-site inspections recommended in section 4.4.3.5, and if not this should be rectified.
20. We doubt how appropriate it is for the supervisory authority to be involved in conducting qualification examinations and issuing qualification certificates, as provided for by Article 16 and reflected in Article 37(2), other than in the next few years (see section 5.3.2.2).
21. We would also question how appropriate it is for the supervisory authority to be involved in the settlement of disputes, as provided for by Article 53. However, given that its decisions in this regard can be appealed to the courts under Article 53(3), we do not regard this as a serious issue in the next 5 years, subject to the precise role of the insurance supervisor in this regard being clarified and strengthened as appropriate. In the longer term, however, we recommend that consideration should be given to the establishment of an independent dispute resolution mechanism.

3.4.2 Legislation: insurance supervisory authority

The recommendations in this section relate to the developments needed to legislation (including regulations and internal procedures) in respect of the independent, stand-alone insurance supervisory authority referred to in recommendation 4 in section 4.4.1. Transitional arrangements until its establishment are discussed in section 4.4.5.

The issues described under each of the following headings should be addressed in the new Law, regulations made under its Article 37(3) item 2, or in internal procedures put in place by the supervisory authority. Deciding which of these destinations is the most suitable for each item is a matter of policy. Generally, however, we recommend that as much is kept in regulations and internal procedures as possible rather than in the new Law, to maximize flexibility. This holds in any jurisdiction, but is especially important in Armenia given the fairly extensive developments likely to be needed to detailed requirements in the next 5 years as the insurance industry evolves. Some key items should be covered by the new Law, however, and these have been marked by an asterisk (*). Amendments to the draft new Law should be made to reflect these.

3.4.2.1 Constitution and governance structure

1. **Legal status***. The supervisory authority should be a separate legal entity. It should be a named corporate body without shareholders.
2. **Composition***. The supervisory authority should comprise an executive and staff. The executive should comprise a head, a deputy and at least one other member. All members of the executive should be appointed by the Ministry of Finance and Economy, but subject to the conditions in point 4 below.
3. **Term of office**. Given the continuity problems that have been experienced in the existing insurance supervisory authority (see section 3.11.4), we recommend that appointments to the executive should have a minimum term of 3 years. It might also be desirable,

however, to specify a maximum term and/or limit on the number of consecutive terms that can be served by an individual.

4. **Appointment and dismissal**. Vacancies on the executive should be advertised, and appointments to it should be freely open to competition. Appointments to the executive should be subject to demonstration of adequate qualification and experience*. Dismissal from the executive should be subject to demonstration that the person concerned is no longer able to carry out their duties effectively, has breached the code of conduct (see point 8 below) or has committed an offence under legislation. If the head is dismissed, the reasons for this should be disclosed publicly. Members of the executive should, other than in exceptional circumstances which should be disclosed publicly, only be appointed or dismissed following a formal consultation process with interested parties, including representatives of the insurance industry.
5. **Conflicts of interest**. Members of the executive should not have occupation outside the supervisory authority, except for scientific or academic work. They should not be shareholders or holders of other investments in, or be members of the managing bodies of, an insurance company or broker which is subject to supervision by the supervisory authority. They should also not become members of the managing bodies or heads of administration of any such insurance company or broker until at least one year has elapsed from the end of their term of office, dismissal or resignation. These restrictions should be disclosed publicly. Similar restrictions should also apply to staff, except that relating to after they have left office (see point 8 below).
6. **Immunity***. Legal protection should be provided to members of the executive as described in recommendation 15 in section 4.4.1. Similar protection should also be provided to staff (see point 8 below).
7. **The head**. The responsibilities of the head should be defined and include organising the work of the supervisory authority and heading its administration; representing the supervisory authority to third parties; concluding contracts with staff; encouraging staff training and development; imposing disciplinary measures as necessary; delegating tasks as appropriate; approving restrictions to prevent conflicts of interest (see point 5 above); issuing orders within his/her competence; and exercising functions assigned to him/her by other members of the executive. The deputy should be required to assume the responsibilities of the head in their absence.
8. **Staff**. Employment should be subject to demonstration of adequate qualification and experience*, and the recruitment policy used by the supervisory authority should be disclosed publicly. All employees should have a work contract. They should perform such tasks as have been delegated to them by the executive, following established procedures which should be documented. Staff should be provided legal protection similar to that provided to members of the executive (see point 6 above). They should be subject to similar restrictions to prevent conflicts of interest as apply to members of the executive, except those relating to after they have left office (see point 5 above). They should be subject to a strict code of conduct that should also apply to members of the executive (see recommendation 4 above) and be rigorously enforced*. This should expressly prohibit breaches of confidentiality, and nepotism and any other form of corruption (see section 3.11.3) on any scale, the perpetration of which by any person should result in their immediate dismissal. No information relating to employees should be released by the supervisory authority except where there is a legal requirement to do so.

9. **Disclosure**. Information on the functions and activities of different parts of the supervisory authority, the relationships between them including details of contact data, and the control thereof should be disclosed publicly.

3.4.2.2 Institutional relationships with the government, parliament and the judiciary

The insurance supervisory authority should be operationally independent in the exercising of its functions and powers. However, it should also be accountable for the actions it takes in fulfilling its mandate to those who delegated responsibility to it, namely the government and parliament.

To ensure operational independence, decisions taken by the supervisory authority should not be subject to ministerial approval. Only matters of general prudential policy, and in particular the making of regulations, should normally be referred (in writing) to the Ministry of Finance and Economy, although in certain cases it may be sensible for the supervisory authority to keep the Ministry informed of its decisions and their possible implications.

To provide accountability to the government, the supervisory authority should be required to prepare an **annual report** for the Ministry of Finance and Economy. This should:

- cover the discharge of its functions during the year; the extent to which, in its opinion, its supervisory objectives have been met; and the matters to which it has had regard in exercising its duties, including the use of its financial resources;
- provide statistical data on the supervised entities; comment on the conditions for effective insurance supervision; and present general observations on the insurance market;
- identify key risks and industry specific vulnerabilities; outline specific plans for redressing the weaknesses; and, subject to confidentiality considerations, provide information about problem or failed insurers, including a description of resolution strategies and interventions;
- cover such other matters as the Ministry of Finance and Economy may require; and have appended to it the financial statements of the supervisory authority for that year (see section 4.4.2.3)*.

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The Ministry of Finance and Economy should have the power to question members of the supervisory authority, on the annual report and generally; conduct reviews of the authority, either on its own account or by hiring specialists; and commission independent inquiries.

To provide accountability to parliament, the Ministry of Finance and Economy should be required to submit a copy of the annual report prepared for it by the supervisory authority to **parliament***. This should have free and direct access to question members of both the supervisory authority and the Ministry of Finance and Economy (which of course is directly accountable to parliament), for example by requiring them to appear before relevant parliamentary committees.

To provide accountability to the judiciary, the new Law should provide for appeals to be made to the courts against decisions taken by the supervisory authority generally (as well as by the Ministry of Finance and Economy)*.

To provide accountability to the public, the annual report should be published.

*3.4.2.3 Source of funding**

We recommend that the insurance supervisory authority should be partly financed by a **levy** on insurers. This should be set as a percentage of the gross premiums, excluding those

relating to compulsory classes of insurance, written by the insurer. We recommend that the percentage is set initially at 0.5% but that the new Law provides for this to be changed in the future by the supervisory authority, following a formal consultation process with interested parties, including representatives of the insurance industry. The levy should be payable quarterly by all insurers, with late payments attracting default interest at a reasonable but punitive fixed rate.

The supervisory authority should have a sufficient budget to enable it to conduct effective supervision, attract and retain skilled staff, provide training, obtain such external specialist advice as is necessary and have adequate supervisory infrastructure and tools. The budget should be assessed having regard to the recommendations made in section 4.4.3. Given the nature of these, it seems inevitable that this budget will need to be substantially greater than that of the existing insurance supervisor, which we understand to be only around US$10k per annum. To the extent that the levies above are inadequate to provide this budget, **additional resources** should be provided by the Ministry of Finance and Economy.

The supervisory authority should be required to submit to the Ministry of Finance and Economy each year a proposed total **budget** for the coming year (together with an estimate of the projected levies for that year) for approval. It should also be required to prepare a set of **financial statements** each year, which should be **audited** by an **independent auditor** (either a private sector firm, or the government audit department but only if this is independent of the Ministry of Finance and Economy), showing among other things its actual income and expenditure during the year. These should be appended to the annual report required to be submitted to the Ministry of Finance and Economy (see section 4.4.2.2) and used as a guide by the two parties in agreeing the supervisory authority's total budget for the following year.

The levy forming part of the above funding structure enhances the accountability of the supervisory authority to the insurers and brokers it supervises. It also provides the authority with significant budgetary independence from the government, particularly given its ability to change the level of levy subject to consultation, and an incentive to supervise the insurance industry effectively to prevent the financial collapse of insurers (which would reduce its levy income). At the same time, the balance of funding from the Ministry of Finance and Economy should ensure that the authority has sufficient resources at all times, and provides the government with an incentive to develop the insurance industry (which would increase levy income and hence reduce the balance payment required).

It may be necessary for development of the insurance supervisory authority to be financed initially at least in part by donor organisations. Both the World Bank and USAID are active in the region in providing such financial assistance, and might be looked to as potential sponsors of training from external consultants (see section 4.4.3.2) and new office facilities and equipment (see section 4.4.3.3), for example. Such finance might take the form of a loan, which could be repaid in due course out of levy income.

3.4.2.4 Decision making and other procedures

The insurance supervisory authority should have clear, transparent processes and procedures for making supervisory decisions. It should have the power to take immediate action when necessary, such as in an emergency situation, and its decision-making lines should be structured so that this can be achieved in practice. It should have open decision-making procedures, which should be tempered only by publicly disclosed confidentiality requirements applying in situations where confidentiality is required by law or necessary for sound regulatory practice or effective communication with other regulators. Supervisory decisions should be demonstrably consistent.

Procedures to ensure the integrity of operations and prevent the abuse of discretion, including internal audit arrangements, should be put in place. All procedures should be published and updated regularly, and changes to these should be subject to prior consultations with interested parties, including representatives of the insurance industry, except in urgent cases.

Issues that should be covered in procedures relating to decision making include with whom responsibility for this lies; the frequency with which any meetings for this purpose should be held; quorum requirements; voting arrangements; submission of relevant papers; chairing arrangements; arrangements for the taking of minutes; signing authorities; and requirements for the declaration of interests and exclusion from the decision making process as a result. All supervisory decisions should be properly documented and relevant files stored safely.

3.4.3 Practice: insurance supervisory authority

The recommendations in this section relate to how the independent, stand-alone insurance supervisory authority referred to in recommendation 4 in section 4.4.1 should operate in practice. Transitional arrangements until its establishment are discussed in section 4.4.5. Article references are to the draft new Law.

3.4.3.1 Overview

The **main duties** of the insurance supervisory authority under Article 37 include:

- the licensing of insurers and brokers, and the maintenance of a state register of licences;
- issuing and publishing relevant regulations;
- conducting qualification examinations and issuing qualification certificates to managers and other specialists to define their qualification and professional adequacy as defined by the Law;
- supervision over insurance and brokerage activity, including ensuring compliance with all requirements imposed by relevant legislation and associated regulations, and supervision of types of compulsory insurance;
- the preparation of an annual report.

The recommendations made in sections 4.4.1 and 4.4.2 **added** to these duties:

- publishing its internal procedures, and making changes to these subject to a consultation process with interested parties;
- holding an annual public meeting to allow discussion of the annual report, which should be prepared for the Ministry of Finance and Economy and be laid before parliament and published;
- releasing to the public directly such other reports or information as it considers necessary for the purposes of increasing public awareness of insurance, describing its role in ensuring the safety of insurance products in particular, and providing relevant statistical data for the public and the insurance industry.

Key elements of the **supervision** process, as envisaged by section 37(4), include:

- the financial monitoring of insurers and brokers by means of analysis and processing of reports and other information in specified formats submitted by them;
- carrying out inspections at insurers and brokers, and surveys among the insured;

- applying sanctions and taking other enforcement action against insurers and brokers in appropriate circumstances.

These duties and supervisory processes should be viewed in the context of the principles described in section 4.3, and in carrying them out, **the supervisory authority should**:

- be fully familiar with the new Law and its associated regulations, the obligations these place on insurers and brokers, and the powers and obligations they confer on the supervisory authority;
- operate, and be seen to operate, firm but fair supervision by enforcing legislative requirements in a consistent and transparent way;
- press for appropriate corporate governance arrangements within insurers, and insist that directors and auditors take their responsibilities seriously;
- promote greater understanding of the insurance industry;
- act proportionately, having regard to the impact of supervision on competition and innovation and the economy;
- target its resources as efficiently as possible;
- seek to be proactive where possible and appropriate, including proposing such changes to the new Law and its associated regulations as are considered necessary at any time taking into account the prevailing circumstances;
- where appropriate, make use of external specialists.

3.4.3.2 Staffing and training

The first **head** of the insurance supervisory authority should be Mr Ashot Gomtsyan, who is the present head of the department of the Ministry of Finance and Economy with current responsibility for insurance supervision ("the existing supervisor").

We recommend that the **executive** should comprise just three members to begin with. A deputy to Mr Gomtsyan and a third member of the executive should be appointed. Whilst these appointees might be drawn from the staff of the existing supervisor or elsewhere within the Ministry of Finance and Economy, we recommend that at least one of them should have direct knowledge of insurance, and preferably have held a senior position in an insurance company.

The existing supervisor has a total of 14 staff. In our view, these staff show high levels of commitment and enthusiasm for their work and carry out their duties, as far as we were able to determine, in a diligent and conscientious fashion. This provides a strong basis for, and allows for the transfer of these staff to, the supervisory authority. Given that there are only 25 insurers (some of which are closed to new business) and 3 brokers (of which only 2 are active) in the insurance market (see section 3.5) and assuming that all staff are content to transfer, this should, in our view, be an adequate **initial level of staffing** for the supervisory authority, particularly if existing practices are improved to increase focus and efficiency (see section 4.4.3.3). However, this level of staffing will clearly need to be **kept under close review** as the insurance market evolves, and it is also highly desirable that several new staff with insurance and related skills be recruited immediately if possible (see below).

Notwithstanding our comments above, recent independent analysis has shown that corruption, albeit often on a modest scale, remains widespread in Armenia and that this extends to state officials (see section 3.11.3). To counter the risk of this occurring in the

supervisory authority, it is important that all staff of the supervisory authority, including the members of the executive, be made subject to both a strict **code of conduct**, which should be rigorously enforced, and to **conflicts of interest** restrictions, as described in section 4.4.2.1.

Additionally, however, we also recommend that **salaries** are substantially increased from their existing levels to an extent that makes them at least competitive with those paid in the private sector, and particularly by insurers. We suggest that members of the executive should initially be paid in the region of $400-600 per month, and staff $200-300 per month. This is seen as essential to enhance the profile and status of the supervisory authority; increase the sense of purpose and level of motivation of its staff; improve retention of existing staff (as with the head, there has been rapid turnover of staff in the existing supervisor that has had a negative impact, see sections 3.11.4 and 4.4.2.1); and make recruitment of new, suitably skilled staff easier. It should also provide a significant disincentive to staff to engage in any form of malpractice. Salaries of staff should be set by the executive; those of the executive should be set by the Ministry of Finance and Economy, but should be subject to review by the independent auditor (see section 4.4.2.3).

Whilst they appear conscientious, the current level of knowledge of insurance and of sound supervisory practice amongst the staff of the existing supervisor is, in our view, very low. We therefore recommend that there is an acute need for **training of staff** on several fronts:

- training on the new Law specifically, to allow staff to become fully familiar with it and its associated regulations, the obligations these place on insurers and brokers, and the powers and obligations they confer on the supervisory authority;
- management training for senior staff, including in particular members of the executive;
- training on sound supervisory practice generally, and on specific aspects of it, e.g. on-site inspection (see section 4.4.3.5);
- professional and technical training for at least some of the staff on insurance and related matters, including accounting and (for a few) actuarial;
- training in information technology, assuming that greater use is to be made of computers in future (see section 4.4.3.3).

Initial **training on the new Law** can and should be provided internally by senior staff in the supervisory authority. However, this will need to be supplemented by training provided by external consultants once detailed regulations and internal procedures have been drawn up. It is desirable that this training be provided by the same consultants as those giving advice on the drafting of the regulations and procedures, although this is not essential.

Training on sound supervisory practice generally should be provided primarily by external consultants. The recommendations in this report represent a first step in this direction; however much more needs to be done in the light of the development of regulations and procedures, with the objectives of producing a **supervision manual** for use by staff of the supervisory authority and providing face to face training on this. Some self-training should also be undertaken by staff of the supervisory authority being encouraged to refer to internationally accepted best practice in insurance supervision, and in particular to IAIS standards. The supervisory authority should also actively seek to gain what information it can through direct contact with foreign insurance regulators, and particularly those in other CIS countries with larger, more developed insurance markets.

Technical training might be obtained from a number of sources:

- Yerevan State University and the Institute of National Economy are developing accountancy training programs based on the Association of Chartered Certified Accountants (ACCA) curriculum, and Yerevan State University is also developing a 2-year actuarial training program, both financed by USAID. Subject to the quality of these courses being satisfactory (the content of these should, and we assume is, western and not Russian), some staff of the supervisory authority should be encouraged to attend them. We understand that the EU University in Yerevan may also, now or in the near future, be able to offer suitable courses in insurance;
- self-training should be undertaken by staff of the supervisory authority being encouraged to take out available correspondence courses in insurance, and in particular at least the early parts of the Chartered Insurance Institute (CII) curriculum. The "core reading" issued by the UK Faculty and Institute of Actuaries provides useful actuarial material suitable for self-study;
- training on insurance and related matters should also be obtained from external consultants.

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Day release should be offered to staff for study purposes, and financial rewards given to those passing exams.

The supervisory authority should actively seek to recruit several new staff with insurance and related skills immediately if possible, to allow transfer of these skills to other staff. We recommend that CII qualification should be required of these, and that this should also be a preferred requirement for all staff wishing to join the authority in the future generally. We also suggest that the supervisory authority actively considers work placements from, for example, AISEC (a French organisation specialising in exchange visits), as these too are helpful in transferring relevant skills.

The development of relevant skills within the supervisory authority in general, and training in particular, should be subject to a pre-determined timescale, compliance with which can then be monitored by the Ministry of Finance and Economy and the sponsor of such external technical assistance as is provided. We also recommend that it is desirable for longer term mentoring to be provided to the supervisory authority by external consultants, particularly in specialist areas such as actuarial, where assistance might be provided on an ongoing basis under contract. Ultimately, the supervisory authority should aim to have, ideally in house but otherwise from external advisors free from conflicts of interest, accounting and audit, actuarial, asset valuation, investment management and loss evaluation expertise.

3.4.3.3 Structure and general practice

The existing supervisor is divided into three units: licensing and supervision; financial reporting; and methodology. Each unit has a head member of staff. Internal staff discussion within each unit is initially with the unit head, with any disputes being referred to Mr Gomtsyan. The unit heads are responsible for passing information from one unit to another as appropriate, including in particular any identified shortcomings in legislation to the methodology unit, but no formal meetings of the unit heads take place. There is quite close liaison between Mr Gomtsyan and the staff, but all decisions are taken by him.

Whilst the above unit structure has some logic, the number of licence applications received each year is currently very low (see section 4.4.3.6) and much of the work currently undertaken by the methodology unit (see section 4.4.3.8) will be transferred to the separate policy advice unit within the Ministry of Finance and Economy (see section 4.4.4) under our recommendations.

For these reasons, and to foster an increased sense of ownership and responsibility towards individual supervised entities, we recommend for **the future** that the insurance supervisory authority is **restructured** so that ordinary members of staff have a specific allocation of insurers and brokers, for all aspects of the operations of which they have individual responsibility as a **supervisor**. The current unit heads should act as **managers** of these supervisors, ensuring consistency of approach between them. Licence applications should be dealt with by one supervisor and one manager working in conjunction (see section 4.4.3.6), and similarly on-site inspections (see section 4.4.3.5). Such policy work as remains within the supervisory authority, which should be firmly focused on delivering sound supervision and protecting the public interest and probably continue to include for the time being disputes settlement, should be undertaken by the managers (see section 4.4.3.8). The executive, with assistance from the managers, should be responsible for preparation of the annual report (see section 4.4.3.9). Consideration might be given to establishing a small internal legal team.

We recommend that there should be **increased delegation** of responsibility, including decision making on certain issues, in the supervisory authority. This should help to encourage initiative and confidence amongst staff, and also allow past experience gained lower down the organisation to filter upwards. However, there should be clear guidelines as to the issues falling into this category, with the head taking all decisions relating to important matters. Work done by the supervisors should be subject to review by the managers, and that done by the managers to review by the head.

All staff should observe the following **general practices** when communicating with insurers or brokers:

- supervision should always be within the powers conferred on the supervisory authority by the new Law, and extreme care should be taken to ensure that, before exercising any functions, sufficient grounds exist for doing so;
- the aim should be to intervene promptly in an insurer's or broker's affairs when, and only when, action is appropriate, having made full and suitable use of all available data in arriving at a judgement of its position; action should be based on a sound understanding of the underlying issues;
- care should be taken to reserve the supervisory authority's position when writing to an insurer or broker for more information etc, in order to avoid giving a false impression that further action will not be taken;
- all letters to insurers and brokers relating to non-compliance with the Law should cite the relevant sections of the Law or its associated regulations whether the letter is formal or not;
- where policy considerations are involved, it is important that staff should talk to each other and particularly to the managers; expertise or past experience relating to the issue in question may exist elsewhere in the supervisory authority, which consultation will reveal.

Legal advice should be requested in appropriate circumstances. Guidelines should be established for when this might be appropriate, e.g. in relation to liquidation and winding up, and for the processes to be followed when seeking and receiving such advice. Similar comments apply to accounting, actuarial and other specialist advice. Staff should be aware, however, that all powers under the new Law are conferred on, and must be exercised by, the supervisory authority.

The supervisory authority should exchange information with foreign insurance regulators as appropriate, and consult and co-operate with other stakeholders within and without the civil

service on matters relating to the sound operation of insurers and brokers. It should also participate in international insurance supervisory bodies, and specifically the IAIS of which it should seek to become a full member in due course.

The existing supervisor makes only limited use of **computers** (see section 4.4.3.4), which are generally old. The supervisory authority should replace these and extend their use, hiring external consultants to advise on how best to do this, to design appropriate databases and to provide relevant training to staff, as necessary. The general **working environment** should also be improved, with new offices, more space and better equipment.

3.4.3.4 Financial monitoring

Data in a prescribed format is submitted by insurers under the existing Law and associated regulations (see section 5.5.1.2) on a quarterly basis to the existing supervisor. This includes a balance sheet, profit and loss account, cash flow statement and a statement of the movement in equity. However, these are produced on a whole company basis only; no data is provided separately for individual classes of business.

The financial reporting unit of the existing supervisor stores some of this data on computer, including assets, sums assured, premiums, reserves and capital. Expenses are not collected. The assets data is restricted to total values by sector; no individual assets are identified. Temporal comparisons are made only annually, based on audited figures. This is to get a picture of the insurance market as a whole and also to identify any outliers among individual insurers. However, no genuine peer comparisons are made, ratios calculated, or questions asked. The main things looked for by the unit are breaches of the reporting and reserving/asset allocation regulations (see section 5.4.1.2), and low and/or reducing levels of capital. Concerns identified are relayed to the supervision unit for it to consider what action to take in response.

Staff in the unit does not appear to appreciate why data by class might be useful, both to the insurers themselves and for supervision, or have any clear idea of accruals or how to calculate loss and expense ratios.

The above level of financial monitoring, in part constrained by the very rudimentary nature of the data submitted by insurers, is **inadequate** for effective supervision. The monitoring process carried out by the insurance supervisory authority in **the future** under section 37 of the new Law should therefore be improved, taking advantage of the enhanced reporting requirements recommended in section 5.5.

The main **objectives** of the monitoring process should be to:

- form a view as to the overall solvency of the supervised entity;
- form a view as to the overall strength of the reserves it holds;
- assess the risks inherent in its business, the likelihood of these risks occurring and the impact that this would have on the insurance market;
- identify any breach of the minimum capital requirements;
- identify any material breaches of relevant regulations, including those relating to reporting, reserving and asset allocation.

The assessment of reserves is relatively straightforward for some types of reserve for which the method of calculation is prescribed, reducing to a check of compliance with the relevant requirements. However for other types, most notably outstanding claims reserves for general business and reserves for life business, it is a demanding task, involving significant amounts

of judgement. It will inevitably be a quite a long time before staff of the supervisory authority is able to perform this task effectively, and there is a need for **technical training** from external consultants on this issue in the meantime.

To begin with, we recommend that the monitoring process conducted by the supervisory authority should focus on:

- for each insurer, checking compliance with reporting requirements (see section 5.5.2.2) and the "minimum financial standards" and associated regulations covering reserving and asset allocation (see section 5.4.2.2) but taking any "soft" reserves (i.e. those for which the calculation is not prescribed) largely as a given;
- storing the following key items of data, for each insurer and in total:
  - total assets;
  - total liabilities;
  - written premiums, for each of the most important classes (see section 5.9.5) and in total, gross and net of reinsurance;
  - earned premiums, for each of the most important classes and in total, gross and net of reinsurance;
  - claims paid, for each of the most important classes and in total, gross and net of reinsurance;
  - claims incurred, for each of the most important classes and in total, gross and net of reinsurance;
  - expenses and commissions, for each of the most important classes and in total, gross and net of reinsurance;
- calculating, and identifying any adverse trends in, the following key ratios (net means net of reinsurance):
  - free assets ratio, calculated as (assets – liabilities) / liabilities;
  - ratio of free assets to earned premiums, calculated as (assets – liabilities) / total net earned premiums;
  - reinsurance ratio, calculated as net written premiums / gross written premiums, for each of the most important classes and in total;
  - loss ratio, calculated as net claims incurred / net earned premiums, for each of the most important classes and in total;
  - expense ratio, calculated as net expenses and commissions / net earned premiums, for each of the most important classes and in total;
  - reserves ratio, calculated as total net reserves / total net written premiums;
- making comparisons between insurers in respect of the above data items and ratios, with the objective of identifying outliers and how individual insurers compare with the industry market average.

When checking compliance with the regulations covering reporting, the supervisory authority should identify any omissions; ensure that any items which should cross-check do so; check compliance with any instructions to forms; check any notes attaching to forms; and make "reasonableness checks" where appropriate. Material non-compliance with any statutory

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requirements should be raised with the insurer or broker. Similarly any points which are ambiguous and require further explanation or which give potential cause for concern either immediately or in the foreseeable future. Questions should also be asked where a particular aspect of an insurer's operations is significantly worse than the industry market average.

The supervisory authority should also take into account non-financial risk factors when forming a view of individual insurers, including, for example, any evidence of corruption or fraud; otherwise adverse impressions of management; over-reliance on one individual; a lack of ready access to additional capital; and known group problems.

Given our comments on the existing supervisor above, there is a need for **immediate technical training** from external consultants for its staff to allow the supervisory authority to perform even the initial level of monitoring recommended above.

In the longer term, the supervisory authority should seek to identify and assess the level of risk run by each of the entities it supervises, having regard to all of the following types of risk:

- capital risk;
- reserve risk;
- asset risk, including market, credit (including reinsurance) and liquidity (including currency and mismatching) risk;
- strategy/environment risk, including legal, tax and regulatory risk;
- control/operational risk;
- group and contagion risk;

and to the different scales at which such risks operate:

- individual company;
- industry sector;
- whole industry;
- wider/global;

and adopt a risk based approach to its supervision, based on an assessment of both the probably of financial failure of the entity, reflecting the assessed level of risk, and the impact that that failure would have on the insurance market, having regard to the size and position of the entity within it.

To do this effectively, the supervisory authority will need to be able to appraise reserve strength properly. This will involve analysing claims reserves and in particular reviewing run-off triangles submitted by insurers by that time, and will require significant external technical assistance to be provided. It will also need to supplement the financial data submitted by insurers and brokers by information obtained from other sources, including for example:

- advice from specialists;
- findings from on-site inspections;
- any other information obtained through the exercise of intervention powers;
- discussions with insurers and brokers;
- discussions with auditors;
- discussions with other Armenian regulators, including the Central Bank;
- discussions with foreign insurance regulators, where relevant;
- discussions with the Insurers Association of Armenia;
- discussions with professional bodies;

- discussions with consumer groups;
- the views of industry practitioners.

Particularly if electronic submission of financial statements is to be required as suggested in section 5.5.2.2, we recommend that the insurance supervisor should consider investing in information technology to allow at least some of the financial analysis described above (e.g. cross-checks, calculation of ratios, etc) to be automated.

3.4.3.5 On-site inspections

The licensing and supervision unit of the existing supervisor carries out inspection visits, as provided for by Article 29(4) of the existing Law. These take place not more than once a year for each insurer; there is no prescribed minimum frequency. Visits are scheduled in advance and authorised by the Minister of Finance and Economy, who also sets their scope. Insurers and brokers are given 3 days' notice of visits and are also advised of their scope.

The visits are comprehensive, taking about 15 days to complete on average, and are conducted by two or three staff; Mr Gomtsyan is never involved. The most important tasks undertaken are checking compliance with the regulations; the legality of contracts and their compliance with the existing Law; the validity of claims; and that reinsurance arrangements comply with the terms of agreed treaties. Reserves are checked against the regulations to the extent possible on a policy by policy basis (with sampling if there are too many). There appears to be no real checking of insurers' systems and controls: the visits are essentially an audit of the policies in force.

Visits are followed up with a report, which is looked at by Mr Gomtsyan. The existing Law is weak on sanctions if problems are identified: it provides for an initial warning and for the withdrawal of licence but nothing in between. Serious breaches of the Law are referred to lawyers and then to the "licensing committee" which decides whether the licence should be withdrawn; for minor breaches, the existing supervisor can act on its own account. The licensing committee is located within the Ministry of Finance and Economy and comprises 7 people, of whom 3 are from the existing supervisor and the other 4 are other heads of department in the Ministry of Finance and Economy or lawyers.

This existing practice provides a basis for on-site inspections to be carried out by the insurance supervisory authority in **the future** under Article 37 of the new Law. Visits would typically be much shorter in other jurisdictions, but some detailed checking of contracts and the validity of claims in particular seems appropriate in Armenia, given the prevalence of malpractice in these areas in the past (see section 3.11.4). However, it is important that inspections are carried out as efficiently as possible, and the supervisory authority should actively seek to shorten these (this will become necessary in any event as the hoped for development of the insurance market materialises) whilst at the same time broaden their scope as described below. As noted in section 4.4.1, it may be necessary to widen the wording of Article 37(4)(b) to permit this broadening of scope.

On-site inspection provides information that supplements the analysis of the financial information sent to the supervisory authority. It allows the capture of reliable data and information about an insurer in order to help assess its current and prospective solvency position, and provides an opportunity to gain some understanding of its business objectives and plans. It also might enable the supervisory authority to obtain information and detect problems that it would not otherwise, for example by:

- identifying problems that the insurer might be ignoring or hiding;

- offering the opportunity to have a personal relationship with the managers, which might inform an assessment of them;
- enabling an assessment to be made of the management's decision-making processes and internal controls;
- dissuading insurers from engaging in corruption or other illegal or improper activities;
- providing an opportunity to analyse the impact of specific regulations and, more generally, to gather information for benchmarking.

It can also be of assistance in dealing with insurers' problems: for example, the supervisory authority:

- may be able to persuade the insurer's management to take action to avoid current or future problems through dialogue, which may be more efficient than taking statutory action;
- can use on-site inspections as an opportunity to provide insurers with information, especially concerning new legislation which might need to be explained in order to avoid misinterpretation.

The main **objectives** of on-site inspection, in relation to an insurer, should be to:

- evaluate its treatment of policyholders, and determine whether unlawful or improper activities are engaged in at their expense or against the public interest;
- check its compliance with legislative requirements;
- appraise its assets and liabilities, its balance of operations, and the technical conduct of its insurance business (e.g. reserving, business plans, investment policy, reinsurance policy);
- assess its accounting and internal control systems, and its corporate governance;
- detect problems that may arise from its organisation or its belonging to a group;
- identify its risk profile, the controls it has in place to manage risks, and detect problems that may affect its capacity to meet its obligations to policyholders in the short and long term.

It is not realistic to expect the supervisory authority to be able to perform all these tasks effectively from the start. To do this requires a proper assessment of the risk profile of the insurer, taking into account all the types of risk listed in section 4.4.3.4, and an appraisal of the systems that the insurer has in place to mitigate these risks, which is necessarily a longer term objective. However, the supervisory authority should actively seek to extend the inspection process beyond mechanical checking of compliance with regulations and examination of contracts and claims to also cover some of the other items listed above, including in particular corporate governance, strategic planning and systems and controls, as soon as possible, obtaining relevant **technical training** as appropriate.

Inspections should be more frequent and in depth when they concern insurers that are in financial difficulties or have a high risk profile, but in any event should be carried out for every insurer at least once every 3 years. A change in the senior management or in the objectives and business plan of the insurer might be a sufficient reason for a new inspection. Consideration might also be given to having intermediate, lower level, inspections.

The inspection should begin with an overview of the insurer in order to properly plan and focus the fieldwork. This should be in the context of the overall insurance industry position

and the insurer's position in it, as well as the broader economic picture. It is likely to encompass, among other things, industry level statistics; the level of competition in the market; the basis for competitive advantage; barriers to entry and the threat of new products; and the relative bargaining power of insurers relative to intermediaries and customers. The inspection should be customised to the insurer's particular features, and to any problems detected on-site. During or at least at the end of the inspection, the supervisory authority should discuss its findings with the insurer and take into account, as appropriate, any relevant comments made by its management. The supervisory authority should prepare a written report for itself on its findings and if appropriate write to the insurer setting out its areas of concern and any action it expects the insurer to take as a result. Follow up action should be taken by the supervisory authority to ensure that corrective action, when identified, has been acted upon by the insurer.

On-site inspection should be carried out by the supervisor responsible for the ongoing monitoring of the insurer and his manager to ensure co-ordination. The manager should consider the allocation of supervisory tasks involved in the inspection between him/her and the supervisor, and whether it is appropriate to outsource parts of the inspection. Assistance from external auditors or actuaries may be very useful and maximize flexibility but the supervisory authority should retain full responsibility for the inspection.

3.4.3.6 Licence applications

The licensing and supervision unit in the existing supervisor checks that all the documents required as part of the licence application under the existing Law and associated regulations (see section 5.3.1.2) have been provided.

Only the directors and chief accountant of the applicant have to be named in the application. These posts are subject to qualification requirements. Qualification certificates are issued by the Ministry of Finance and Economy on the successful completion of examinations. Alternatively, individuals having at least 3 years' experience in the insurance industry have equivalent status. In practice, a list of acceptable people is held by the Ministry and those named in the application checked against this.

The regulations require the submission of a business plan in a prescribed format, but there is no direct link between capital requirements and the business proposals of the applicant. Provided the minimum capital requirement under the Law is met, all that is required is observance of the "normative ratio", with risk above this level needing to be reinsured (see section 5.4.1.2).

The decision to approve or reject the application is taken by a committee in the Ministry of Finance and Economy. This comprises 7 people, 3 of whom are from the existing supervisor; the other 4 are other heads of department in the Ministry or lawyers. The decision is taken by majority vote.

Licence applications have to be processed within 30 days; if the committee has not voted by that time, the licence is issued by default. Applicants are met and issues arising discussed as part of the application process, and legal advice is sought as necessary. If the application is rejected, a fresh one can generally be made straight away, depending on the reasons given for rejection (i.e. if there is any point). There is an appeals procedure to the courts against the committee's decision. In the case of applications with minor deficiencies, approval of the application can be granted on a conditional basis, with correction of the deficiencies required within 10 days. Otherwise, however, the licence decision is black and white. There is no current practice of imposing more onerous requirements for a temporary period on insurers

which have recently been licensed. There are currently very few licence applications (around one a year on average).

This existing practice provides a basis for the assessment of licence applications by the insurance supervisory authority in **the future** under section 40 of the new Law.

The **purpose** of licensing insurers is to enable the supervisory authority to exercise control over entrants to the market, and in particular to prevent applicants which do not have viable business proposals or suitable managers and controllers from entering it, to protect the interests of policyholders and to maintain confidence in the industry.

The assessment of the licence application by the supervisory authority should be **objective**, and **based on** an appraisal of the **level of risk** presented by the applicant to policyholders. This appraisal should be made on a sound basis, taking into account all relevant information available, including in particular the enhanced business plan and information on managers and controllers submitted as part of the application recommended in section 5.3.2.2. Licence applications should be dealt with by one supervisor and their manager working in conjunction.

The assessment of the business plan should focus on its overall viability and in particular the projected solvency position of the insurer. It should be a pre-requisite for it to be acceptable for it to demonstrate that the insurer will be able to meet the "minimum financial standards" recommended in section 5.4.2 **throughout** the 3-year period covered by it. The assessment of persons holding key positions in the insurer should focus on their experience of insurance, competence and propriety. In cases where there is doubt over any of these issues, the supervisory authority should be prepared to reject the application.

In the case of an extension of authorisation (see section 5.3.2.2), the supervisory authority should pay close regard to the claims and expenses experienced by the insurer in respect of its existing business, its general standing, and whether there are any perceived problems with the extension.

Following the granting of a licence, we recommend that the supervisory authority should consider exercising appropriate intervention powers (see section 5.6) to impose requirements on the new insurer to strengthen its level of control over the insurer during its early years. Where this is not done, there should, as a minimum, be an initial period of heightened supervision, during which the insurer's performance is monitored closely, with the objective of evaluating the extent to which this is in line with that projected in the business plan, and to allow the authority to take appropriate action where this performance is significantly worse than expected or otherwise gives cause for concern.

As noted in sections 4.4.1 and 5.3.2.2, we doubt how appropriate it is for the supervisory authority to be involved in conducting qualification examinations and issuing qualification certificates, as provided for by Article 16 and reflected in Article 37(2) of the draft new Law, other than in the next few years.

Because of its current limited skills base and the demanding nature of the task, we strongly recommend that the supervisory authority should seek external **technical assistance** in its assessment of licence applications in the next few years. This should not be unduly costly given the current low level of market activity and number of applications.

3.4.3.7 Intervention

The licensing and supervision unit of the existing supervisor is responsible for taking appropriate action in respect of insurers where, based on information provided by the

financial reporting unit, on-site inspections or otherwise, their operations or financial position give cause for concern. However, the existing Law provides only very limited intervention powers; in particular, there are no measures open to the existing supervisor between merely giving warnings and cancelling or limiting the insurer's licence (see section 5.6.1.2).

For **the future**, the draft new Law provides the insurance supervisory authority with greatly increased intervention powers, a review and possible further enhancement of which we have recommended in section 5.6 should be considered. Recommendations relating to the practice that should be adopted by the supervisory authority in this new environment are set out below.

Where insurers fail to meet supervisory requirements, and where their continued solvency comes into question, the supervisory authority should intervene to protect the interests of policyholders. It should make use of the intervention powers available to it to take timely and effective action, including both preventative and corrective measures.

The action taken by the supervisory authority should be both suitable and necessary to achieve its supervisory objectives. Depending on the nature of the problem identified, a graduated response may be required. The supervisory authority, preferably working in cooperation with the management of the insurer, should identify remedial measures that are necessary and establish a timetable for their completion. It should enforce corrective action and, where necessary, impose sanctions.

The supervisory authority should make use of sanctions only when this is necessary and serves a useful supervisory purpose. In particular, **on no account** should they be used simply as a means of raising money for the state through the imposition of financial penalties, or placing insurers and their officials under unnecessary duress.

Supervision should always be within the powers conferred on the supervisory authority by the new Law, and extreme care should be taken by the authority to ensure that, before exercising any functions, sufficient grounds exist for doing so. The aim should be to intervene promptly in an insurer's affairs when, and only when, action is appropriate, having made full and suitable use of all available data in arriving at a judgement of its position. Action should be based on a sound understanding of the underlying issues, and where the supervisory authority has any doubt over its capability or competence in assessing these, it should seek external **technical assistance**. The supervisory authority should not shy away from taking firm action where this is necessary,

It is not possible to specify the contents of **action plans** for rectifying breaches of "minimum financial standards" (see sections 5.4 and 5.6) as the circumstances of each individual case will vary. To be acceptable, however, such a plan should provide for the breach to be rectified within a specified timescale, which should be clear to both the insurer and the supervisory authority. What is an acceptable timescale will depend on the severity of the breach and on the remedial action required or proposed; where the breach is of a "technical" nature, this timescale should generally be short.

The supervisory authority should monitor progress against the agreed action plan carefully. Exercise of other intervention powers might be considered in this context, for example that under Article 37(4) of the new Law to make enquiries of the insurer where it is considered that the interests of policyholders may be at risk, the primary objective being to identify as early as possible any material departure from the plan, and/or any time at which the likelihood of its eventual materialisation falls below an acceptable level. In such circumstances, serious consideration should be given to **suspension of** the insurer's **licence**,

subject to the insurer first being given the opportunity to explain the reasons for the non-materialisation of the plan and how these might be overcome.

Termination of an insurer's **licence** is a serious matter, and one that can only be taken on the grounds listed in Article 50(1) of the new Law.

In addition to its powers under the new Law, the supervisory authority enjoys the benefit of the general principle that everything is permitted in law unless it is prohibited. This provides it with the option to take **informal action**. This might be the most appropriate response in the cases of relatively minor violations of the new Law. Other forms of informal intervention action quite commonly used by insurance supervisors include:

- accepting undertakings;
- suggesting a course of action to an insurer;
- interpretation of the Law and its associated regulations for insurers and the public;
- informal investigation of possible unlicensed activity;
- reporting unprofessional conduct to relevant professional bodies;
- informal requests for additional information.

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3.4.3.8 Methodology unit

The methodology unit in the existing supervisor comprises four staff including the unit head, which post is currently vacant but about to be filled.

The unit looks at international material, including IAIS standards provided in the past as part of USAID funded technical assistance. It tries to analyse the extent to which Armenian insurance law complies with these, and makes recommendations to improve this compliance, for implementation by the other units. It has had the responsibility for producing the draft new Law, in consultation with the other units.

The unit is also responsible for developing state policy on insurance. It is the only source of advice to the Ministry of Finance and Economy on insurance matters, although the national statistics department also sometimes provides relevant data. It also processes comments and recommendations made by other ministries relating to insurance.

The unit responds to letters received from policyholders. A turn round time of 3-4 days is set for this. The main complaints received relate to fraudulent practice and the former Soviet insurers which had not honoured claims against them; impoverishment caused by the replacement of the Soviet rouble with the AMD also featured large (see section 3.3.1).

The unit is also involved in settling disputes, although these were often of a factual nature. Decisions taken by the unit in this regard can be appealed to the courts.

For **the future**, we recommend that the work currently undertaken by the unit on developing state policy on insurance should transfer to the separate policy advice unit within the Ministry of Finance and Economy recommended in section 4.4.1. Such policy work as remains within the supervisory authority, which should be firmly focused on delivering sound supervision and protecting the public interest and include the unit's other existing functions, should be undertaken by the managers. As noted in section 4.4.1, we would question how appropriate it is for the supervisory authority to continue to be involved in the settlement of disputes, as provided for by Article 53 of the draft new Law. However, given that its decisions in this regard can be appealed to the courts under Article 53(3), we do not regard this as a serious issue in the next 5 years, subject to the precise role of the insurance supervisor in this regard being clarified and strengthened as appropriate. In the longer term, however, we recommend

that consideration should be given to the establishment of an independent dispute resolution mechanism.

3.4.3.9 Annual report, annual public meeting and providing information to the public and insurers

The **annual report** to the Ministry of Finance and Economy recommended in section 4.4.1, which should be laid before parliament and published, should be produced by the executive with assistance from the managers, and have the scope described in section 4.4.2.2. This includes some statistical data on the supervised entities.

The existing supervisor publishes only very limited market data covering just total market premiums, reinsurance premiums, paid claims, sums assured and numbers of contracts. No data is provided for individual insurers, or for individual classes of business. (Individual insurers themselves are required to publish some information.) This is the least information published by any insurance regulator amongst the CIS countries.

This level of disclosure is inadequate for the recommended annual report, and should be enhanced to include data for individual insurers and classes of business. This should include as a minimum, for each insurer:

- total assets;
- total liabilities;
- written premiums, for each of the most important classes and in total, net and gross of reinsurance;
- claims paid, for each of the most important classes and in total, net and gross of reinsurance;

and ideally all the data items listed in section 4.4.3.4, together with at least some of the ratios listed in that section. The level of disclosure should be increased in time.

The **annual public meeting** to discuss the annual report recommended in section 4.4.1 should be attended by the executive. The supervisory authority should ensure that at least one month's notice of the meeting is provided.

As well as producing the annual report, the supervisory authority should also be proactive in releasing to the public directly such other information (in reports, pamphlets, etc) as it considers necessary for the purposes of increasing public awareness of insurance. This should, for example, describe its role in ensuring the safety of insurance products, promote risk management, and provide relevant statistical data for the public and the insurance industry.

It should give particular priority to the collection and distribution of data that can be used for estimating future financial loss, and hence for the pricing of products and reserving. For example, if this is not already provided in the annual report, it should provide details of numbers of claims (and of policies in force so that claims frequency can be determined), average claim amount and maximum claim amount for each of the most important classes of business for the market as a whole.

It should research and publish a list of centres of data analysis that have relevance to private insurance to ensure that the existence of these is known to insurers and other interested parties.

It should also seek to publish statistical information based on actual claims data which it has previously collected from insurers and collated. It should be proactive in researching whether insurers in Armenia would be prepared to submit such data in this way. If not, it should

suggest instead that insurers submit data in an agreed format to an independent third party, which would be responsible for analysing it and passing the results back to the supervisory authority for publication. This is likely to have the advantage that insurers would be willing to provide more detailed (and hence potentially more useful) data to such a third party than they would to the supervisory authority.

The supervisory authority should also be proactive in presenting information to the public on its role in ensuring the safety of insurance products. It should consider giving details of some the work undertaken during on-site inspections in this regard, and to promoting awareness of the new power that it has under Article 37(4) of the new Law to carry out surveys amongst policyholders to check the validity and adequacy of claims, giving details of how it intends to exercise this power in practice.

Members of the executive should, without any special authorisations, be ready to provide information to the public on the supervisory authority's objectives and the exercise of its functions in pursuit of those objectives. A designated member of staff should be made responsible for providing information to third parties and for public relations generally.

3.4.4 Policy advice unit

The policy advice unit within the Ministry of Finance and Economy recommended in section 4.4.1 should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry, the promotion of competition within it, the maintenance of sound principles of insurance regulation, and the promotion and delivery of public education on insurance matters. In doing so, it should take a holistic view, taking into account not only supervisory issues but also wider micro- and macro-economic trends.

The unit should also have responsibility for advising the government on the performance of the independent insurance supervisory authority, by monitoring and reporting on how well it is meeting its objectives. Failure by the supervisory authority in this regard might reasonably and objectively be indicated or measured by:

- significant insurer failures and/or losses for policyholders;
- incidences of corruption, fraud, money laundering or other financial crime;
- significant mismanagement or misconduct;
- significant market abuse or malfunction;
- widespread financial illiteracy or inadequate public understanding of particular products or services;
- successful litigation against the supervisory authority on grounds of inconsistency or failure to meet its obligations under the new Law;
- failure to meet pre-agreed targets relating to the development of relevant skills within the authority in general and to training in particular (see section 4.4.3.2).

The unit should make use of the annual report described in section 4.4.3.9 submitted by the supervisory authority to the Ministry of Finance and Economy in performing this task. The unit should also review and advise the Ministry on those parts of the report covering the supervisory authority's views on the conditions for effective insurance supervision; its general observations on the insurance market; the key risks and industry specific vulnerabilities that it has identified and its outline specific plans for redressing the weaknesses.

The unit should engage in regular consultation with industry stakeholders, including representatives of insurers, insurance intermediaries, those involved in insurance education, professional bodies of the audit and actuarial professions and consumers, as well as with officials from other ministries and staff of the insurance supervisory authority, and should make regular reports to the government on the development of the insurance market. It should also encourage and facilitate training in insurance.

We recommend that the unit should comprise three members, with one appointed its head. We suggest that the first head might be the deputy head of the existing supervisor and head of its methodology unit (this post is currently vacant but is about to be filled). Whilst the other two appointees might also be drawn from the staff of the existing supervisor or elsewhere within the Ministry of Finance and Economy, we recommend that at least one of them should have strong competition background.

3.4.5 Timescale and transitional arrangements

The **policy advice unit** within the Ministry of Finance and Economy should be established as **soon as possible** and in any event **by the time of the establishment of the independent insurance supervisory authority**.

The **independent insurance supervisory authority** should be established **as soon as possible**, and **no later than 31 December 2005**. In the interim, supervision of insurance should be carried out by the existing insurance supervisor. This should operate having regard to the principles and practices recommended in sections 4.4.2 and 4.4.3 in so far as these are currently relevant and practical. It should aim to produce a first annual report for the Ministry of Finance and Economy in the terms recommended in section 4.4.3.9 for the year 2004.

The recommended **changes to** the **draft new Law** should be made at its second reading in parliament around now. Development of the associated **regulations and internal procedures** of which we have recommended the nature and outline content is not such an urgent priority but should be completed as **soon as possible**, and **no later than 31 December 2005**.

3.4.6 Comparison with other states

The structure of insurance regulation and supervision in other CIS states varies. In both Georgia and the Ukraine, the insurance supervisor is an independent body, as recommended for Armenia, with that in Georgia financed by a levy on gross market premiums. In Kazakhstan, responsibility for supervision of insurance rests with the central bank. In both Uzbekistan and Azerbaijan, the insurance supervisor remains a department within the Ministry of Finance.

As implied in section 4.3, it is best practice in western countries for there to be an independent insurance supervisor, together with a separate source of policy advice to government on insurance matters. The reasons why we have recommended this model as being appropriate for Armenia are as set out in section 4.3.3.

4 SUPERVISORY LEGISLATION

4.1 Introduction

Under item 1 of the signed contract, we are required to:

- in consultation with the existing insurance supervisory authority and other relevant government and market bodies (as appropriate), review all relevant insurance market supervisory legislation, both existing and proposed, including regulations and decrees;
- identify the legislative developments needed to provide a coherent legal framework for the supervision of the insurance market including, inter alia, authorisation, financial monitoring, intervention powers, transfers of business and liquidation/winding up;
- identify the nature and outline content of the regulations and decrees required to strengthen market solvency including capital reserving requirements, attendant investment rules and reinsurance regulations;
- recommend the appropriate balance between prudential supervision, market self regulation and centralised control.

Our findings and recommendations on this part of the project other than those relating to the structure of the insurance supervisor are set out in the sections 5.2 to 5.9 below. The structure of insurance supervisor is covered in section 4.

4.2 Overview

4.2.1 Principles

It is desirable that insurance supervisory legislation in Armenia develops in time to a position that compares well with all IAIS principles. However, it is, in our opinion neither feasible nor desirable to require full compliance with these principles in the next 5 years.

This reflects the current nascent state of the insurance industry, of which not too much should be expected too soon. There is a need to nurture this to some extent initially, and not to regulate it out of existence: development of the market and of its regulation need to go hand in hand. In particular, it should be recognised that it will take time to develop professional skills in both the insurance supervisor and insurers.

The recommendations made in section 5 therefore seek to have regard to the scale of the industry; only in areas where scale does not represent a real practical constraint are they more closely based on ideals. At the same time, however, they seek to ensure compliance with the most important IAIS principles from the outset, and to recognise the benefits that competition brings to policyholders.

There is a need for maximum flexibility whilst the insurance market develops, and consequently we recommend that the new Law should confine itself to setting out broad principles, with detailed provisions placed in regulations made under it. Because regulations can be changed by the insurance supervisor without the need for recourse to parliament, this allows provisions to be phased in or out as necessary with relative ease, and the insurance supervisor to respond quickly to events if needed.

Because of the continuing existence of corruption (see section 3.11.3) and the lack of mutual trust which currently exists between the public, insurers and the insurance supervisor, much of it for good reason (see section 3.11.4), we **rule out** any form of **self regulation** by the insurance industry in Armenia, at least in the shorter term. However, we also regard it as

important that **centralised control** should be **kept to a minimum**. Instead, the aim should be to create an environment in which insurers are subject to sound prudential standards enforced by an effective, independent insurance supervisor, whilst at the same time being placed under pressure to be competitive. Such an environment should provide protection for policyholders whilst at the same time encouraging innovation and efficiency in the market, to the benefit of both policyholders and the economy.

As well as taking the steps set out in the remainder of section 5, we recommend that a **further review** of Armenian insurance supervisory legislation is conducted **after 5 years** to appraise the changes made to it by then and to make recommendations for any further changes considered necessary at that time in the light of the development of the insurance market to that date.

4.2.2 Hogan report recommendations

The high level recommendations made in the Hogan report (see section 2.3) relating to supervisory legislation generally may be summarised as follows:

- the current review provides a golden opportunity to put key legislative foundations in place to assist development of the insurance market;
- a two pronged approach should be adopted, with framework legislation that sets out principles supported by detailed technical regulations;
- there should be an incremental legislative development program over a number of years, to allow the building of supervisory capacity and facilitate orderly market development; regulations should be rolled out and implemented over this period; a reasonable timeframe for this is 5 years;
- reaching IAIS standards in insurance supervision generally should be a long term goal, which will require significant external support and technical assistance;
- the overall aim should be to enact legislation which will give the insurance supervisor powers to supervise the industry and to enforce compliance with legislative requirements, with the ultimate objective of protecting policyholders; it is a good principle to assign powers to the insurance supervisor which in turn create or generate a series of reciprocal obligations for insurers and brokers;
- the insurance supervisor should have adequate powers to protect policyholders, including in the following areas: authorisations; changes of control; corporate governance and internal controls; prudential requirements; capital adequacy and solvency; reinsurance; financial and statistical reporting and monitoring; on site inspections; business conduct and relationships; penalties and sanctions; and confidentiality;
- the new Law highlights many of the broader supervisory and regulatory issues that need to be addressed; however they require significant reorganisation and elaboration, and there are a number of areas in which the new Law can be improved; certain issues need to be addressed from a contract law perspective.

As reflected in our comments in section 5.2.1, we generally concur with these high level findings, most of which have been reflected in the draft new Law as it now stands (see sections 5.3 to 5.9), although we regard 5 years as too short a timeframe in which to expect full compliance with IAIS standards as they might imply.

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However, in our view, a number of specific recommendations made in the Hogan report are unrealistic, expecting too much too soon of the insurance industry, or otherwise unhelpful. The most important of these are:

- those relating to risk management and solvency assessment, and in particular that for the adoption of the EU solvency margin regime;
- those relating to the roles and responsibilities of actuaries and external auditors, and in particular that requiring every insurer (life and non-life) to have an in house actuary;
- those relating to the content of financial statements to be submitted by insurers;
- that ruling out a new insurer being licensed for both life and non-life business.

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The recommendations in sections 5.3 to 5.9 are consistent with these comments, and such significant differences as we have with the comments and recommendations made in the Hogan report are highlighted in those sections. We have not commented specifically on the detailed legislative wordings suggested in the Hogan report, as this is not appropriate to the strategic level of the project and not required by its terms of reference (see section 2.1). However, in most cases these are much more complex than, and otherwise differ from, those we would have drafted, and, in our view, pay insufficient regard to the current reality of the Armenian insurance market.

4.2.3 Overall assessment

In the context of the principles set out in section 5.2.1, our overall assessment is that the draft new Law covers satisfactorily many of the supervisory and regulatory issues which need to be addressed. However, there are a number of aspects of this over which we have some reservations, including:

- its length and relative complexity, which we suggest might prove overambitious and potentially counter-productive in encouraging development of the market;
- the very detailed nature of some of its provisions, which we suggest would be better placed in regulations;
- its provisions relating to "basic economic norms", which we suggest should be replaced by a simpler and more effective set of "minimum financial standards" (see section 5.4.2.2);
- the inclusion of certain provisions which we consider unrealistic and unhelpful in the next 5 years, for example that requiring every insurer (life and non-life) to have an in house actuary within 2 years (see section 5.9.9); and the exclusion of certain other provisions which we consider to be important, e.g. that for financial statements to be prepared in accordance with international accounting principles (see section 5.5.2.2);
- the balance drawn between penalties and sanctions on one hand and measures to encourage orderly and sustained development of the industry on the other (see section 5.6.2.2);

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and there is clearly also a need for the development of regulations in a number of important areas.

The recommendations in sections 5.3 to 5.9 seek to address these points, whilst at the same time recognising the fact that the draft new Law has already received its first reading in parliament (see section 2.2), and that substantial changes to it are therefore unlikely to be a

practical option. Their emphasis is therefore on making significant but non-structural changes to the draft new Law, and outlining required regulations.

Sections 5.3 to 5.8 cover respectively the important areas of licensing; prudential requirements (relating to minimum capital requirements, reserves, assets, solvency, reinsurance and premiums); financial reporting; intervention powers; transfers of business; and liquidation/winding-up. Where relevant, and in accordance with the signed contract, they recommend the nature and outline content of regulations (or other legislative provisions) that should be made in these areas. However, as specifically excluded by the signed contract, they do not provide full drafts of these: drawing these up needs to be done later, as reflected in the subsequent technical assistance envisaged by the terms of reference for the project (see section 2.1), which process can be expected to take some time. Section 5.9 covers other areas in which we consider the draft new Law should be improved; these focus on apparent omissions and other perceived areas of weakness, even where these are not explicitly referred to in the signed contract.

Comments on the parts of the draft new Law relating directly to the structure of the insurance supervisor are included in section 4. Sections 5.3 to 5.9 should therefore be read in conjunction with section 4 for our views on the draft new Law as a whole.

4.3 Authorisation

4.3.1 Existing and proposed legislative requirements

4.3.1.1 Draft new Law

The Articles of the draft new Law which are relevant to the licensing of insurers and brokers are Articles 40 to 43 and 51.

Article 40 sets out the **basic principles** of the licensing process. It requires this to be carried out in accordance with the procedure defined in the new Law, the Law on Licensing, and other relevant legislation. The licence is the means by which the insurance supervisor grants permission to an insurer (broker) to carry out insurance (brokerage) activity; it records this fact; and also any terms or requirements relating to that activity, with which the insurer (broker) must comply. A separate licence must be issued in respect of each of any compulsory classes of insurance, which can be made subject to specific terms and conditions. Licences are issued on a permanent basis, and are non transferable. Licence applications must be determined by the insurance supervisor within 30 days. Licence approval is subject to payment by the insurer (broker) of a licensing fee.

Article 41 specifies the **documents to be submitted** as part of the licence application. For insurer applications, these include:

- the name, legal form and location of the applicant;
- the type of licensed activity proposed;
- copies of the applicant’s charter and registration certificate;
- copies of the professional qualification certificates of the applicant’s executive director, chief accountant and actuary; relevant documents pertaining to the appointment of these individuals; and samples of their signatures;
- the internal organisation chart of the applicant;

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- written statements from individuals with more than 10% shareholdings in the applicant and from its managers that their interests or positions in the company do not violate the requirements of Articles 16(3) and (2) respectively on propriety;
- a 3-year business plan, showing the types of business to be undertaken, and:
  - number of contracts;
  - sums assured;
  - premiums;
  - commissions;
  - bonuses (i.e. repayments upon expiry of term of contract);
  - franchise (i.e. claim amounts for which the insurer is not liable);
  - operational costs;
  - reserves and allocations of assets backing them;
  - reinsurance volume;
  - claims due;
  - profit (loss);

  where the figures in the business plan are calculated in accordance with requirements made under the Law;
- the balance sheet of the applicant at the month end preceding the application approved by the relevant authority; or for a new company, a note on the composition and structure of its assets and liabilities at the date of its registration, approved by the relevant authority or the applicant's executive director and chief accountant;
- rules relating to each type of business to be undertaken, including:
  - insurance object;
  - definition of claim events;
  - term of insurance;
  - procedures for and schedule of payment of insurance premiums;
  - mutual rights and responsibilities of the parties;
  - circumstances in which claims can be rejected;
  - procedures for the settlement of disputes and relating to the clarity of terms in insurance contracts;
- sample policy documents for each type of business to be undertaken;
- justification of the premiums for each type of business to be undertaken (see section 5.4);
- the previous year end balance sheets of any legal entities with more than 10% shareholdings in the applicant, approved by the relevant authority;
- relevant documents verifying the existence of the applicant's equity capital; and
- any other documents required under legislation.

Similar requirements also apply to broker applications, except those relating to the business plan, rules over insurance contracts, sample policy documents, justification of premiums and evidence of equity capital.

Article 42 specifies the **grounds on which** the **licence application may be rejected** by the insurance supervisor. For insurer applications, these include:

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- the documents submitted by the applicant under Article 41 are incomplete, fake, distorted or otherwise not in accordance with the Law and other relevant legislation;
- the applicant does not have the right to engage in the licensed activity proposed either under its charter or the Law;
- the proposed premiums are not justified (see section 5.4);
- failure of the applicant to comply with threshold rates of "basic economic norms" (see section 5.4);
- compliance with the requirements of Articles 16(2) and (3) has not been ensured;
- the rules relating to each type of business to be undertaken do not include all the information required by legislation or contain provisions contradicting this;
- the net assets of the applicant and/or legal entities having more than 10% shareholdings in it are less than "the amount of statutory capital";
- the figures in the business plan have not been calculated in accordance with requirements made under the Law;
- any other circumstances envisaged under the Law.

Similar grounds also apply to broker applications, except those relating to figures in the business plan, rules over insurance contracts, prudential requirements and justification of premiums.

Where a licence application is rejected by the insurance supervisor, the reasons and legal grounds for this must be stated. The applicant is permitted to submit a new application, starting the process again, in such circumstances.

In the case of non-material deficiencies in the licence application, the insurance supervisor may approve this subject to the condition that these deficiencies must be corrected by the applicant within 10 days; failure of the applicant to do so results in rejection of the application.

Article 43 covers **restatements** of licences. It requires an insurer (broker) making amendments to its charter to submit these to the insurance supervisor; and where it has changed its name, location or organisation, to apply to the supervisor for the restatement of its licence. Where reorganisation in the form of "spin off" or "division" involves the creation of new legal entities, the licence can be provided to them only based on the procedure set out in the Law for the granting of a licence. Restatements of licences must be recorded in the register of licences maintained by the insurance supervisor.

Article 51 provides for **appeals** to be made to the court against a decision taken by the insurance supervisor to reject an application for a licence or the restatement of a licence. It also covers qualification testing results. It provides for appeals to be made to the insurance supervisor beforehand, which are considered by committees or through hearings.

4.3.1.2 Existing Law

The licensing of insurers (only) is covered in **Article 30** of the existing Law and in **regulations** made under it.

Article 30(3) requires that insurers are licensed to carry out life and non-life voluntary and compulsory insurance, and to carry out reinsurance if their business consists exclusively of reinsurance. Article 30(2) requires that the licensing of insurers is carried out by the

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insurance supervisor. Article 30(4) provides for regulations to be made covering "the order of licensing, terms and criteria" of insurers.

The associated "regulations for licensing of the insurance activity in the Republic of Armenia" specify the procedure for the licensing of insurers. This is generally very similar to that contained in the draft new Law described in section 5.3.1.1, and for this reason it is not reproduced here.

4.3.2 Analysis and recommendations

4.3.2.1 Principles

The purpose of licensing insurers is to enable the insurance supervisor to exercise control over entrants to the market, and in particular to prevent applicants which do not have viable business proposals or suitable managers and controllers from entering it, to protect the interests of policyholders and to maintain confidence in the industry.

The licensing procedure in general, and the information which the applicant for a licence is required to submit to the insurance supervisor in particular, should be clearly defined and publicly disclosed.

The assessment of the licence application by the insurance supervisor should be objective, and based on an appraisal of the level of risk presented by the applicant to policyholders. This should take into account all relevant information that is available, and that which the applicant is required to submit to the insurance supervisor should be sufficient for this risk assessment to be made on a sound basis. It should therefore include relevant information on managers and controllers, as well as a business plan sufficient to facilitate an appraisal of the financial and business risk profile of the applicant.

After granting a licence, it is desirable that the insurance supervisor should monitor the performance of the recently licensed insurer to evaluate the extent to which this is in line with that projected in the business plan, and to allow it to take appropriate action where this performance is significantly worse than expected or otherwise gives cause for concern.

4.3.2.2 Draft new Law

In our view, the draft new Law adheres to the principles set out in section 5.3.2.1 reasonably well. However, we have the following comments on this.

1. Many of the provisions in Articles 40 to 43 are very detailed and we suggest would be better placed in regulations, as under the existing Law.
2. Apart for any compulsory classes of insurance as provided for in Article 40(7), it is not clear that licences will be granted other than for life business or non-life business as a whole. We strongly recommend that the licence granted to an applicant should cover only the **classes** of life or non-life business (see section 5.9.5) that it includes in its business plan. Otherwise, there is a risk that having obtained a licence on the basis of this plan, the insurer may begin writing new classes of business, potentially significantly increasing its risk profile and threatening its solvency. This requirement should be made clear.
3. Related to point 2 above, where an insurer having been licensed for certain classes of business wishes to begin writing new classes, it should be required to submit an application for **extension** of its licence to include these, following the same procedure as for a new applicant. This requirement should be added.

4. Also related to point 2 above, Article 54(2) states that, until the new Law comes into force, all existing licences are considered as non-life insurance licences. It is unclear, however, what, if any, "grandfathering" of existing licences is anticipated under the new Law. We recommend that insurers should not be granted licences for all classes of business under the new Law merely by virtue of their existing licence, but should be required to apply for a licence under the new Law for just those classes (both life and non-life) which they currently write, or propose to write in the next 3 years (i.e. the period covered by the business plan).
5. We disagree with the recommendation made in the Hogan report (page 18) that new insurers should not be allowed to be **composites**, i.e. licensed for both life and non-life business. This is a requirement (for new applicants) under the EU Insurance Directives but is, in our view, unnecessarily restrictive for the Armenian insurance market, at least for the foreseeable future. This is especially so given the tiny volume of life business at present (see section 3.2); a requirement for existing insurers wishing to enter this class to set up new insurers for this purpose would inevitably stifle its development. However, it is important that where an insurer writes both life and non-life business, these are managed separately (see section 5.9.6). The draft new Law does not appear to prohibit composites, and hence does not require amendment in this regard.
6. Whilst we agree that it is probably desirable (though not essential) to state grounds on which the insurance supervisor may reject a licence application, as set out in Article 42, these grounds should be neither too formulaic nor exclusive. The reality is likely to be that the insurance supervisor may, on occasions, wish to reject a insurer licence application because of concerns over the viability of the applicant's business proposals or the suitability of its managers or controllers even though none of the specific violations listed in Article 42(1) apply.

   Items 10 and 11 in Article 42(1) may offer some flexibility in such circumstances; however, we suggest that Article 42 should be amended to make it clear that this operates on a "without prejudice" basis: i.e. that just because none of its items apply, this does not mean that the licence application will necessarily be approved. A potential downside to this is that it could be seen as weakening the objectivity of the process by which applications are assessed, but this is countered by the requirement in Article 42(5) for the reasons (and legal grounds, which would be widened by making the above change) for rejecting the application to be disclosed to the insurer.
7. The contents of the business plan listed in Article 41(1) item 9 should be reviewed, as this currently appears inadequate to afford a proper assessment of the risk profile of the applicant. In particular, given its extreme importance in the Armenian insurance market (see section 3.2), there is too little information on reinsurance, which should be expanded to require disclosure of the types of reinsurance to be used, maximum retentions, the names of reinsurers and copies of proposed treaties. It should be an explicit requirement to produce both projected revenue accounts and balance sheets for each of the 3 years covered by the plan, showing clearly the effect of reinsurance and respecting the need for life and non-life business to be managed separately (see section 5.9.5). It should provide a summary of the overall business strategy of the applicant; clearly define the classes of business for which a licence is sought (see point 2 above); and indicate the sources of business. The assumptions used to calculate the figures shown in the plan, both in respect of pricing and reserving, should also be disclosed.

   We suggest that it might be helpful for the insurance supervisor to draw up a **proforma business plan** for use by applicants. However, this should not be too rigid, setting

minimum standards only, with applicants free to submit such further information as they wish.

8. Consistent with our comments on reinsurance in point 7 above, we recommend that, to the extent that this is not already covered by its items 6, 10 or 11, Article 42(1) should be expanded to include a reference to the applicant failing to have adequate reinsurance arrangements in place.
9. We suggest that a reference to the existence of "close links" with other insurers or other supervised entities which it is considered will prevent, or compromise, effective supervision might also be added to Article 42(1).
10. The requirements for the managers of insurers to be of good character and to possess qualification certificates imposed by Articles 16(2) and (4), and the attendant provisions under Article 41(1) items 3 and 8, allow the insurance supervisor to exercise some control over their fitness and propriety. However, we suggest that Article 41(1) should be amended to require further information on the managers, and controllers, than is required under the above two items and items 4 and 7, given the impact that these parties have on the risk profile of the applicant.

    We doubt how appropriate it is for the insurance supervisor to be involved in conducting qualification examinations and issuing **qualification certificates**, as provided for by Article 16, other than in the next few years, and we also regard the one year's working experience in Article 16(8) which is needed to be allowed to sit qualification examinations as too short. We recommend that these requirements are replaced as soon as possible by a general industry experience requirement, assessed by the insurance supervisor, buttressed by relevant qualifications issued by independent bodies.
11. Article 40(4) requires a licensed insurer to comply with all requirements under the Law. However, we suggest that it should be made a requirement for the managers of an applicant for an insurer licence to provide a written undertaking in the application that the applicant, if licensed, will comply fully with the Law, and in particular Article 21 with regard to its responsibilities to policyholders. This undertaking should be added to the items to be submitted listed in Article 41(1) (a failure to provide this thereby becoming an additional ground for rejection of the licence under Article 42(1) item 1). We also recommend that Article 21 should be expanded to include a requirement to act consistently and professionally in dealing with policyholders, and to safeguard their interests and treat them fairly.
12. The reference to "economic norms" in Article 42(1) item 6 should be replaced by one to "minimum financial standards" in line with the recommendations made in section 5.4. The reference to "statutory capital" in Article 42(1) item 9 is also ambiguous, and should be clarified and/or reviewed in the light of those recommendations.
13. We suggest that the wording of Article 43 is not very clear, at least in the English translation. Article 43(8) refers to the "Licensing Committee" but this term does not appear to be defined (see also section 5.9.1).
14. The references to "the actuary" in Article 41(1) items 3 to 5 should be removed in line with the recommendations made in section 5.9.9.
15. Article 40(11) appears to be unnecessary, a similar statement having already been made in Article 40(2).

16. We are unclear of the rationale for the requirement under Article 40(6) for the insurance supervisor to register all licensed insurers that reinsure more than half of their gross liabilities.

4.3.2.3 Supervisory practice

Recommendations on the practice of the insurance supervisor in future with respect to licence applications are contained in section 4.4.3.6.

4.4 Prudential requirements: capital, reserves, assets, solvency, reinsurance and premiums

4.4.1 Existing and proposed legislative requirements

4.4.1.1 Draft new Law

The Articles of the draft new Law which cover prudential requirements for insurers are Articles 29 to 31, 34 and 35.

Article 29 covers insurance **reserves and** the **allocation of assets** to match them. It requires the establishment of reserves in respect of both life and non-life insurance liabilities. The types of reserve to be held and the procedure for their establishment are set out in rules specified by the government. These rules may cover:

- the definition of basic types of reserve;
- the basic principles of generation, methods of calculation, and procedure for the accumulation, of reserves, including additional reserves;
- the classification of categories of insurance for the purpose of these calculations;
- controls over the amount of premiums which are allocated to meet the operational expenses of the insurer.

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Assets must be allocated to match the reserves in accordance with rules specified by the government. These rules are based on the principles of protecting policyholders' interests, diversification of investment and reduction of risk, and the maintenance of solvency and liquidity of the insurer, and may cover:

- directions and thresholds of allocation of reserves;
- assets allowed or prohibited for the allocation of reserves.

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For life contracts only, loans to policyholders are permitted against reserves but any such loan cannot exceed the amount of reserve established for the contract held by the policyholder to whom the loan is granted. In the event of a claim before redemption of the loan, the outstanding loan amount is deducted from the claim payment.

Article 30 specifies a **minimum capital requirement** of 50m AMD, and provides for increases to this figure to be made by the government. Such increases cannot be made more than once per annum or as set out in a defined schedule covering several years. It also requires insurers to comply with **"basic economic norms"** designed to ensure their continued solvency and liquidity. The rates and methods of calculation of these norms are specified by the government.

Article 31 covers these **basic economic norms**. These are defined in Article 31(1) as the following:

- the minimum capital requirement in Article 30;
- the "capital adequacy norm", defined as the minimum ratio of the "amounts of total (own) capital" to "the risk weighted assets";
- the "liquidity norms", defined as:
  - the minimum ratio of "high liquidity assets" to the amount of insurance reserves;
  - the minimum ratio of current assets to current liabilities;
- the norm of maximum insurance liability per policyholder;
- the norm of maximum insurance liability per three policyholders;
- the norm of "maximum insurance liabilities", defined as the ratio of the "total amount of free capital and insurance reserves" to the "total sum of insurance amounts under all current insurance contracts", depending on the number of contracts and the "extent of claims (the proportion)";
- the "maximum level of requirements" of the insurer towards one individual and affiliated persons.

Article 31(2) requires the "thresholds of" the basic economic norms and the procedure for their calculation to be defined separately for insurers carrying out life and non-life insurance, but for those applied to all insurers in these two groups to be identical.

It also provides a **power** for the insurance supervisor **to apply "restrictive norms"** going beyond the basic economic norms (i.e. increase the minimum or reduce the maximum) against insurers which have failed to adhere to the basic economic norms.

Article 31(3) provides for the government to specify a maximum norm of operational expenses to be covered by premiums in respect of any compulsory classes of insurance, and other rates of economic norms for insurers writing such classes.

Article 31(4) covers the calculation of the basic economic norms. It requires the risks to be aggregated or treated separately according to specified criteria relating to concentration of location, exposure to conditions and risk factors, contract terms and the identity of the insured. It also requires insurance liabilities not to be reduced on account of **reinsurance** where the reinsurer is not licensed in its home country, or is insolvent, bankrupt or subject to specified types of supervisory intervention and/or sanction.

Article 31(5) makes the executive director of the insurer responsible for compliance with the basic economic norms (except where violation was caused by a decision of the company's management authority, execution of which by the executive director was compulsory), and the chief accountant responsible for compliance with the rules on their calculation. In the case of actual or probable violation of a norm, the chief accountant is required to immediately inform the executive director, who must undertake measures required to eliminate or prevent the violation.

Article 31(6) requires insurers violating any economic norm to submit to the insurance supervisor an **action plan** for eliminating the violation, the terms and procedure for implementation of which must be agreed with the insurance supervisor and considered as an assignment given by it.

Article 31(7) requires the submission by insurers to the insurance supervisor of **reports** on the basic economic norms, the format, procedure, terms of completion and filing of which are specified by the government.

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Article 34 provides a power for the insurance supervisor to prohibit insurers from making use of **reinsurance** with reinsurers identified (by means of the procedure set out in that Article or otherwise) as being insolvent, in a poor financial state or subject to specified sanctions imposed by the insurance supervisor in their home country. It also imposes disclosure requirements on insurers with regard to reinsurance (see section 5.5).

Article 35 covers the **justification of premiums**. It requires insurers to periodically report to the insurance supervisor the premiums charged for each class of business, together with justification of these. The format, procedure and timing of such reports are specified by the government.

Premiums are justified:

- by being calculated using actuarial methods based on reliable statistical data (i.e. statistical data produced, or findings of surveys conducted, by international and other independent organisations, or statistical data recorded by insurers which have carried out insurance in the class concerned for at least 3 years, or data received from other sources envisaged in legislation); **or**
- on the basis of the premiums charged under reinsurance contracts, provided that each reinsurer enjoys high rating in the international financial market according to the data of rating services, or has had information in respect of it provided by the insurer which does not demonstrate that it is insolvent, in a poor financial state or subject to specified sanctions imposed by the insurance supervisor in its home country (see section 5.5).

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The procedure for justification of premiums is defined by the government. Failure to comply with this procedure results in premiums being considered unjustified, for which sanctions can be applied by the insurance supervisor (see section 5.6).

Insurers must not charge premiums under any insurance contract which are less than the justified premiums stated in the most recent report submitted to the insurance supervisor.

4.4.1.2 Existing Law

The Articles of the existing Law which cover prudential requirements for insurers are Articles 25 and 26.

Article 25 requires the establishment of **reserves** in respect of both life and non-life insurance liabilities. The calculation of reserves **and** the **allocation of assets** to match them are set by regulations made by the government. Insurers are required to invest not less than 50% of the reserves in “reliable investments” defined by the government.

Article 26 specifies a **minimum capital requirement** of 20m AMD, and provides for increases to this figure to be made by the government. Such increases cannot be made more than once per annum or as set out in a defined schedule covering several years. The current minimum capital requirement is 50m AMD.

It also requires insurers to “preserve the **normative ratio** between the insurance responsibilities accepted by them and their assets”. The method of calculation of this ratio is defined by the government. Insurers are obliged to reinsure their insurance obligations in excess of the normative ratio.

The “regulations on establishing of insurance reserves and their allocation” made under Article 25 may be summarised as follows.

The insurer must establish **reserves** to meet its obligations under both non-life and life contracts. The technical reserves for **non-life contracts** should include:

- an unearned premium reserve;
- loss reserves, both for outstanding reported claims and IBNR;
- additional technical reserves;
- catastrophe reserves;
- a loss variation (i.e. equalisation) reserve;
- other reserves (arising from peculiarities of the contract);

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with a "reserve for preventative arrangements" (to finance arrangements for the prevention of accidents, etc) held in addition, where relevant.

For the purpose of the calculation of the **unearned premium reserve**, contracts are separated into three groups: group 3 covers contracts of indefinite term; group 2 covers credit and similar insurance; and group 1 covers all other contracts. For group 1 contracts, the reserve is calculated either (a) on a daily pro-rata basis (i.e. the 365ths method for annual contracts and its equivalent for non-annual contracts), or (b) using the 24ths method. The premium that is apportioned is the "initial insurance premium" defined as the gross premium less initial commission less sums directed to the reserve for preventative arrangements in the relevant report period. For group 2 contracts, the reserve is taken as 100% of the initial insurance premium. For group 3 contracts, it is taken as 40% of the initial insurance premium.

Loss reserves for outstanding reported claims are calculated separately for each contract. The reserve is determined on the basis of the loss incurred. Where the amount of the claim is not yet known, the maximum possible amount of claim, subject to a maximum of the sum assured, is used in the calculation. A loading of 3% is applied to the reserve to allow for claims settlement expenses.

The **IBNR reserve** is taken as 10% of the initial insurance premium if the report period is one year and the same absolute amount for other periods (i.e. 10% of the initial insurance premiums for each of the last four quarters where the report period is 3 months, for example).

A **catastrophe reserve** is required to be held in respect of extraordinary claims caused by "unpreventable forces" or catastrophes for those classes of insurance susceptible to such claims, but its method of calculation is not prescribed.

A **loss variation reserve** is required to be held to compensate for when the insurer's losses are greater than expected, but its method of calculation is not prescribed.

Any **reserve for preventative arrangements** is formed from assignments of the gross premium specified in the overall premium rate as aimed for that purpose.

For **life contracts**, a maximum of 15% of the initial insurance premium may be used to meet administrative costs, with the remainder being transferred to reserves. The premiums for such contracts must be calculated by means of an actuarial computation using mortality rates and respecting norms on rates of investment return.

The calculation of reserves is set out in a series of prescribed forms.

The **allocation of assets** to match reserves should be done "on the basis of diversity, reimbursement, profitability and liquidity". The specific requirements (presumably in addition to that in Article 29) include:

- no more than 20% in foreign currency securities;
- no more than 50% in bank deposits;
- no more than 20% in non government securities;
- no more than 40% in property;
- no more than 80% in government securities;

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- no more than 10% in cash in hand;
- nil in shares;
- nil in "intellectual property" (i.e. "know how", etc).

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We have not seen a written description of the **normative ratio**. However, based on information provided by the licensing and supervision unit of the existing insurance supervisor (see section 4.4.3.6), we understand that this restricts the "insurance risk" (i.e. sums assured) that can be **retained** by an insurer to 15 times the level of its "capital and reserves" (i.e. its net assets).

4.4.2 Analysis and recommendations

4.4.2.1 Principles

The insurance supervisor should develop and impose on insurers prudential requirements to mitigate the risks to which they are exposed. These requirements, which should be objective, internally consistent, transparent and clearly understood by insurers, should require them to:

- evaluate and manage the risks they assume, in particular by making appropriate use of reinsurance and setting premiums at an adequate level and on a sound basis;

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- comply with standards for establishing adequate technical reserves and other provisions, making appropriate allowance for reinsurance recoveries; these standards should require an appropriate degree of prudence to be incorporated in reserves and for these to be calculated using reliable and objective methods, to allow proper comparison of insurers; the allowance for reinsurance should have regard to the likely security of the reinsurer(s) with which it is effected;
- comply with standards on investment activity; these should include requirements relating to investment policy, asset mix, valuation, diversification, matching, currency localisation, liquidity and risk management, and should focus in particular on the assets matching technical reserves;
- maintain assets in excess of their liabilities at all times, and ensure that the level of risk that they assume has regard to their existing solvency position.

The insurance supervisor should have the authority and ability to assess the adequacy of reserves held, and to require these to be increased if necessary. Appropriate control levels should also be put in place to act as indicators or triggers for early supervisory action, before problems become serious threats to an insurer's solvency.

4.4.2.2 Legislation: overview

In our view, the draft new Law contains useful provisions to allow adherence to the principles set out in section 5.4.2.1 to be achieved, subject to the regulations provided for by it being drafted appropriately. We also strongly support the extent of use that has been made of regulations in this area, which will maximize flexibility and allow prudential requirements to be progressively strengthened as the desired development of the insurance market materialises. However, we recommend that Article 31 in particular should be reviewed as discussed below to increase its effectiveness.

We suggest that the "basic economic norms" defined in Article 31 are unnecessarily formulaic, and in places ambiguous. For example:

- the definition of the "capital adequacy norm" is unclear, both with regard to "total (own) capital" and "risk weighted assets";

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- the definition of the "norm of maximum insurance liabilities" is unclear, and in particular why the ratio described should not be subject to a minimum rather than a maximum;
- the definition of "maximum level of requirements towards one individual and affiliated persons" is unclear, and in particular how this differs from the norm of "maximum insurance liability per insurant";
- it is unclear why the two liquidity ratios are described as "marginal" rather than "minimum".

More generally, we suggest that references to "capital" and "reserves" are sometimes ambiguous. "Capital" might refer to the amount of issued and fully paid up share capital on one hand, or the amount by which an insurer's assets exceeds its liabilities on the other. Similarly, "reserves" might refer to technical reserves and other policyholder liabilities on one hand, or other "internal" reserves such as the share premium account or the profit and loss account shown in the insurer's balance sheet on the other.

We also have the impression from our discussions with staff of the existing insurance supervisor that the way in which capital, and the assets which represent it, are thought about is not always the most instructive. We are also concerned by how easy it would be for the insurance supervisor to enforce compliance with the basic economic norms.

For these reasons, we **recommend** that the **basic economic norms** in Article 31(1) are **replaced** by the following set of **"minimum financial standards"**:

1. A requirement to have the minimum level of issued and fully paid up share capital prescribed in Article 30.
2. A requirement for the technical reserves shown in the balance sheet to be calculated as prescribed in regulations, and other liabilities to be calculated in accordance with international accounting principles.
3. A requirement for **all** assets shown in the balance sheet to be valued as prescribed in regulations.
4. A requirement for the assets to be no less than the liabilities, each valued as above, and for the net assets (= assets – liabilities) and assets backing current liabilities to have adequate liquidity, as prescribed in regulations.
5. A requirement for the assets in which the technical reserves are invested to (a) match the liabilities for which the reserves are held by currency and term, and (b) have adequate liquidity, as prescribed in regulations.
6. A requirement for the total **gross** premiums written in any year not to exceed a fixed multiple, to be prescribed in regulations, of the net assets at the previous year-end.
7. A requirement to justify premiums following the procedure in Article 35.

These standards should apply equally to all insurers irrespective of the classes of business they write, including life business, but the associated regulations should differentiate between life and non-life business where appropriate. (The wording of Article 31(2) appears to imply that insurers should not be allowed to write both life and non-life business; we recommend that such a restriction should not apply (see section 5.3) and that this Article should be amended to clarify this).

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The issued and fully paid up share capital in point 1 represents the amount of money – in whatever form – subscribed by the insurer's shareholders. Article 30(1) should be amended to make it clear that it refers to issued and fully paid up share capital.

The requirement in point 6 should hold irrespective of any increase which has been made to the insurer's issued and fully paid up share capital since the previous year-end. Where such an increase in capital is expected or required (see section 5.4.2.3), and where the limit imposed on gross written premiums is likely to bite, this gives the insurer an incentive to subscribe the additional share capital before the previous year-end (but see also our comment below).

Article 31(6) should be amended to refer to a violation of any of the above minimum financial standards, and should be extended to additionally require the insurer to submit to the insurance supervisor an **action plan** such as is described in that Article **if** its **assets exceeds its liabilities** (each valued as above) **by less than 10% of** those **liabilities**, or would do so following any proposed distribution (in whatever form) to shareholders.

A violation of point 6 would, like any other, trigger an action plan under Article 31(6) but we suggest that in *some* circumstances, for example where the insurer's issued and fully paid up share capital had been significantly increased since the previous year-end, this violation need not be a cause for concern, and that the insurance supervisor might be prepared to accept no action being taken.

Further comments and recommendations on the various elements of the minimum financial standards including the nature and outline content of the regulations referred to are provided in sections 5.4.2.3 to 5.4.2.9. As explicitly excluded by the signed contract, however, we have not attempted to draft these regulations. As noted above, we recommend that the prudential requirements imposed by these regulations should be progressively strengthened as the desired development of the market materialises.

4.4.2.3 Minimum capital requirements

In deciding whether, and if so by how much, the minimum issued and fully paid up share capital requirement under Article 30(1) should be increased from its current level of 50m AMD, it is necessary to weigh:

- the need to introduce greater capacity into the insurance market to develop it, and to allow insurers to retain more of their gross liabilities;
- the existing insurers' current levels of capital; these are generally modest and in many cases at the current minimum, but a few insurers have substantially higher levels of capital (see section 3.5.3);
- the ability of the existing insurers to raise additional capital, and the potential impact of this on the size of the market; our impression based on the discussions we have had is that some of the smaller insurers would struggle to raise additional capital, but that generally, and certainly for the few largest insurers, this should not be a particular problem;
- the extent to which the existing insurers may raise their capital levels voluntarily; one or two insurers are understood to be seriously considering this but they appear to be in a small minority;
- the desirability of keeping the more professional, sound, vibrant and innovative insurers in the market;

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- the extent to which it is considered acceptable or desirable for smaller, less reputable, professional or active insurers to be pushed out of the market; or for there to be some consolidation of the market; and the desirability of changes in market size being driven as far as possible by market forces, and of not reducing the level of competition against the interest of policyholders;
- the requirements of the World Bank following the recommendations made by the FSAP completed in 2001 (see section 2.3); these demand a substantial increase in minimum capital levels, at least over a 5 year period;
- the desirability of not forcing insurers to hold excessive amounts of capital unnecessarily;
- the need for increases in capital to go hand in hand with the desired development of the market, and generally for these to be realistic and proportionate;
- the potential impact of higher capital requirements on new entrants to the market, both positive (deterrence of non-serious applicants) and negative (stifling growth of the market).

Taking all these factors into account, we recommend that the minimum issued and fully paid up share capital requirement under Article 30(1) should be increased progressively over the next 5 years, according to a defined schedule made under that Article. We suggest that increases are made mid-year each year from 2004 to 2008 inclusive to raise the minimum to the following levels:

Date:	1 July 2004	1 July 2005	1 July 2006	1 July 2007	1 July 2008
Insurers not licensed for life business:	100m AMD	150m AMD	200m AMD	225m AMD	250m AMD
Insurers licensed for life business:	100m AMD	150m AMD	200m AMD	275m AMD	350m AMD

but subject to these being reviewed in the light of actual development of the market.

The higher levels of minimum capital for insurers writing life business reflect the longer term nature and higher risk profile of that business, the relatively greater increases in capital for these insurers being deferred until 2006 to reflect the currently very small amount of life business in the market but the potential for this to increase significantly in a few years' time.

4.4.2.4 Reserving requirements

In our view, the reserving requirements imposed by the regulations under the existing Law described in section 5.4.1.2 are generally satisfactory for **non-life** classes, and we recommend that similar requirements are placed in regulations made under the new Law, subject to the following comments:

1. There should be general requirement for all liabilities for non-life business to be valued according to international accounting principles, and that these should take into account all contingent and prospective liabilities.
2. Article 31(4) paragraph c) appears to imply that liabilities might be calculated net of reinsurance in the balance sheet. We recommend that they should be calculated gross, with the reinsurers' share of reserves shown as an asset in the balance sheet.

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3. The daily pro-rata or 24ths methods should not be used to calculate the unearned premium reserve where the level of risk is not expected to be even over time; in such circumstances, allowance should be made for the anticipated pattern of risk. Other acquisition costs as well as initial commission should also be deducted from the gross premium before apportionment.
4. Other technical reserves should include, in particular, an unexpired risk reserve, calculated as the amount, if any, by which the total amount of claims and expenses expected to arise after the valuation date from contracts in force at that date exceeds the aggregate of the unearned premium reserve and any premiums expected to be paid under those contracts after the valuation date.
5. The 10% and 3% figures in the IBNR reserve and claims settlement expenses allowance in the reserve for outstanding reported claims respectively should both be regarded only as minima, with higher amounts held if the insurer's actual experience requires this.
6. The need for a loss variation (equalisation) reserve should be reviewed: even in the EU, this is required only for credit insurance (although many member states hold such a reserve for other classes too). If one is to be required, the basis on which transfers to and from it are made should be prescribed.
7. A catastrophe reserve should be required at least in respect of extraordinary claims caused by earthquakes, and possibly other risks too (e.g. damage to the nuclear power station) but we suggest that, as currently, there is no need to prescribe the basis on which this should be calculated.

All these provisions could be introduced **straight away**, but we suggest that it is probably acceptable and appropriate for the extent to which insurers should be expected to establish other technical reserves, including catastrophe reserves, and to which the insurance supervisor should enforce these requirements, to be gradually increased over the next 5 years.

The basis of calculation of reserves for **life** contracts is not clearly defined in the current regulations. Given the currently very small volume of life business in the market and its exclusively comprising term assurances (see section 3.6.8), we consider it acceptable for this business to be reserved for using non-life business principles in the **next few years**.

However, **at such time as** the volume of this business becomes **significant**, or its nature changes to include contracts with an investment element, it would be necessary to introduce specific reserving requirements for it. These should include the following key elements:

- reserves determined by an actuary making proper provision for all liabilities on prudent assumptions for investment return, mortality, expenses, etc;
- allowance made for all guaranteed benefits, expenses including commissions, any bonuses and any options;
- credit taken for reinsurance and future premiums;
- prospective calculation on an individual policy basis;
- no arbitrary changes to be made to assumptions between valuations;
- appropriate recognition of profit over duration of contract;
- mortality assumptions based on insurer's own claims experience if credible and on internationally published mortality tables, adjusted as appropriate and including margins for adverse changes;

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- interest rates used for discounting liabilities no greater than investment return on assets backing reserves (calculated appropriately) less a prudential margin;
- implicit or explicit allowance for future expenses, adequate to cover expenses likely to be incurred in fulfilling existing contracts allowing for the effect of inflation, and having regard to insurer's recent expenses.

4.4.2.5 Asset valuation rules

We recommend that rules covering the valuation of assets should be kept simple and as unrestrictive as possible to begin with. This reflects the very limited range of investment opportunities currently available to insurers (the main assets held being just government bonds, property and bank deposits) and the small size of the market. At the same time, however, it is important that they seek to address current critical problems.

We recommend that the following valuation rules should apply **straight away**:

- no value to be placed on intangible assets, e.g. goodwill, logos, value of future profits, etc;
- no value to be placed on assets not mentioned in the rules;
- property to be valued in accordance with international accounting principles; this means at cost less depreciation less impairment losses, which is equivalent to recoverable amount, being the higher of the net sale price and the present value of future cash flows from the property over its useful life; generally, therefore, property should be valued at realisable/market value;
- bank deposits to be valued as the amount that can reasonably be expected to be recovered in respect of them/assignment value, i.e. generally close to face value;
- government securities to be valued at assignment/redemption value;
- other domestic securities to be valued at assignment value, but no value to be placed on those with a credit rating below a specified level;
- foreign securities (including in principle shares) to be valued at market/assignment value, but no value to be placed on those with a credit rating below a specified level or not meeting other specified criteria (e.g. for shares, having a listing on at least one of a specified list of stock exchanges, or, if unlisted, being subject to independent professional valuation);
- reinsurers' share of technical reserves (see section 5.4.2.4) to be valued as the amount of such reserves reinsured, but subject to any limits as described in section 5.4.2.8;
- office equipment and other fixed assets to be valued in accordance with international accounting principles, i.e. at cost less depreciation;
- outstanding premiums to be valued at face value, but no value to be placed on those outstanding for longer than a specified period;
- all other debts to be valued as the amount that can reasonably be expected to be recovered in respect of them/assignment value.

Professional property valuers are currently in short supply in Armenia (see section 3.11.8). However, we understand that a few of these do exist, and recommend that the insurance supervisor should authorise some or all of these to carry out property valuations for insurers, and make it a condition for properties to have been valued by one of these valuers not longer

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ago than a specified period for them to be included in the balance sheet. The costs of such valuation should be borne by the insurer. If this is not practical, an alternative would be for the insurance supervisor to place the onus on the independent auditor of the insurer to validate the value placed on properties in its balance sheet, hiring professional valuers from abroad as necessary, and enforcing this by applying pressure on individual auditors which appear not to be meeting this requirement by referring them to the association of auditors.

For many properties (e.g. ex-Soviet factories, rural premises, etc), such a requirement is expected to sharply reduce their value in insurers' balance sheets. However, it is, in our view, essential that this change be made because, at present, apparent financial strength reported in the balance sheet is, in reality, often not there. This is of obvious concern both because it distorts the insurer's true financial position and because it potentially allows the insurer to write more business in the future than it safely can. Existing insurers whose balance sheets are seriously impaired by this change should be required by the insurance supervisor to increase their issued and fully paid share capital, as necessary.

The various credit rating and other criteria referred to in the above rules should be set at a fairly low level to begin with, and then progressively strengthened over the next 5 years as the desired development in the market materialises and the choice and use of different types of investments widens. The rules themselves should also be reviewed, and strengthened and/or added to as appropriate, during this period and afterwards. In the long term, they might impose, for example:

- special rules for the valuation of investments by an insurer in, and debts owed to an insurer by, connected companies; and
- stricter rates of depreciation for fixed assets than required by international accounting principles.

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4.4.2.6 Matching requirements

Rules covering the matching of assets to technical reserves should complement (only, not replace) the general safety, diversification and liquidity requirements in Article 29(2).

Again, we recommend that these rules should be kept simple and as unrestrictive as possible **to begin with**. However, they should contain the following key elements:

- a localisation rule, whereby liabilities denominated in a certain currency should be matched by assets in that currency to a specified minimum extent;
- a requirement for liabilities to be matched by assets of similar term;
- limits on the types and amounts of assets that can be used to match technical reserves, to ensure that liabilities are matched by assets of appropriate nature and to maintain adequate diversification and liquidity.

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We suggest that an initial minimum tolerance level for the localisation rule of around 50% would be reasonable. However, a higher figure than this might be considered, as our impression is that matching by currency is not a particular problem for insurers: whilst all claims are actually paid in AMD, benefits under both non-life and life policies can be expressed either as fixed amounts in AMD or in US$, and current accounts and deposits denominated in both AMD and US$ are available locally.

The matching by term requirement need not be prescriptive. It should also not be a current problem for insurers given the short tail nature of their business, although it could become one in the future if life business develops significantly.

For the latter rules above, we suggest initially:

- a minimum amount in government securities, say 30%;
- a maximum amount in other domestic securities, say 20% (note that by their being in the balance sheet at all, such securities have satisfied the specified criteria mentioned in section 5.4.2.5);
- a maximum amount in property, say 30%;
- no shares allowed;
- if market conditions dictate this only, a maximum amount in deposits with banks not meeting specified credit criteria, but otherwise no limit on bank deposits;
- a maximum amount in foreign securities, say 20% (but also subject to the localisation rule above and to these not containing shares; note that by their being in the balance sheet at all, such securities have satisfied the specified criteria mentioned in section 5.4.2.5);
- no limit on the reinsurers' share of technical reserves, other than any described in section 5.4.2.8;
- a maximum amount in office equipment or other fixed assets, say 5%;
- a maximum amount in debts due from connected companies, say 5%;
- a maximum amount in debts in aggregate, say 15%;
- a minimum amount of liquid assets (the definition of which should be prescribed) in aggregate, say 60%.

where the percentages are applied to the gross amount of the technical reserves minus the value of the reinsurers' share of these reserves.

The assets covering technical (mathematical) reserves in respect of life business should be managed separately from those for other classes of business to comply with Article 32(4) of the draft new Law, and should be available for that purpose only. They should be made subject to a different set of rules from those above (generally requiring less liquidity) in theory, and also in practice if the volume of life business in the market increases significantly. In the next few years, however, we recommend that they should be subject to the same rules.

The above percentages should be progressively strengthened over the next 5 years as the desired development of the market materialises (for example, we suggest that the percentage limit for property is brought down to say 15% by the end of that period). The rules themselves should also be reviewed, and strengthened and/or added to as appropriate, during this period and afterwards. In the long term, they might impose, for example:

- asset exposure limits (i.e. limits on the amount of individual assets and types of asset permitted as cover for the technical reserves); and
- counterparty limits (i.e. limits on the amount of assets of all types held with individual counterparties permitted as cover for the technical reserves).

4.4.2.7 Solvency

The minimum financial standards recommended in section 5.4.2.2 do not include an explicit solvency margin requirement, i.e. a minimum amount by which an insurer's assets must exceed its liabilities.

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Such a requirement, based on the EU solvency margin regime, is recommended in the Hogan report (page 4). We disagree with this recommendation, our view being that the introduction of such a requirement in Armenia at present is unnecessarily complex and disproportionate given the current size of the insurance market: there are many more developed markets in the world which do not operate such a regime. We also disagree with the comment made in the Hogan report (page 10) that within 5 years, Armenia should be in a fair position to adopt the risk based elements likely to have been introduced into the EU solvency margin regime by then, and with that made (page 38) on risk assessment by insurers, involving a holistic approach to risk management and requiring them to submit risk management plans to the insurance supervisor for review, our view being that both of these are unrealistic.

We recommend that a review should be carried out in 5 years' time as to whether an explicit solvency margin requirement should be introduced in Armenia at that time. Until then, however, we recommend that the maintenance of solvency of insurers in the Armenian insurance market should rest on the following four pillars:

- the minimum financial standard 4 recommended in section 5.4.2.2 requiring the assets of the insurer to be no less than its liabilities, each valued in accordance with prescribed rules, and for the net assets (= assets – liabilities) and assets backing current liabilities to have adequate liquidity, as prescribed in regulations;
- the requirement recommended in section 5.4.2.2, to be effected by amending Article 31(6) of the draft new Law, to require the insurer to submit to the insurance supervisor an action plan such as is described in that Article if its net assets are less than 10% of its liabilities, or would become so following any proposed distribution (in whatever form) to shareholders;
- the minimum financial standard 6 recommended in section 5.4.2.2 limiting the total gross premiums written by the insurer in any year to a fixed multiple, to be prescribed in regulations, of its net assets at the previous year-end;
- the minimum financial standard 7 recommended in section 5.4.2.2 requiring the insurer to justify its premiums following the procedure set out in Article 35 of the draft new Law.

The first requirement above requires the insurer to remain solvent at all times, and also seeks to maintain adequate liquidity of its net assets in particular to help ensure that these can be made available quickly to meet any unexpected liabilities, and to prevent excessive gearing in its balance sheet. The second provides an early warning mechanism and a means by which remedial action can be taken to seek to safeguard the solvency of the insurer, operating in a similar way to how action triggered by a breach of an explicit solvency margin would have done. The third acts as a brake on the insurer's activities and assumption of risk where its current level of solvency is such as make this desirable to safeguard its future solvency position. The fourth is also concerned with safeguarding the insurer's future solvency position.

We suggest that the regulations put in place with regard to maintaining **liquidity** of the insurer's net assets and assets backing current liabilities should include:

- if market conditions dictate this only, a maximum amount in deposits with banks not meeting specified credit criteria;
- a maximum amount in debts due from connected companies, say 15%;
- a maximum amount in debts in aggregate, say 30%;

- a minimum amount of liquid assets (the definition of which should be prescribed) in aggregate, say 30%;

where the percentages are applied to the amount of net assets and assets backing current liabilities.

We suggest that the **fixed multiple** to be prescribed in regulations referred to in the third requirement should be 6 (six) for all insurers initially (this figure is loosely based on an inversion of the "premiums basis" calculation in the EU solvency margin regime) **but subject to** the insurance supervisor **testing** this **for reasonableness** in the market. This multiple should also be kept under review in the light of experience and actual development of the market; in particular, it might be appropriate to introduce in the future different multiples for insurers writing different classes of business, and particularly life business if this class grows significantly.

The above percentages should be progressively strengthened over the next 5 years as the desired development of the market materialises, and the rules themselves should also be reviewed, and strengthened and/or added to as appropriate, during this period and afterwards.

4.4.2.8 Reinsurance

The prudential requirements imposed on insurers should require them to evaluate and manage the risks they assume, in particular by making appropriate use of reinsurance. They should also require the allowance for reinsurance that can be taken into account in the balance sheet to have regard to the likely security of the reinsurer(s) with which it is placed.

In this regard, we welcome the draft new Law allowing the use of reinsurance (Article 18) and also:

- the provision in Article 31(4) requiring insurance liabilities not to be reduced on account of reinsurance where the reinsurer is not licensed in its home country, or is insolvent, bankrupt or subject to specified types of supervisory intervention and/or sanction;
- the provision in Article 34 imposing disclosure requirements on insurers with regard to reinsurers, including information relating to their financial strength and whether they are subject to sanction by the insurance supervisor in their home country, except where they have a rating given by international rating agencies not lower than a minimum specified by government decree; and
- the provision in Article 34 providing a power for the insurance supervisor to prohibit insurers from making use of reinsurance with reinsurers identified (by means of the above procedure or otherwise) as being insolvent, in a poor financial state or subject to specified sanctions imposed by the insurance supervisor in their home country.

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In discussions during our work on the project, we have been given the impression that the insurance supervisor is considering imposing a requirement on insurers not to reinsure more than 90% (say) of their gross liabilities. The draft new Law does not provide the insurance supervisor with a power to control, and in particular restrict, the amount of reinsurance used by insurers (other than in the special circumstances described above) and therefore if this restriction were to be introduced directly, the draft new Law would need to be amended to provide such a power.

However, something similar could be achieved indirectly without changing the draft new Law by imposing a restriction, in regulations made under Article 29, on the value that can be placed on the reinsurers' share of technical provisions asset shown in the balance sheet (see section 5.4.2.4, point 2). This has the advantage of being less prescriptive, in the sense that

an insurer would still be allowed to reinsure more than 90% of its gross liabilities if it wished, whilst at the same time reducing the extent to which the security of policyholders' benefits depends on the reinsurance, by virtue of the insurer needing to hold other assets to match the 10% of its gross technical reserves no longer matched by the reinsurers' share of technical provisions asset.

In deciding whether to impose a restriction of this kind, either directly or indirectly as explained above, it is necessary to weigh:

- the desirability of insurers retaining more of their gross liabilities from the point of view of reducing the outflow of money from Armenia through reinsurance premiums;

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- the desirability of insurers engaging in real insurance rather than merely fronting business;
- the extent to which insurers will wish to retain more of their gross liabilities anyway once they have the ability to do so on account of the increases in minimum capital requirements recommended in section 5.4.2.3;
- the desirability of retentions being set by the market and not being imposed;
- the potential risk of forcing insurers to retain some of their gross liabilities when they may have inadequate expertise in pricing, reserving and risk management;
- the need for certain large and unusual risks to be reinsured above the level of the restriction;
- the need to recognise that the security of policyholders' benefits depends on the financial strength of the individual reinsurers with which the reinsurance is placed.

In principle, we are not generally in favour of imposing restrictions on the amount of reinsurance that insurers can use. However, we also suspect that some of the existing insurers in the market reinsure 100% of their gross liabilities not (or at least not only) because they strictly need to, but rather because they are content to carry on what is, in effect, brokerage business, and that this is likely to continue even following the increases in minimum capital requirements. We also consider it desirable to create an additional incentive, beyond that created by the exemption from the disclosure requirements imposed under Article 34 for reinsurers of sufficient credit rating, for insurers to place their reinsurance with high quality reinsurers, thereby increasing the level of security of policyholders' benefits.

Given these comments, we recommend that the insurance supervisor should consider imposing a **restriction** on the value that can be placed on the reinsurers' share of technical provisions asset shown in the balance sheet where the gross liabilities are reinsured to a reinsurer with a credit rating below a specified level. This restriction should be applied to individual risks, with:

- no restriction applied to specified large or unusual risks;

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- no restriction applied where the risk is reinsured to a reinsurer with a credit rating above a specified level (which we suggest should be the same as that at which disclosure of the reinsurer's financial strength is not required under Article 34);
- a restriction of say 90% applied where the risk is reinsured to a reinsurer with a credit rating below the above level but above a second (lower) specified level;

- a more onerous restriction of say 70% applied where the risk is reinsured to a reinsurer with a credit rating below this second level;
- more onerous restrictions than those in the previous two bullets perhaps applied where the risk is in a compulsory class of insurance.

Such an approach allows insurers to still reinsure 100% of their gross liabilities if they have a genuine need to, whilst at the same time providing them with a financial incentive to retain some of these liabilities if they do not, and to place the reinsurance which they do use with high quality reinsurers. (We understand that Kazakhstan imposes similar restrictions on the use of reinsurance (though directly, we believe) and that Georgia is also considering introducing them.)

Having been set at an initial level, the above restrictions should be kept under review as the desired development of the market materialises. In theory, it might be desirable to make them more onerous for most risks as capacity in the market increases and the need for reinsurance decreases. However, this might well not be necessary if market forces lead to insurers retaining more of their gross liabilities anyway.

We recommend against requiring **deposits** in respect of reinsurance. These are not liked internationally; are administratively burdensome; and are not well suited to Armenia's situation given the problems still faced by its banking sector, the lack of a bank guarantee scheme and that many of the reinsurers used by the local insurers are of high credit rating.

4.4.2.9 Premiums

We support the principle behind Article 35 of the draft new Law of the insurance supervisor requiring insurers to disclose and provide justification for the premiums they charge, subject to our comments on the use made of this information by the insurance supervisor in section 5.4.2.10. This is a sensible half way house between its exercising direct control over premiums and giving insurers complete freedom to set premiums without disclosure, and is an important tool in seeking to safeguard the future solvency of insurers. We recommend that this requirement should remain in force for the foreseeable future; in the long term, it would be desirable to remove it, but this must wait until the insurance market has developed sufficiently to allow much greater confidence to be placed in the product pricing process and the adequacy of premiums.

In practice, however, we have the following comments:

1. Article 35 provides insurers with an option for justifying premiums: calculation by actuarial methods, or justification on the basis of reinsurance premiums charged, subject to the reinsurer having a credit rating above a specified level.

   The second option is helpful, but it is important for the way in the insurance supervisor would use the reinsurance premiums to decide whether the premiums charged by the insurer were reasonable or not to be both objective and transparent. We assume that this would have regard to the extent to which the premiums charged by the insurer exceeded the reinsurance premiums, and subject this excess to some kind of maximum.

   This second option is not available when the reinsurance is placed with less secure reinsurers, and we assume would also not be available where the amount of reinsurance used was below a certain level (if this is correct, Article 35 should be amended to make this clear). In such cases, actuarial justification of premiums is required. However, we question how realistic a requirement this is in the next few years given the current lack of actuarial expertise available in the market (see section 3.11.8) and recommend that this

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should not require all insurers to have an in house actuary (see section 5.9.9). We recommend that it be replaced - except for insurers writing life business, and even then only after a specified period, for which it should be retained - by a more general requirement for calculation by the insurer having regard to the level of risk underwritten and for disclosure of the basis on which the calculation has been made to the insurance supervisor.

2. It is not clear how Article 35 sits with the apparently more onerous and blanket requirement in Article 9(3) for insurers to calculate premium rates "based on actuarial methods using the actuarial spreadsheet and norms of return on investment of insurance reserves". Similar comments to those above also apply to this requirement.

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We support the provisions in Articles 9(2) and 31(3) giving the government (and not the insurance supervisor) direct control over the premiums charged for compulsory classes of insurance for the reasons explained in section 6.2.7.2, and recommend that these should remain in force for the foreseeable future.

5.4.2.10 Supervisory practice

The drafting of the regulations containing many of the prudential requirements should be undertaken by the separate policy unit in the Ministry of Finance and Economy recommended in section 4.4.1 but the insurance supervisor should also be closely involved in providing input to this process. A similar comment also applies to the recommended revisions made to these in the light of actual experience and as the desired development of the insurance market materialises.

Once the prudential requirements are in place, the focus of the insurance supervisor should be on monitoring insurers' compliance with them. This should be done by analysis of financial statements submitted by insurers (see section 4.4.3.6) and making on-site inspections (see section 4.4.3.7).

The insurance supervisor's role in reviewing the premiums and the justification for them submitted by insurers places a considerable level of responsibility on it. There is clearly a potential for policyholders, perhaps with some justification, to criticise the insurance supervisor if an insurer were to get into financial difficulties when its premiums had been "signed off" by the supervisor. It is also imperative that the means by which the insurance supervisor decides whether the premiums charged by an insurer are reasonable or not are both objective and transparent. It is therefore **essential** that the insurance supervisor:

- **on no account** misuses its reviewing premiums charged by insurers to object to these without good reason, or place insurers and their officials under unnecessary duress;
- acquires the skills necessary to perform the review process effectively; in the next few years, this will require it to obtain **external technical assistance** with this task (and others, as necessary, see section 4.4.3).

4.5 Financial reporting

4.5.1 Existing and proposed legislative requirements

4.5.1.1 Draft new Law

The main Articles of the draft new Law which cover financial reporting are Articles 32 and 33, but Articles 31, 34 and 35 also contain relevant provisions.

Article 32 requires the **submission** by insurers and brokers to the insurance supervisor **of** "annual and interim **financial and inspection statements** on their performance", as well as other reports specified in legislation.

It requires the government to specify the "chart of accounts of the insurer's financial activity, the instructions on the application of these, forms of inspection reports to be provided by insurers and brokers for the surveillance of their financial statements and financial stability, instructions on their completion, and the procedure and timing for their submission.

It also requires life, non-life and reinsurance transactions to be recorded separately.

Article 33 requires the **publication of** the insurer's **annual balance sheet and financial statements**, together with the conclusion made by the auditor thereon, within 6 months of the year-end. The audit conclusion forms an inseparable part of, and must be attached to, these documents.

It also requires insurers to disclose such other information as is specified in legislation.

Article 31(7) requires the submission by insurers to the insurance supervisor of **reports on** the **"basic economic norms"** (see section 5.4), the format, procedure, terms of completion and filing of which are specified by the government.

Article 34 requires disclosure of **information on reinsurers**. Subject to the exemption described below, it requires insurers making use of reinsurance to disclose to the insurance supervisor, by the year-end, information on the reinsurers with which they have signed reinsurance contracts during the year, including:

- a copy of the licence issued to a foreign reinsurer by the insurance supervisor in its home member country;
- the reinsurer's annual balance sheet for the previous financial year, certified by the relevant authority and including the audit conclusion thereon;
- if available, written information on any sanctions taken against a foreign reinsurer by the insurance supervisor in its home member country, and if not available a statement to this effect.

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Where the reinsurance is effected through a broker, the insurer is required to provide the same information on the broker.

The insurance supervisor is permitted to receive additional information on foreign reinsurers from the insurance supervisors of their home member countries, and from relevant international organisations. Where this information reveals that a particular reinsurer is insolvent, in a poor financial state, or subject to specified sanctions imposed by the insurance supervisor in its home country, the insurance supervisor may prohibit local insurers from using its services or signing reinsurance contracts with it.

Insurers are **exempted** from the above disclosure requirements where the reinsurance is placed with reinsurers with a rating given by international rating agencies not lower than a minimum specified by government decree. This minimum is required to be determined based on the classification and rating scales of rating services of international reputation.

Insurers are required to report to the insurance supervisor on reinsurance transactions in compliance with format, procedure and timing specified by the government.

Article 35 requires insurers to periodically **report** to the insurance supervisor **on** the **premiums** charged for each class of business, **together with justification** of these. The format, procedure and timing of such reports are specified by the government.

4.5.1.2 Existing Law

The Articles of the existing Law which cover financial reporting are Articles 27 and 28.

Article 27 provides for “charts of accounts, forms and indicators of reporting and accounting for insurance transactions” to be set by the government. It also requires life and non-life transactions to be recorded separately.

Article 28 requires the publication of the insurer’s annual balance sheet and profit and loss account, after certification of their accuracy by an auditor, within 3 months of the year-end.

We have not been provided with a copy of the **regulations** made under Article 27. However, based on information provided by the financial reporting unit of the existing insurance supervisor (see section 4.4.3.4), we understand that insurers submit information to it on a quarterly basis. This includes a balance sheet, profit and loss account, cash flow statement and a statement of the movement in equity. However, these are produced on a whole company basis only; no data is provided separately for individual classes of business. It also seems clear to us that these are not produced (at least consistently) in accordance with international accounting principles.

4.5.2 Analysis and recommendations

4.5.2.1 Principles

The insurance supervisor should receive information necessary to conduct effective off-site monitoring and to evaluate the condition of individual insurers and the insurance market as a whole, with the aim of identifying potential problems, thereby providing early detection and prompting corrective action before these problems become more serious.

The format and content of such information, and the frequency with which it should be submitted to the insurance supervisor, should be specified. The reporting requirements should reflect supervisory needs, and not place an unnecessary administrative burden on insurers. They should apply equally to all licensed insurers in the market, and be reviewed periodically. They should form the general basis for off-site analysis, with additional information being requested from individual insurers where necessary on a case by case basis.

The information submitted to the insurance supervisor should be prepared using appropriate accounting and actuarial standards which are comprehensive, documented, transparent and consistent, and which are applied in a manner that allows the insurance supervisor to properly evaluate the financial condition of insurers.

The insurance supervisor should require the information submitted to it to be disclosed publicly in order to give existing and prospective policyholders a clear view of insurers’ business activities and financial position, and the risks to which they are subject.

4.5.2.2 Legislation

In our view, the draft new Law contains useful provisions to allow adherence to the principles set out in section 5.5.2.1 to be achieved, subject to the regulations provided for by it being drafted appropriately. However, we have the following comments.

1. Article 32 does not make it an explicit requirement for the financial statements submitted to the insurance supervisor to be prepared using **international accounting standards**. We regard this as a serious omission, which should be rectified.

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Accounting systems are central to the provision of the information needed by the insurance supervisor and existing and prospective policyholders to make reasonable assessments of an insurer's operations and assess its future prospects. They should provide a real picture of economic gains and losses, and establish rules that are applied uniformly to all insurers. Each accounting item, and the precise method used to evaluate these, should be stated so that the financial condition of an insurer can be disclosed without any ambiguity.

International accounting standards are not consistently applied in Armenia at present, which position needs to be rectified. In particular, it is essential that accruals accounting is employed. This is practical, there being accountants in Armenia who are familiar with it, and its already being used outside the insurance sector. We understand that, as a result of a recent USAID funded project on accounting and auditing, international accounting standards are to be adopted by all private sector firms in Armenia, and that recommendations have been made for future reporting requirements, auditing standards, non governmental certification for auditors and accountants, and curriculum development. We understand that these have been the subject of consultation with the Ministry of Finance and Economy, and that a new accounting law is currently being considered by parliament.

2. Article 33 requires the publication of the conclusion of an independent auditor on the annual financial statements submitted by insurers as well as of the financial statements themselves. However, the draft new Law does not appear to contain an explicit requirement for the financial statements to be audited by such an auditor, and for the audit conclusion to be submitted to the insurance supervisor along with the financial statements themselves, and this should be added.

3. The 6 months given under Article 33 for the submission of annual financial statements is twice as long as the 3 months given under Article 28 of the existing Law, and we would question whether such a relaxation is necessary or appropriate.

4. The requirement in Article 34 for the information specified in that Article to be provided in respect of the broker where reinsurance is placed through a broker should be in addition to, rather than instead of, the requirement to provide this information in respect of the reinsurer. We assume that this is intended, but the wording of this Article should be amended to make this clear.

5. Whilst Article 33 only requires publication of insurers' annual financial statements, we recommend that interim financial statements provided for by Article 32(1) should be required from insurers on a **quarterly** basis, as is currently the case, but that these need not be audited or publicly disclosed. We recommend that these should cover the **financial year to date** rather than just the quarter in question (i.e. those for the third quarter should cover the 9-month period 1 January to 30 September, for example).

6. We are not sure what reporting requirements are imposed on insurers in Armenia by company law, tax law, etc, or the extent to which these are influenced by all the existing insurers in the market being closed joint stock companies (see section 3.5). The comments below refer to the information which insurers should be required to submit to the insurance supervisor under the new Law for supervisory purposes. However, it will be necessary for insurers to also comply with all other reporting requirements to which they are subject under other laws. If possible, it is desirable that the information - or relevant parts of it - submitted to the insurance supervisor should be acceptable for these other purposes too, although this is not essential.

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The nature, extent and content of the financial statements submitted to the insurance supervisor under Article 32(1) should evolve over time as the desired development of the insurance market materialises, and should be specified in regulations made under Article 32(3). As explicitly excluded by the signed contract, we have not attempted to draft these regulations. However, comments and recommendations on the nature and outline content of these are set out below.

We recommend that the information to be submitted should be kept as simple as possible **to begin with**, and certainly **not** include all the items listed in the Hogan report (pages 20-21) as being desirable to be "phased in as soon as possible". However, they should contain sufficient information to allow the insurance supervisor to:

- check compliance with the "minimum financial standards" and their associated regulations recommended in section 5.4;
- collect key items of data for publication in the annual report recommended in section 5.4.3.9;
- identify any adverse trends in insurers' operating performance; and
- make comparisons between insurers with respect to key indicators, with the objective of identifying outliers and how individual insurers compare with the industry market average.

Consistent with this, we recommend that the quarterly financial statements submitted to the insurance supervisor should include **straight away** and for the foreseeable future, as a minimum:

- a balance sheet;
- a revenue account for each of the most important classes (see section 5.9.5) and in total, showing in particular:
    - written premiums, gross and net of reinsurance;
    - earned premiums (= written premiums – increase in unearned premium reserve), gross and net of reinsurance;
    - claims paid, gross and net of reinsurance;
    - claims incurred (= claims paid + increase in outstanding claims reserve), gross and net of reinsurance;
    - commissions, gross and net of reinsurance;
    - expenses, gross and net of reinsurance;
- a profit and loss account;
- a description of how the technical reserves shown in the balance sheet have been calculated;
- a description of how all the assets shown in the balance sheet have been valued, including any limits imposed on the reinsurers' share of technical reserves (see section 5.4.2.8);
- a breakdown of the assets in which the technical reserves are invested, showing separately government securities, other domestic securities, property, bank deposits, foreign securities, the reinsurers' share of technical reserves, office equipment or other fixed assets, debts due from connected companies and other debts;

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- a schedule showing the liabilities in respect of which the technical reserves have been established broken down by currency, and the assets matching each of the corresponding blocks of technical reserves again broken down by currency;
- a breakdown of the net assets and assets backing current liabilities, showing separately bank deposits, debts due from connected companies and other debts in particular;
- the information on reinsurers required under Article 34 of the draft new Law;
- details of the premiums charged for each class of business, together with justification of these, required under Article 35 of the draft new Law;
- a statement by the directors, if such be the case, that all the minimum financial standards and their associated regulations, and all reporting requirements, have been complied with;
- for the annual financial statements only, the conclusion by the independent auditor on the financial statements.

In the long term, the above reporting requirements should be enhanced to include more of the items listed in the Hogan report referenced above. In particular, separate reporting should be required for life business at such time as the volume of this business becomes significant, and disclosure of information on claims analysis, including run-off triangles as appropriate, should be required. However, we disagree with the recommendation made in the Hogan report (page 21) to "just adopt EU forms" as (a) no EU wide standard set of forms exists and (b) such reporting is likely to be overly complex for the Armenian insurance market and potentially also ill suited to quarterly reporting.

We recommend that early consideration should be given to requiring **electronic submission** of financial statements, which should be realistic given the relatively low cost of technology.

4.5.2.3 Supervisory practice

Recommendations on the practice of the insurance supervisor in future with respect to analysis of financial statements submitted by insurers are contained in section 4.4.3.4.

4.6 Intervention powers

4.6.1 Existing and proposed legislative requirements

4.6.1.1 Draft new Law

The majority of provisions in the draft new Law relating to intervention powers are contained in Articles 37 and 44 to 51. However, Articles 14, 31 and 34 also contain relevant and important powers.

Article 37(4) specifies the **powers** which the insurance supervisor has. These include in particular:

- carrying out inspections at insurers and brokers, and surveys of the insured to check the validity and adequate payment of claims;
- applying sanctions against insurers and brokers and their officials in the event of violations of relevant legislation;
- bringing an action to protect the interests of the state in the event of violations of relevant legislation by insurers and brokers;

- applying sanctions and bringing an action against persons carrying out non-licensed insurance or brokerage;
- at any time, making enquiries of insurers and brokers where sufficient, reasonable grounds exist to believe that the interests of the insured may be at risk.

Articles 44 to 50 expand upon the sanctions that the insurance supervisor can apply to insurers and brokers and on what grounds.

Article 44 lists the **types of sanctions** which can be applied, which include written warnings, penalties, suspension of licence and filing an application to the court for the termination of licence. Penalties can be applied to individuals as well as firms.

Article 45 specifies the **grounds** on which sanctions can be taken. These are numerous and detailed but include, for insurers:

- failure to comply with required recording and safekeeping procedures for policies (see section 5.9.10);
- failure to report and justify premiums (see section 5.4);
- charging premiums below justified premiums or specified minima for "specific classes of insurance";
- failure to establish adequate reserves or comply with allocation rules for assets covering these (see section 5.4);
- failure to submit required documents, including in particular financial statements, complying with relevant regulations, or including misleading information in these;
- failure to comply with specified accounting rules;
- failure to comply with "basic economic norms" (see section 5.4);
- failure to disclose required information on reinsurers and brokers;
- failure to appoint an executive director, chief accountant and actuary; these posts being vacant; or their being held by persons lacking the required qualification;
- failure to act on warnings and requests for the correction of violations;
- obstruction of on-site inspections or failure to provide required documents;
- selling contracts through non-licensed brokers or non-approved agents;
- failure to carry out insurance in accordance with relevant legislation;
- failure to carry out specific classes of insurance within required standards or to provide policyholders with rules, terms and policy documents;
- effecting reinsurance with reinsurers which are insolvent or in a poor financial state;
- failure to restrict activity to insurance.

Similar grounds also apply to brokers, except those which are specific to insurance, and are supplemented by that of placing business with non-licensed insurers.

Article 46 covers the **procedure** to be followed **in applying penalties to individuals**. Such penalties fall to be applied according to the procedure, and at the level, defined in the Code of Administrative Violations for all the violations listed in Article 45 except those relating to appointments and maintenance of the executive director, chief accountant and actuary (and

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providing an organisational chart). They are applied on the basis of a decision taken by a commission established by the insurance supervisor, comprising its head, the relevant unit head, a legal representative and other employees. Unless the individual responsible for ensuring compliance with the legal requirement which has been violated are named in relevant legislation, the penalty is applied against the firm's executive director. Non-payment of penalties is subject to confiscation by court order. Penalties levied are paid to the state budget.

Article 47 covers the **procedure** to be followed **in giving warnings** to insurers and brokers. Warnings can be issued in respect of any of the violations listed in Article 45 or any other violation, except where this is to serve as a ground for suspension, or filing an application to the court for termination, of the licence. They can be issued at any time within a year of the violation being discovered. Elimination of the violation is mandatory within 15 days unless the warning specifies a longer deadline. They can also require the insurer or broker to take action to prevent future violations.

Article 48 covers the **procedure** to be followed **in applying penalties to firms**. Such penalties fall to be applied for the violations listed in Article 45 relating to appointments and maintenance of the executive director, chief accountant and actuary (and providing an organisational chart), and for the payment of claims in the absence of all required documentation. Where more than one violation exists, a penalty is applied for each. The amounts of penalty are specified, being 5% of the claim paid for the latter violation and between 15 and 25 times the salary, rising to between 30 and 50 times the salary for a repetition within one year, for the post concerned for the former violation. They are applied on the basis of a decision taken by the commission established by the insurance supervisor described in Article 46. Non-payment of penalties is subject to confiscation by court order. Penalties levied are paid to the state budget.

Article 49 covers the **procedure** to be followed in **suspending a licence**. Legal violations must be classified according to the principles set out in the Law on Licensing as grave, deliberate or periodic. During the suspension, the insurer or broker must not carry out the licensed activity, except in so far as this is aimed at eliminating the violation or has been directed by the insurance supervisor. Such activity carried out during the suspension is unlicensed. The suspension prohibits insurers writing new contracts or taking on new liabilities, except where otherwise directed by the insurance supervisor, but does not exempt them from their existing liabilities.

A licence can be suspended only by a decision taken by the Licensing Committee. The **grounds** on which a licence can be suspended are specified in Article 49(7). These are numerous and detailed but include, for insurers:

- transfer of licence to a third party;
- severe violations of the terms of the licence, or the Law and its associated regulations;
- obstruction of on-site inspections or failure to provide required documents;
- failure to report and justify premiums (see section 5.4);
- cancellation of the qualification certificate of relevant officials;
- periodic violations;
- application has been filed with the court for the termination of the licence;
- disclosure of misleading information in submitted documents;

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- failure to establish adequate reserves (see section 5.4);
- failure to comply with “basic economic norms” (see section 5.4);
- failure to respond to warnings given under Article 47;
- in the event of liquidation or bankruptcy;
- failure to restrict activity to insurance;
- at the request of the insurer.

Similar grounds also apply to brokers, except those which are specific to insurance.

Detailed provisions apply to the length of the suspension, depending on the ground on which it is exercised, and the date at which it takes effect. Where more than one ground for suspending the licence exists, a decision is taken in respect of each of them. The suspension becomes void upon termination of its specified term. Licence suspensions must be made within 3 months of the date the violation was committed. Decisions regarding licence suspensions must be communicated to the insurer or broker within 15 days; otherwise any decision to suspend the licence is void, and the insurance supervisor is not entitled to raise the issue of suspension again on the same ground.

Article 50 covers the **procedure** to be followed in **filing an application to the court for the termination of a licence**. The **grounds** on which a licence can be terminated are, for insurers:

- discovery of fake or misleading material information in submitted documents;
- in the event of liquidation;
- severe damage caused as the result of insurance activity;
- deliberate violations;
- suspension of the licence at least twice during one year under Article 49, subject to the grounds on which this was exercised;
- carrying out suspended activity during suspension of the licence;
- failure to restrict activity to insurance;
- discovery of money laundering or funding of illegal operations;
- at the request of the insurer;
- as otherwise provided for in relevant legislation.

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Similar grounds also apply to brokers, except that restricting activity to insurance.

A terminated licence is void. Licence terminations must be made within 12 months of the date the violation was committed, or within 15 days where the ground is discovery of fake or misleading material information in submitted documents. Except where the ground for this is liquidation of the insurer or broker or its own request, termination of the licence can only be effected by the insurance supervisor filing an application for this to the court, and it becomes effective (if granted) on the date of the court decision. Termination of the licence in the case of liquidation of the insurer or broker or its own request is at the decision of the insurance supervisor, and if approved takes effect from the date of liquidation or the decision respectively.

Article 51 provides for **appeals** to be made to the court against a decision taken by the insurance supervisor to suspend a licence. It provides for appeals to be made to the insurance supervisor beforehand, which are considered by committees or through hearings.

Article 14(2) allows the insurance supervisor to require specific information and documents from insurers relating to claims exceeding 10% of the minimum capital requirement (see section 5.4).

Article 31(2) provides a power for the insurance supervisor to apply "**restrictive economic norms**" going beyond the "basic economic norms" (see section 5.4) against insurers which have failed to adhere to the basic economic norms.

Though not strictly an intervention power, **Article 31(6)** requires insurers violating any basic economic norm to submit to the insurance supervisor an **action plan** for eliminating the violation, the terms and procedure for implementation of which must be agreed with the insurance supervisor and considered as an assignment given by it.

Article 34(1) provides a power for the insurance supervisor to prohibit insurers from making use of **reinsurance** with reinsurers identified (by means of the procedure set out in that Article or otherwise) as being insolvent, in a poor financial state or subject to specified sanctions imposed by the insurance supervisor in their home country.

4.6.1.2 Existing Law

The only intervention powers under the existing Law are those included in the general powers of the insurance supervisor listed in **Article 29(4)**, namely:

- carrying out inspections at insurers;
- warning insurers in the event of violations of relevant legislation, and if they do not respond appropriately, cancelling or limiting the operation of their licence until the shortcomings are eliminated or a decision is taken to annul the licence;
- applying to the court against persons carrying out non-licensed insurance.

4.6.2 Analysis and recommendations

4.6.2.1 Principles

Where insurers fail to meet supervisory requirements, and where their continued solvency comes into question, the insurance supervisor should be able to intervene to protect the interests of policyholders. The supervisory legislation should therefore give it adequate and appropriate powers to enable it to take timely and effective action in such circumstances, including both preventative and corrective measures.

The action taken by the insurance supervisor should be both suitable and necessary to achieve its supervisory objectives. Depending on the nature of the problem identified, a graduated response may be required. The insurance supervisor, preferably working in cooperation with the management of the insurer, should identify remedial measures that are necessary and establish a timetable for their completion. The insurance supervisor should enforce corrective action and, where necessary, impose sanctions.

4.6.2.2 Draft new Law

In our view, the draft new Law adheres to the principles set out in section 5.6.2.1 reasonably well. However, we suggest that it perhaps places too much emphasis on penalties and

sanctions and too little on provisions designed to allow the insurance supervisor to take effective preventative action in particular.

The existing Law provides very weak intervention powers, in particular with regard to the lack of any measures open to the insurance supervisor between merely giving warnings and cancelling or limiting the insurer's licence. It is therefore appropriate for intermediate sanctions to have been inserted into the draft new Law. However, these are now conspicuous, long and detailed. In contrast, intervention powers aimed at maintaining the healthy financial state of insurers, and requiring remedial action where they do get into financial difficulties, are relatively few and low profile. It is possible that this reflects the recommendations of the Hogan report, which place considerable emphasis on penalties and sanctions "pitched at such a level to act as a serious deterrent to potential violators" (page 48) but are largely silent on other forms of intervention.

The existence of a wide range of sanctions in the draft new Law is not of itself a problem, however, **provided that** the insurance supervisor makes use of these only when this is necessary and serves a useful supervisory purpose. In particular, **on no account** should these sanctions be misused by the insurance supervisor simply as a means of raising money for the state through the imposition of financial penalties, or placing insurers and their officials under unnecessary duress. This would only perpetuate the lack of mutual trust which currently exists between insurers and the insurance supervisor (see section 3.11.4) and stifle development of the insurance market. It would also waste supervisory time, which is at a premium, particularly as some needs to be made available for relevant training (see section 4.4.3.2).

The draft new Law does contain some other intervention powers which appear to be flexible and useful, but we recommend that consideration should be given to making some amendments to these, and to augmenting them with other appropriate powers.

The following comments expand on the above general observations.

1. Whilst it is probably not appropriate to place these in regulations, the provisions in Articles 45 to 50 are very long and detailed. We recommend that these are reviewed to (a) identify any (for example, those containing minor requirements but within short deadlines) that are not considered strictly necessary having regard to our comments above, and delete them, and (b) seek to summarise or cross reference these, for example by referring less to breaches of specific requirements under the Law and more to breaches of whole Articles. The insurance supervisor should, in any event, apply the sanctions in these provisions with restraint.
2. The power in Article 37(4) for the insurance supervisor to make enquiries of the insurer where it is considered that the interests of policyholders may be at risk is useful, and should be interpreted widely.
3. It is unclear how useful the power in Article 31(2) to apply more restrictive economic norms on an insurer which has breached basic economic norms would be in practice, given that the breach is a condition for its being invoked; however, we assume that a breach some time in the past which had now been corrected could still be used as a ground for imposing stricter norms.
4. Though not strictly an intervention power, the requirement in Article 31(6) for insurers violating any economic norm to submit to the insurance supervisor an **action plan** for eliminating the violation, the terms and procedure for implementation of which must be agreed with the insurance supervisor and considered as an assignment given by it, is useful.

Curiously, however, failure to meet this requirement does not appear explicitly in the grounds listed in Article 45(1) for applying sanctions against the insurer, although it is presumably covered by the general failure in its item 26. We recommend that it should be added as an explicit ground in that Article, and more importantly that the insurance supervisor should itself have the right to require such an action plan from the insurer upon identification of a violation of any economic norm.

We also recommend that this requirement for the insurer, and this power for the insurance supervisor, should be extended to where the net assets of the insurer fall below 10% of its liabilities (see section 5.4).

Article 31 should be amended to reflect these comments and the recommendations made in section 5.4. The references to "basic economic norms" in this Article, and in Article 45(1) item 15 and Article 49(1) item 16 should also be replaced by one to "minimum financial standards" in line with these recommendations.

5. We recommend that consideration should be given to amending the draft new Law to provide the insurance supervisor with the following additional intervention powers, exercisable on appropriate grounds selected from those listed in Article 45(1) and to be specified, and aimed mainly at providing for preventative action:

   - accelerate the submission of financial statements, or increase the frequency of their submission;
   - restrict the amount of gross premiums that can be written (this is probably already provided for by Article 31(2) if amended as recommended in section 5.4);
   - prevent the free disposal of assets, or require assets to be held in trust (this might also already be provided for by Article 31(2) if amended as above);
   - the right to obtain information from third parties, such as auditors;
   - a general residual power to take any action considered necessary for the protection of policyholders, but subject to this not being achievable through the exercise of other intervention powers instead.

6. Article 45(1) item 6 makes reference to specified minimum premiums for "specific insurance types". We assume that the latter phrase refers only to compulsory classes of insurance, as Article 9(2) provides for fixing of premiums only for such classes, and that this should be clarified. (The position with regard to justified premiums is clear from Article 35.)

7. The references to "the actuary" in Article 45 should be removed in line with the recommendations made in section 5.9.9.

8. The reference to a subsidiary of the insurer in Article 50(1) item 8 is consistent with the restrictions imposed by Article 7(3) but we are not sure of the rationale for these (see section 5.9.3).

9. Assuming that the insurance supervisor becomes an independent body as recommended in section 4.4.1, it will be necessary to decide whether penalties should be paid to the "National Budget" or to the insurance supervisor.

10. There is an asymmetry between insurers and brokers with regard to the "other cases envisaged under the law" provision in Articles 49(7) (absent) and (8) (present) (see also section 5.9.1).

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11. Article 49(6) refers to the “Licensing Committee” but this term does not appear to be defined (see also section 5.9.1).
12. As noted in section 4.4.1, the new Law should provide for appeals to the courts against decisions taken by the insurance supervisor generally, including in particular its exercise of intervention powers. Article 51 of the draft new Law should be amended to provide for this (the existing Law contains such a provision in its Article 32).

4.6.2.3 Supervisory practice

Recommendations on the practice of the insurance supervisor in future with respect to exercise of intervention powers are contained in section 4.4.3.7.

4.7 Transfers of business

4.7.1 Existing and proposed legislative requirements

There do not appear to be any specific provisions relating to the transfer of business from one insurer to another in either the existing Law or the draft new Law.

Article 43 of the draft new Law does refer to “reorganisation” of an insurer, requiring an application to be made for a “restatement” of its licence in such circumstances. Articles 43(3) and (4) refer respectively to reorganisations involving “spin off” and “division”, providing for transfer of the insurer’s licence to new entities created thereby only after the application procedure for a new licence has been followed. However, there is no corresponding reference to mergers of entities, or any direct reference to the transfer of insurance business or to any terms or conditions attaching to this.

4.7.2 Analysis and recommendations

4.7.2.1 Principles

Insurance policies are legal contracts between an insurer and its policyholders. The insurer should not be able to unilaterally alter the terms of policies by merging with, or transferring some of its policy liabilities to, another insurer. The ability of insurers to make such full or partial transfers of business should therefore be restricted in insurance supervisory legislation, to protect the interests of policyholders. Approval for transfers should be required from the insurance supervisor, and should normally be granted only if it is satisfied that existing policy values, and (especially in the case of the life business) policyholders’ reasonable benefit expectations, will not be reduced if the transfer proceeds. This extends to the policies and policyholders of both insurers concerned.

4.7.2.2 Legislation

The draft new Law should be amended to include provisions relating to the transfer of business from one insurer to another to reflect the principles in section 5.7.2.1.

The new Law itself need only include a short Article stating that such transfers (which seem quite likely to arise in the near future, particularly if there is some consolidation of the insurance market as a result of the increases in minimum capital requirements recommended in section 5.4) are subject to approval by the insurance supervisor, with the procedure to be followed in this regard set out in regulations made under that Article.

As specifically excluded by the signed contract, we have not attempted to draft any such regulations. However, we set out below indicators of what these should cover.

1. Where a transfer is proposed, the insurer from which the business will be transferred (“the transferor”) should submit an application to the insurance supervisor.
2. The contents of the application should be specified. This should include, as a minimum:
    - a general statement of particulars of the proposed transfer;
    - details of the policies to be transferred, including their number and value, subdivided by class of business;
    - statements showing the total assets and liabilities of both the transferor and the insurer to which the business will be transferred (“the transferee”) both before and after the proposed transfer;
    - details of any reinsurance arrangements in respect of the business concerned that will pass to the transferee;
    - certification that the proposed transfer has been approved by the directors of both the transferor and transferee.
3. The preconditions for approval of the application by the insurance supervisor should be specified. These should include, as a minimum:
    - the application is complete in all material respects, including the required certification of directors’ approval of the proposed transfer;
    - the transferee is licensed for all classes of business to be transferred;
    - the transferee, and the transferor where relevant, meets the “minimum financial standards” (see section 5.4) after the proposed transfer.
4. Any requirements for the proposed transfer to be disclosed to the policyholders of the transferor and transferee (or more widely), and to allow representations to be made by them to the insurance supervisor, should be stated. We suggest that such requirements are probably unnecessary in Armenia in the next 5 years.
5. Any requirement for the proposed transfer to be subject to external review by an insurance expert or auditor should be stated. Again, we suggest that such a requirement is probably unnecessary in Armenia in the next 5 years.
6. Where the insurance supervisor refuses the application, the reasons for its decision should be disclosed to both the transferor and transferee.
7. Other procedural matters (for example, any deadline by which the insurance supervisor must make a decision on the application, etc) should also be specified.

4.7.2.3 Supervisory practice

The primary objective of the insurance supervisor should be to enable insurers to effect transfers of business whilst at the same time protecting policyholders against the risk that their legitimate claims may not be met.

The insurance supervisor should be clear about the rationale for the proposed transfer, and in particular mindful of the fact that this could be indicative of the transferor being in financial difficulties and wishing to transfer some of its liabilities. It should hold meetings with the transferor and transferee to discuss the transfer, as appropriate.

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The decision to approve or reject the proposed transfer should be taken only by the head of the insurance supervisor or by a relevant committee. The transfer should not be approved unless and until the insurance supervisor is satisfied that:

- all the preconditions for approval stated in the regulations (see section 5.7.2.2) are met;
- all contracts included in the proposed transfer are valid;
- generally, there is no evidence to suggest that the policyholders of the transferor in particular will be disadvantaged by the transfer, compared with their current position.

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The insurance supervisor should seek legal advice on the transfer as necessary, and particularly where this is likely to be rejected; there should be adequate legal authority for any rejection of the transfer.

Where the transferor has no business remaining after the transfer, its licence should be terminated as soon as practicable after the transfer has taken place.

Because of its current limited skills base and the complex nature of the task, we strongly recommend that the insurance supervisor should seek external **technical assistance** in its assessment of transfer applications in the next few years.

4.8 Liquidation/winding-up

4.8.1 Existing and proposed legislative requirements

4.8.1.1 Draft new Law

Article 39 of the draft new Law requires insurers to be liquidated in compliance with the procedure defined by the law (i.e. the legislation of Armenia generally, implied). Registration of the liquidation can take place only after certification by the insurance supervisor of the absence of liabilities of the insurer to policyholders and the state.

4.8.1.2 Existing Law

Article 33 of the existing Law requires insurers to be liquidated in accordance with the legislation of Armenia.

4.8.2 Analysis and recommendations

4.8.2.1 Principles

The legal and regulatory framework should define insolvency and establish the criteria and procedure for dealing with it. In the event of winding up proceedings, this framework should give priority to the protection of policyholders.

The insurance supervisor should have the ability to close or assist in the closure of an insurer which is insolvent. It is, however, also desirable that the legal and regulatory framework provides a range of options for the orderly exit of insurers from the market and, in respect of insurers which are no longer financially viable, for the insurance supervisor to be involved in resolutions that require their take over by, or merger with, a healthier insurer.

4.8.2.2 Legislation

We understand that, whilst both the existing Law and draft new Law refer to it, no legislation covering insolvency of insurers currently exists in Armenia. There is a need for this to be put in place.

As specifically excluded by the signed contract, we have not attempted to draft any such legislation. However, we set out below some general observations on this, and indicators of what it should cover.

1. Some draft insurer insolvency legislation, closely based on that relevant to banks, was produced by Mr Storr Venter for the insurance supervisor as long ago as 1997, and we suggest that this might provide a useful starting point. Whilst we have not seen this, we also understand that Kazakhstan has such legislation in place which is well regarded, and we recommend that careful consideration should be given to this as a basis for Armenian legislation in this area. The EU Directive covering insurer insolvency (Directive of the European Parliament and of the Council on the reorganisation and winding up of insurance undertakings (2001/17/EC)) contains some high level principles, at least some of which we suggest might also be helpful.
2. Insurers are subject to company law as well as insurance company law, and close regard should be had to the way in which winding-up is addressed in both of these. In particular, any provisions made under the draft new Law should be subject to, and consistent with, company law. They should be complementary to it, and not create unnecessary duplication.
3. Winding-up should normally be permitted on both a voluntary and compulsory basis, and be subject to a court process. The insurance supervisor should have the right to make an application to the court for the compulsory winding-up of an insurer on specified grounds, including but not limited to insolvency (as defined in company law, generally).
4. The winding-up decision, the winding-up process itself and its effects, both substantive and procedural, on all parties involved in it should be specified. The role of the insurance supervisor in the process should be clearly defined. It should have a duty to keep other parties involved in the process informed, the right to be kept informed by those parties, and the right to be heard by the court. Creditors should have the right to lodge claims and submit written observations during the process.
5. Rules should be made with regard to the lodging, verification and admission of claims; the distribution of proceeds from the realisation of the insurer's assets; the ranking of claims; and which parties bear the costs and expenses incurred in the winding-up process (which are likely to be considerable). These provisions would generally be set out in regulations.
6. It is important that policyholders are afforded **special protection** in a winding-up. This should be achieved either by granting valid claims that they have against the insurer by virtue of their insurance policies precedence over those of all other creditors of the insurer with respect to those assets held by it covering the reserves in respect of those policies; or by granting them precedence over those of other creditors of the insurer, except those relating to salaries of its staff and amounts owed to the state (for tax, social security, etc), with respect to the assets held by it generally.
7. It is desirable that provision should also be made for reorganisation measures to be adopted by the insurance supervisor. These are measures aimed at preserving or restoring the financial soundness of an insurer to prevent, as far as possible, the need for it to be wound-up. These might include, for example, temporary administration; suspension of payments; claims reductions; transfers of business (see section 5.7); and various types of compromise arrangement. Where relevant, similar principles should apply to such reorganisation measures as to winding-up proceedings.

We suggest that Article 39(2) of the draft new Law, under which registration of the liquidation can take place only after certification by the insurance supervisor of the absence of liabilities of the insurer to policyholders and the state, should be reviewed. Even where policyholder liabilities are given precedence as described above, it is possible that these cannot be met in full by an insolvent insurer. The reference to an absence of liabilities should be amended to make it clear that such liabilities are limited to the amount to which policyholders are entitled, as determined by the court. We are not sure how this provision links to that in Article 27(2) for the termination of insurance contracts 60 days after the liquidation of the insurer.

4.8.2.3 Supervisory practice

Insolvency and winding-up are relevant to insurance supervision for two reasons:

- there are obvious implications for existing policyholders if an insurer becomes insolvent;
- winding-up may itself be part of an appropriate supervisory response to events; in particular, it may be desirable to wind-up an insurer to protect not just the interests of existing policyholders but also those of prospective new policyholders who might be adversely affected if the insurer were allowed to continue to trade.

The primary objectives of the insurance supervisor should be to prevent insolvent insurers from continuing to trade, and to seek to ensure that any liquidation of an insurer is carried out in the best interests of its policyholders.

The precise role of the insurance supervisor in the winding-up process itself depends on the legislative provisions that are put in place, but should include as a minimum the items listed in point 4 in section 5.8.2.2.

4.9 Other issues

4.9.1 Structure of the draft new Law

We regard the overall structure of the draft new Law as satisfactory. However:

- it appears that a number of terms (e.g. Licensing Committee, see section 5.3.2.2) are not defined, and definitions are generally hard to find as they are contained in numerous Articles. We recommend that a specific Article be created containing **definitions** of all technical terms;
- we would question the appropriateness of vague and apparently "catch all" provisions such as appear in numerous places, for example Articles 41(1) item 16, 41(2) item 11, 42(1) item 11 and 42(2) item 7.

4.9.2 Only insurers allowed to do insurance

Whilst we appreciate that there are no local reinsurers in Armenia at present, we recommend that references to "insurers" throughout the draft new Law should include reinsurers and that these should be subject to the same regulatory and supervisory requirements as other insurers, and that the draft new Law should be amended to make this clear.

We also suggest that the draft new Law should be amended to specifically prohibit non-admitted insurance.

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4.9.3 Insurers not allowed to do other than insurance

We recommend that Articles 7 and 8 should be amended to make it clear that insurers may engage **only** in insurance business, and that any activity of investment carried out by an insurer must be directly related to this; this should apply not only to the assets backing the technical reserves but also to other assets of the insurer.

Article 7(3) prohibits an insurer from being a founder of an organization carrying out production and commercial-intermediary activity, and from having more than a 10% shareholding in such an organization. We are unclear of the rationale for this restriction.

4.9.4 Insurance contracts

We support the lack of a requirement in the draft new Law for prior approval of insurance contracts by the insurance supervisor. However, there is clearly a need for the insurance supervisor to carry out appropriate checks on contracts, most notably during on site inspections (see section 4.4.3.5).

Whilst we gather that this is fairly common practice in CIS countries, it is not permitted in the UK for an individual to enter into an insurance contract in favour of third parties, as (s)he has no insurable interest under the contract.

The last clause of Article 5(1)(a) is unclear, at least in the English translation.

We are unsure of the significance of the term "cumulative" in Articles 5(4) and (5).

Article 5(6) implies that life contracts are endowments, in that it refers to a guaranteed payment on expiration of the term of the contract as well as on death; this is not correct, as the payment in the former case is generally limited to a return of premiums paid (or more, see Article 11(5)) under existing life contracts.

4.9.5 Classes of business

Articles 5(2) and (3) are not very clear, at least in the English translation, and in our view fail to give an adequate classification of insurance business. Such classification is important as it should determine the types of business that insurers can write (see section 5.3.2.2) and also influence reporting requirements (see section 5.5.2.2).

We recommend that business is initially classified according to the following **"classes"** for the purpose of both licensing and financial reporting:

1. **Accident and health**: insurance contracts providing fixed pecuniary benefits or benefits in the nature of indemnity (or a combination of both) against risks of the person insured sustaining injury as the result of an accident or of an accident of a specified class; or dying as the result of an accident or of an accident of a specified class; or becoming incapacitated in consequence of disease or of disease of a specified class, inclusive of contracts relating to industrial injury and occupational disease but exclusive of life contracts; or sustaining loss attributable to sickness or infirmity, but exclusive of life contracts.
2. **Motor**: insurance contracts against risks of the person insured sustaining injury, or dying, as a result of travelling as a passenger in a motor vehicle; or loss of or damage to vehicles used on land, including motor vehicles but excluding railway rolling stock; or to merchandise, baggage and all other goods in transit in motor vehicles; or against damage arising out of or in connection with the use of motor vehicles on land including third-party risks and carrier's liability.

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3. **Marine and transport**: insurance contracts against risks of the person insured sustaining injury, or dying, as a result of travelling as a passenger other than in a motor vehicle; or against loss of or damage to railway rolling stock; or upon vessels used on the sea or on inland water, or upon the machinery, tackle, furniture or equipment of such vessels; or to merchandise, baggage and all other goods in transit other than in a motor vehicle; or damage arising out of or in connection with the use of vessels on the sea or on inland water, including third-party risks and carrier's liability.
4. **Aviation**: insurance contracts against risks of the person insured sustaining injury, or dying, as a result of travelling as a passenger in aircraft; or upon aircraft or upon the machinery, tackle, furniture or equipment of aircraft; or to merchandise, baggage and all other goods in transit in aircraft; or damage arising out of or in connection with the use of aircraft, including third-party risks and carrier's liability.
5. **Fire and other damage to property**: insurance contracts against loss of or damage to property (other than land vehicles and goods in transit) due to fire, explosion, storm, natural forces other than storm, nuclear energy or land subsidence; or loss of or damage to property (other than land vehicles and goods in transit) due to hail or frost or to any event (such as theft) other than those already mentioned.
6. **Liability**: insurance contracts against loss of or damage to vehicles used on land, including motor vehicles but excluding railway rolling stock; or arising out of or in connection with the use of aircraft, including third-party risks and carrier's liability; or arising out of or in connection with the use of vessels on the sea or on inland water, including third-party risks and carrier's liability; or from incurring liabilities to third parties, the risks in question not being risks of the types already mentioned.
7. **Credit and suretyship**: insurance contracts against risks of loss to the person insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through insolvency) of debtors of theirs to pay their debts when due; or arising from their having to perform contracts of guarantee entered into by them, contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or customs bonds or similar contracts of guarantee.
8. **Other general**: insurance contracts against risks of loss to the person insured attributable to interruptions of the carrying on of business carried on by them or to reduction of the scope of business so carried on; or attributable to their incurring unforeseen expense; or attributable to their incurring legal expenses (including costs of litigation); or providing either or both of assistance (whether in cash or in kind) for persons who get into difficulties while travelling, while away from home or while away from their permanent residence, or assistance (whether in cash or in kind) for persons who get into difficulties otherwise than as already mentioned; or of a kind not falling into any of the other classes above.
9. **Life**: insurance contracts on human life or contracts to pay annuities on human life, where the benefits are wholly or partly to be determined by reference to the value of, or the income from, property of any description (whether or not specified in the contracts) or by reference to fluctuations in, or in an index of, the value of property of any description (whether or not so specified) (linked) or otherwise (non-linked); or to provide a sum on marriage or on the birth of a child, being contracts expressed to be in effect for a period of more than one year; or providing specified benefits against risks of persons becoming incapacitated in consequence of sustaining injury as a result of an accident or of an accident of a specified class or of sickness or infirmity, being contracts that are expressed

to be in effect for a period of not less than five years, or until the normal retirement age for the persons concerned, or without limit of time, and either are not expressed to be terminable by the insurer, or are expressed to be so terminable only in special circumstances mentioned in the contract; or tontines; or capital redemption contracts; or contracts to manage the investments of pension funds, or such contracts that are combined with contracts of insurance covering either conservation of capital or payment of a minimum interest; or collective insurance contracts; or social insurance contracts.

It may be appropriate to further refine these classes in the longer term. In particular, if the volume of life business increases significantly, the life class should be divided into the different types of cover described in that class.

It is appropriate that the designation of certain classes of insurance as compulsory is a matter for the government and not the insurance supervisor under Article 4(2).

4.9.6 Composites

For the reasons stated in section 5.3.2.2, we disagree with the recommendation made in the Hogan report (page 18) that new insurers should not be allowed to be composites, i.e. licensed for both life and non-life business.

It is, however, important that where an insurer writes both life and non-life business, these are managed separately, so that one activity cannot be required to support the other. Consistent with this, we support the provision in Article 32(4) for life, non-life and reinsurance transactions to be recorded by insurers separately.

4.9.7 Foreign insurers

For the reasons stated in section 6.2.3, we disagree with the implication in the Hogan report (page 20) that foreign insurers should be allowed to establish branches in Armenia, at least for the time being. However, we strongly support the lack of any restriction on foreign ownership of the legal entities described in Article 7 which can be licensed as insurers to carry on insurance business in Armenia. This provides for the establishment of insurance subsidiaries of foreign companies in Armenia subject to local regulatory requirements, the presence of which would be welcome as this would serve to increase competition and potentially transfer technological and managerial know-how to the country in particular.

4.9.8 Corporate governance and sound and prudent management

Whilst Articles 15 and 16 contain a number of provisions on this, there is relatively little in the draft new Law on corporate governance or internal controls that should operate within insurers. We do not regard this as a serious weakness in the next couple of years, our impression being that corporate governance generally is in its infancy in Armenia. In the medium term, however, requirements in this area should be progressively strengthened as the desired development of the insurance market materialises, and in line with development of the commercial sphere generally and professions such as auditing.

Whilst the new Law should make reference to it, we recommend that corporate governance should be primarily addressed in a wider capital markets context through company law. In the medium term, we suggest that a charter should be issued covering such matters as, for example, the roles and responsibilities of directors, the establishment of Board policy in areas such as investment, risk management, dividend declaration, etc, and internal audit.

Such issues are very important, as problems with insurers often have their source in lax management, poor internal controls and moral hazard, where their owners lack the proper

incentives to act prudently and to supervise managers effectively. Strong regulatory and supervisory arrangements which complement and support the operation of market discipline are indispensable to the stability of insurance markets, but in the absence of effective market discipline, the entire burden of control falls on the insurance supervisor, which may not have the requisite capacity. Corporate governance is also particularly important in countries like Armenia which are in transition because inflow of foreign capital is often closely linked with its establishment and development.

Insurers should in the medium term be required to develop an ownership and corporate governance structure that protects the rights of all interested parties. They should put in place internal control procedures and policies which are adequate for the nature and scale of their business, implemented by skilled personnel and carefully monitored by management, and should have effective means to measure, monitor and control the various risks they face. The **Insurers Association** of Armenia should be encouraged to set up its own mechanisms and institutions to impose business guidelines and a code of conduct on insurers to limit as far as possible detrimental practices.

4.9.9 Requirement for an in-house actuary

Articles 15(2) and (4) require every insurer (both life and non-life) to have an in-house actuary, subject to the provision in Article 55(3) deferring this requirement until 2 years after the coming into force of the new Law.

Despite this deferral, we regard this requirement, which was recommended in the Hogan report (page 25), as unrealistic and unhelpful in the next 5 years, not least because of the as yet inadequate supply of properly qualified actuaries in Armenia. In our view, the nature of the non-life insurance currently written in Armenia is such that mandatory actuarial input (and certainly in-house rather than from external consultants) in respect of it is unnecessary, and the volume of life business is also currently so small that we seriously question whether this is needed for this class either in the next 5 years.

Given these comments, we recommend that the requirement for an in house actuary should be dropped altogether, with emphasis being placed instead on requiring insurers to use proper accruals accounting (see section 5.5.2.2). If this is considered too radical a change, alternatives are to remove the in-house part of the requirement; to limit the requirement to insurers licensed to write life business; to retain the requirement but with the 2 years in Article 55(3) replaced by an indefinite period to be specified by the insurance supervisor in due course after consultation with interested parties; or combinations of these.

If the requirement is retained, as noted in sections 4.4.1 and 5.3.2.2, we doubt in any event how appropriate it is for the insurance supervisor to be involved in conducting qualification examinations and issuing qualification certificates, as provided for by Article 16, to managers of insurers, including in particular the actuary, other than in the next few years. This arrangement should be replaced as soon as possible by qualifications issued by independent professional bodies.

4.9.10 Recording and safekeeping of policies

Article 36 requires insurance policies to be printed at registered printing houses, to comply with sample forms and to carry serial numbers. We recommend that stamping of policies by the insurance supervisor (by means of revenue stamps not use of a rubber stamp) is preferable to this requirement, both on cost grounds (stamping could be made subject to a fee) and because the propriety of the printing house cannot be guaranteed. The recent incidence of invalid green cards offered by a local insurer issued by an apparently reputable but in fact

fraudulent foreign insurer demonstrates the difficulty in identifying printing fraud, these cards having been numbered.

4.9.11 External audit

As noted in section 5.5.2.2, the draft new Law does not appear to contain an explicit requirement for the annual financial statements submitted by insurers to the insurance supervisor to be audited by an independent auditor.

More generally, there is little if anything in the draft new Law covering the duties of external auditors, and we recommend that consideration should be given to adding some provisions on this, covering, for example:

- approval of external auditors by the insurance supervisor (we understand that a list of approved audit firms is already held by the existing insurance supervisor);
- the scope of the audit and the procedures to be adopted with regard to this (it should be borne in mind that with small insurers such as are found in Armenia, the external auditor's role is limited to a single visit at the year-end to audit the financial statements, and given this we suggest that many of the detailed provisions recommended in the Hogan report (pages 22 to 25) in this area are unlikely to be appropriate in the next few years);
- any "whistle blowing" requirement to be imposed on external auditors.

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4.9.12 Change of control and change of directors and managers

Subject to this intended to be covered by Article 43, the draft new Law does not appear to contain any provisions relating to changes of control of insurers or changes of their managers.

The insurance supervisor should be able to grant or deny approval to a person (legal or natural) that wants to acquire significant ownership or a controlling interest (both of which terms should be defined) in an insurer. Notifications for these should therefore be required. Before granting its approval, the insurance supervisor should be satisfied that those seeking control of the insurer meet the same criteria applied during the licensing process (see section 5.3), including those relating to financial fitness. The new owners should not significantly increase the risk profile of the insurer, or hinder its effective supervision. Similar notifications requirements should also apply to changes of directors and managers of insurers.

We recommend that provisions to this effect are added to the draft new Law.

4.9.13 Intermediaries

Subject to the provision in Article 55(2) that requirements in the draft new Law making new types of activity subject to licensing, and changes in the licence terms and requirements that restrict the rights of brokers (and insurers) or define new responsibilities for them, being deferred until 6 months after its coming into force, brokers are treated in a very similar way to insurers under the draft new Law.

Whilst this is probably satisfactory, we would question whether this is in all cases strictly necessary, and suggest that it might have been better to have a dedicated chapter in the draft new Law covering regulation of intermediaries (we appreciate that Article 13 does this in part). Our comments in section 5 have deliberately focused primarily on requirements relating to insurers.

We are unclear why Article 13(2) restricts agents to being individuals only.

We recommend that regulations made under Article 13(2) should prescribe in some detail the information that should be provided by intermediaries (and insurers) to prospective policyholders about insurance contracts before the point of sale.

Whilst we appreciate that there is no local reinsurer in Armenia at present, we suggest that Article 13(4) should not restrict the placement of reinsurance by brokers to foreign reinsurers only.

4.9.14 Other

1. Any conflicts between the draft new Law and the Civil Code and all other relevant laws should be eliminated. It is also desirable that unnecessary duplication is avoided; instead the draft new Law should seek to expand upon, or interpret in an appropriate way, other legal requirements.
2. The draft new Law does not provide the insurance supervisor with a general power to grant individual insurers concessions against its provisions in appropriate circumstances. Such a power can be very useful, but might be considered unduly flexible in Armenia at the current time.
3. We recommend that an Article is added to the draft new Law to make it clear that insurers are subject to its provisions on a continuous basis and not just at balance sheet dates, for example.
4. We welcome the provision prohibiting money laundering and the funding of illegal operations in Article 14 but are slightly surprised that this does not appear in company law instead.
5. Article 54(1) is not very clear, at least in the English translation.

5 DEVELOPMENT OF THE INSURANCE MARKET

5.1 Introduction

Under item 3 of the signed contract, we are required to:

- in consultation with the existing insurance supervisor and other relevant government and market bodies (as appropriate), review the nature and structure of the insurance market;
- in consultation with the existing insurance supervisor and any other relevant government and market bodies (as appropriate), review such plans, strategy papers and other related documents as have been produced and are available in Armenia;
- identify the policy considerations/direction for the encouragement of the healthy development and capacity building of the insurance market, including a survey of the capacity of insurance companies to increase the minimum capital requirements and to meet other prudential requirements;
- evaluate in outline the nature, feasibility, desirability and the supervisory implications of establishing compulsory classes of insurance;
- identify the feasibility, required structure and source of funding of an insolvent insurer policyholder protection scheme;

A summary of our review of the nature and structure of the insurance market is given in section 3. Our recommendations relating to minimum capital requirements are given in section 5.4. Our other findings and recommendations relating to this part of the project are set out in section 6.2.

5.2 Analysis and recommendations

5.2.1 Overview

The key challenges facing the insurance industry in Armenia based on our review of its nature and structure are described in section 3.11. In summary, these are:

- a lack of awareness of the benefits of insurance;
- low incomes and poor economic growth;
- corruption;
- a lack of mutual trust and ineffective supervision;
- a past lack of political will and coordination;
- a lack of compulsory classes;
- low levels of capital and small retentions;
- a lack of insurance and accountancy/audit professionals;
- a lack of data; and
- restricted investment opportunities.

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The recommendations set out in sections 6.2.2 to 6.2.11 respectively seek to address each of the above issues. Section 6.2.12 covers the possibility of creating an insolvent insurer policyholder protection scheme. Section 6.2.13 makes some other suggestions for consideration.

It is, however, **important to keep these recommendations in perspective**. It seems inevitable that the insurance market in Armenia will remain very small for a number of years to come. Key problems like poverty, the weak state of the economy and corruption clearly go much wider than insurance, and will take time to address. They need to be tackled at a

structural level by the government, and we are not qualified to give expert advice in these areas.

There is no reason why the insurance industry should be singled out for harsher treatment than other areas of the financial services sector, and particularly banks. There is therefore a need for the recommendations made in this section and the report generally, which in accordance with the terms of reference for the project relate only to the insurance sector, to be viewed by the government in the wider context. In some instances, recommendations which make perfect sense for the insurance industry may not do so taking a holistic point of view.

It is, in our view, also important not to expect too much too soon of such a small insurance industry. There is a need to nurture this to some extent initially, and not to regulate it out of existence: development of the market and of its regulation need to go hand in hand. The recommendations made in this section therefore seek to have regard to the scale of the industry; only in areas where scale does not represent a real practical constraint are they more closely based on ideals.

As well as taking the steps set out in the remainder of this section, we recommend that a **further review** of the Armenian insurance market is conducted **after 5 years** to appraise the development that has taken place by then and to make recommendations for any further structural changes to the market which are considered necessary at that time in the light of this.

5.2.2 Awareness

It is a fundamental requirement for growth of the insurance market for businesses and individuals to want insurance. In order that people perceive value in having this, an awareness of the benefits of being able to reduce financial risk though use of insurance products is needed. Such awareness is currently at a very low level (see section 3.11.1)

To a large extent, insurers should be expected to put resources into improving public awareness of the benefits of insurance, out of self interest. The **Insurers Association** of Armenia should play a role in this by taking steps to raise the profile of insurance generally, and to advertise its benefits to the public in particular, making a specific budget available for this and seeking to obtain such financial and technical assistance as is required. One specific step that it should take is to develop its own website, providing information on insurance. It should also promote and take part in television and other media open debates on insurance.

Precisely because of their obvious self interest, however, it is likely that there will be public suspicion of insurers' endeavours in promoting the use of insurance. To the extent that this applies, and that it has an interest in greater public understanding of insurance, it therefore falls upon the government to introduce a public education program on insurance.

The **policy advice unit** within the Ministry of Finance and Economy recommended in section 4.4.1 should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry and the promotion and delivery of public education on insurance matters. It should prepare a plan for public education, aimed particularly at **schools, businesses, farmers** and other appropriate outlets, to explain insurance and the benefits it offers in mitigating the risk of financial loss, and should be provided with a specific budget for this purpose. It should ensure that material on the use of insurance is included in the civil education programs given by all high schools in the country and in relevant university curricula. It should also promote and take part in television and other media open debates on insurance.

As well as publishing an annual report on the exercise of its functions and providing statistical information on the insurance market, and holding an annual meeting to allow public discussion of this, as recommended in section 4.4.3.9, the **insurance supervisor** should also be proactive in releasing to the public directly such other reports or information as it considers necessary for the purpose of increasing public awareness of insurance, and should allocate a specific budget for this.

Awareness of insurance would be substantially increased by the introduction of compulsory classes of insurance, and this is strongly recommended (see section 6.2.7).

5.2.3 Affordability

There is clearly a limit to what can be done about the currently extremely low levels of per capita income and widespread poverty that exist in Armenia (see section 3.11.2). Only rapid and sustained economic growth will have a marked positive impact on this.

It is, however, important for the government to recognise that growth of the insurance market will itself help grow the economy, as well as bring about significant social benefits. The government should therefore not simply wait for economic growth before taking action with respect to insurance, but rather seek to be as proactive as possible. Given that the economy remains in transition, it will inevitably take time for demand for insurance to grow but for the above reasons we regard it as an appropriate use of resources for the government to actively encourage this.

A critical requirement in a market economy for growth in demand for insurance, and hence for the development of the insurance industry, is that the insurance market is **competitive**, on the grounds that this is the most effective mechanism for ensuring that premiums for insurance products are set at an appropriate level, and in particular are not too high, leading to inefficient use of resources and the unnecessary exclusion of potential purchasers of insurance through non-affordability.

With competition goes a risk of unsound practice. However, competition should not be weakened to any material extent on account of this risk, which should instead be countered through appropriate supervisory structures and legislation, which requires sound business practices to be observed but does not stifle competition (see sections 4 and 5).

We recognise that it may take some time to organise a significant level of competition in the insurance market. However, the **policy advice unit** within the Ministry of Finance and Economy recommended in section 4.4.1 should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry and the promotion of competition within it.

An important obstacle to competition is cartel-like behaviour on the part of insurers. This is especially pertinent to a market forming part of a transition economy with a relatively small number of participants, as in Armenia. The government should therefore seek to eliminate such behaviour as far as possible. In this regard, and to maximize competition, the government should consider the extent to which **foreign direct insurers** should be permitted and encouraged to write business in Armenia.

Article 7 of the draft new Law allows risks in Armenia to be written only by locally registered insurers, mirroring the same requirement imposed by Article 6 of the existing Law. However, there is no restriction on local insurers being wholly owned subsidiaries of foreign insurers, or on the transfer abroad of profits of local insurers. The main issue that falls to be considered, therefore, is whether foreign insurers should, as an alternative, be permitted to write risks in Armenia through a branch.

Branch structures are often problematic from a supervisory viewpoint. The home countries of the foreign insurers operating branches may have widely differing standards of supervision, even to the extent that the branch operations are not supervised. The Armenian insurance supervisor should generally wish to supervise the branch on a comparable basis to local insurers, but in practice this may not be straightforward. For example, the foreign insurer may not be able to easily produce accounts for just the branch conforming to Armenian regulations. It is also desirable for the Armenian insurance regulator to obtain accounts for the foreign insurer's global business produced on an Armenian basis but these are even less likely to be available.

An exception to the above general rule might be considered where the home country of the foreign insurer operating the branch was subject to a high level of supervision for the whole of its business, including that written by the branch, such as would be the case for EU insurers, for example. However, it would then be necessary for the Armenian insurance supervisor to consider (a) what, if any, safeguards it should put in place, for example treaty and/or ring fencing of assets arrangements, to allow concessions to be given against the normal Armenian regulatory requirements; and (b) whether such concessions placed local insurers at an unfair competitive disadvantage.

Such considerations are not straightforward, and for this reason; the fact that it is unclear whether such insurers would wish to operate in Armenia on a branch basis in any event; and that the alternative option of establishing a subsidiary in Armenia subject to local regulatory requirements is already open to them, we recommend that branch structures of any kind should **not** be permitted in Armenia, at least for the time being, despite the increase in competition that these could theoretically bring. This also removes the potential risk of insurers in other CIS countries in particular opening up branches in Armenia for money laundering or other fraudulent purposes (such activity between republics was commonplace in the USSR) and the challenge that this would present to the insurance supervisor in deciding whether or not to allow such branch operations. It is, however, appropriate for handling agreements between CIS countries to be encouraged by the government and the insurance supervisor.

Competition aside, to maximize the affordability of insurance, we recommend that the government should also:

- strive to continue to grow the Armenian economy;
- consider paying subsidies to part finance payment of insurance premiums to those unable to meet their full cost generally;
- consider allowing payment of premiums under non-life insurance contracts as an expense against tax for both individuals and firms as an incentive to effect insurance (Article 9(4) indicates that life insurance contracts already enjoy tax relief); and
- strive to improve communications within the country, thereby opening up the possibility of new and potentially cheaper forms of distribution of insurance (e.g. direct mail).

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5.2.4 Corruption

It is important that the government takes all steps that it can to fight corruption (see section 3.11.3). There have already been a number of positive and very welcome developments in this regard, and these should be continued.

Work on fighting corruption was begun by the government some time ago and an outline program prepared in 2002. A national government anti-corruption commission led by the

Prime Minister, Mr Andranik Markarian, has since been set up to develop this program, and this is now seen as the key instrument in rooting out corruption. The program includes measures to be taken to combat administrative corruption, and the establishment of an international working group with responsibility for drawing up an anti-corruption strategy and improving anti-corruption legislation.

A Law on State Procurements, aimed at restraining the appetite of corrupt government officials, has already been passed and appears to be proving effective. A number of other drafts laws on licensing, public service, and income declaration of senior government officials, all aimed at eliminating corruption, have also been prepared by the government and are likely to be adopted by parliament in 2003.

The government's apparent determination on this issue in general, and the above initiatives in particular, have been welcomed by the Organisation for Security and Cooperation in Europe (OSCE), a regional security organisation based in Vienna, financed by 55 participating states in Europe, Central Asia and North America, and concerned with facilitating political processes, preventing or settling conflicts and promoting civil society and the rule of law. The head of its Yerevan office and the Prime Minister met in January 2003 to discuss how best to take the program forward and in particular what assistance this might be provided with by international organisations. OSCE is committed to maximising such assistance and promoting the commission's work. The government's initiatives are also being supported strongly by the World Bank, and extensively by the wider international community.

Fighting corruption requires consistent and long term work. It is important that the **government** continues to manifest political will and determination on this issue and view it as a priority. Specific steps that it should take in this regard include:

- tightening up and correcting ambiguities in laws to prevent evasion and deliberate misinterpretation or misuse;
- creating a genuinely independent judiciary;
- providing in laws for severe punishment of perpetrators of corruption;
- increasing accountability of state officials to the government, parliament, the courts and the public;
- introducing strict codes of code of conduct for public servants, requiring among other things the disclosure of interests; the avoidance of conflicts of interest; and the exclusion of individuals with vested interests from decision taking, and ensuring that these are rigorously enforced;
- requiring the summary dismissal of state officials found to have taken bribes;
- countering employment through bribery and nepotism by introducing objective and transparent recruitment and dismissal procedures;
- offering legal protection to those reporting incidences of corruption; and
- seeking to maximise economic growth, increase economic efficiency, reduce false employment and increase salary levels, to reduce the incentive for corruption.

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It is also important that **individuals** should bear increased personal responsibility for the situation in the country, as without this no state or other public initiative to reduce corruption is likely to be successful. This means curbing their personal inclination towards corruption, and also being more willing to report incidences of corruption perpetrated by others.

5.2.5 Mutual trust and supervision

It is a fundamental requirement for growth of the insurance market for businesses and individuals to want insurance. In order that people perceive value in having this, it is essential that they can have full confidence that they will be treated fairly and in particular that their due claims on insurers will be met. This in turn requires a sound system of insurance supervision, as the ordinary person or firm does not have adequate information (or if having this, lacks the capacity to process it) to assess the soundness of an insurer.

Establishing such public trust in the insurance industry requires action both from the government and the insurance supervisor, and from insurers. This is needed to seek to overcome the suspicion that the public has had in commercial enterprises in general in the past, and the elimination of the various scams indulged in by insurers, described in section 3.11.4. There is a need for the government and the insurance supervisor to **work together** with the Insurers' Association, individual insurers and brokers to establish appropriate relationships between insurers and both policyholders and brokers, and generally to seek to ensure that insurance supervision is conducted in an effective way. Specific actions that should be taken are set out below.

The **government** should:

- outlaw money laundering and all other types of fraud (Article 14 of the draft new Law does this);

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- establish an independent, adequately resourced insurance supervisor, which is accountable to the government, parliament, the courts, insurers and the public;
- establish a separate policy advice unit within the Ministry of Finance and Economy, which should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the maintenance of sound principles of insurance regulation;
- put in place supervisory legislation which seeks to ensure that, in all reasonably foreseeable circumstances, insurers can meet their obligations to policyholders, and that insurers and intermediaries behave honestly and openly;
- take comparable steps to improve the regulation and supervision of banks and other parts of the financial services sector, the problems of which appear to dwarf those of the insurance industry.

The **insurance supervisor** should:

- generally recognise, clamp down on, and develop procedures for countering, widespread and known scams;

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- check that all policies written by insurers are in classes for which they are licensed;

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- check the existence, propriety and adequacy of reinsurance arrangements;
- investigate and clamp down on accounts which are considered to be fraudulent or of dubious propriety written by insurers;
- strengthen controls over the issue of policies; it is recommended that stamping of policies by the insurance supervisor (by means of revenue stamps not use of a rubber stamp) is preferable to merely requiring policies to be printed in an approved printing house (see section 5.9.10);
- check the terms of policies carefully, particularly for travel medical policies;

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- challenge policies issued by insurers established by local industrial and commercial groups exclusively to meet their insurance needs, where these appear to be unnecessary or motivated by group tax reduction;
- consider requiring the registration of agents if these are considered to be a party to scams or other fraudulent practice (a distinction exists between brokers and agents worldwide but agents appear to do more in Armenia than is typical);
- consider introducing arrangements requiring client money handled by brokers to be held in trust if these are considered to be a party to scams or other fraudulent practice;
- not perceive the Insurers Association of Armenia as a threat, but rather treat this with respect in representing the views of its members;
- produce an annual report, which should be published, on the exercise of its functions and providing statistical information on the insurance market, and hold an annual meeting to allow public discussion of this;
- be proactive in describing its role in ensuring the safety of insurance products in particular;
- review the complaints handling procedures that insurers have in place.

Insurers should:

- cease being a party to scams or other fraudulent practice;
- promote and uphold high standards, with the objective of driving fraudulent insurers out of the market; the Insurers Association of Armenia should play a leading role in this by denying or terminating membership for fraudulent insurers, thereby enhancing its credibility with, and its ability to influence, the insurance supervisor; foreign owned insurers should also strive to set a good example in this regard;
- through the Insurers Association of Armenia, seek to raise the profile of insurance;
- clamp down on potentially invalid claims by challenging these robustly;
- establish efficient and effective complaints handling procedures.

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External auditors should play their part in seeking to ensure insurers are taking the steps above. It is also important that members of the **public** cease being a party to scams or other fraudulent practice, and that they purchase insurance only where they have a real need for it.

Detailed comments and recommendations on the structure of insurance regulation and supervision, and on supervisory legislation, are given in sections 4 and 5 respectively, which expand on the points on these made above.

5.2.6 Political will and coordination

It is important that the **government** shows a greater level of commitment to develop and reform the insurance market, and take concrete measures to effect and encourage this, than has been evident until the last couple of years (see section 3.11.5), as this is essential to establish the market's long term viability. There is strong evidence that this is now the case, being provided by the recent passing of the Law on Licensing and the Law on Legal Acts, the drawing up of the draft new Law and the commissioning of projects such as this, and this is to be strongly welcomed.

Both the government and parliament need to fully understand the role of insurance and its strategic importance. It is also necessary to improve coordination both between government ministries and technical advisors, and for the government to take a more holistic approach, than has been evident until the last couple of years, but again there strong evidence that this is happening, e.g. the creation of a database to improve coordination between, and reduce overlap of, development projects funded by different donor organisations (see section 3.11.5). Advice from international organisations such as the World Bank, the IMF and USAID should continue to be sought by the government.

The **Insurers Association** of Armenia should have a role in lobbying the government and parliament for greater commitment and coordination.

5.2.7 Compulsory classes

5.2.7.1 Feasibility and desirability

The experience of other CIS countries demonstrates that it is **feasible** to introduce **some** compulsory classes of insurance in Armenia, of which there are currently none (see section 3.11.6). **Georgia**, for example, has **compulsory third party motor insurance for bodily injury** and **compulsory property insurance for fire and major perils for commercial premises,** and **Azerbaijan, Uzbekistan, Kazakhstan and Turkmenistan** have all introduced **compulsory third party motor insurance along similar lines** to Georgia. Whilst some problems have been encountered, these have generally been successful.

The introduction of compulsory classes of insurance is clearly **desirable** in general viewed purely in terms of growing gross premium income in the insurance market and of increasing awareness of insurance. However, it is not the role of government to force people to insure themselves unless there are good **social reasons** for doing so. It is also important that making a class of business compulsory can be made to work **in practice**.

In our view, there are good social reasons for the government to make **third party motor** insurance compulsory. Traditionally in Armenia, motor accidents have resulted in the driver at fault paying compensation to the injured party by private agreement. However, with the number of high value vehicles now on the road, private settlements for accidents are becoming increasingly problematic with people unable to pay sometimes coming under personal threat (see section 3.6.6). There is also clearly a bodily injury risk. We also consider it to be practical to make this class compulsory, as there should already be sufficient infrastructure in place to enforce this. Specifically, the annual road test already required should not be passed until evidence of third party motor insurance is provided. We therefore strongly recommend that the government does this (this is a decision for the government and not the insurance supervisor, see section 5.9.5), but paying close regard to the comments in section 6.2.7.2.

Another class which we consider it feasible and desirable to make compulsory is **workmen's compensation/employer's liability** insurance, and we recommend that the government also does this.

Whilst there are good social reasons to make property insurance against fire and earthquake compulsory in Armenia – being in an earthquake region, the risk of earthquake is the largest single risk facing the country; the effects on both individuals and the economy of the lack of earthquake cover when the north west of the country was devastated by an earthquake in 1988 were catastrophic (see section 3.3.1) and the same could happen again – we do not consider it practical to do so at present, at least for residential property, due to many people in Armenia being too poor to pay for it. However, we suggest that the government may wish to

consider making this class compulsory for larger commercial premises (for which affordability should be less of an issue and the difficulty of property valuation should also be less acute) in due course, as in Georgia.

We do not consider compulsory health insurance to be feasible option at present, not least due to the closed nature of the health system caused by hospitals being unwilling to produce a fixed price list for treatment, medicines, dressings, etc, or to guarantee medical standards.

The government may wish to consider requiring certain types of insurance for specific individuals or in specific circumstances in addition (see section 6.2.13).

5.2.7.2 Regulatory implications and practicalities

Compulsory classes of insurance give rise to particular regulatory problems. In particular, because purchase is not voluntary, competitive pressure is weakened. Insurers are therefore potentially able to hold premiums higher than they need to be to enable them to make higher profits, against the interests of policyholders. For this reason, it is likely to be necessary to impose a **ceiling** on the premiums that can be charged by insurers for compulsory insurance products. A **floor** on premiums may also be needed, to prevent one large well capitalised insurer, say, from writing business at a loss in an attempt to force other players out of the market, again against the longer term interests of policyholders. Control over premiums for compulsory classes of insurance is provided for by Article 9(2) of the draft new Law. Appropriate penalties should also be applied to individuals who fail to purchase compulsory classes of insurance, and mechanisms put in place to identify such cases.

The **policy advice unit** within the Ministry of Finance and Economy recommended in section 4.4.1 has a particular role in relation to compulsory insurance. The design of, and conditions for, compulsory insurance products should be determined by this unit rather than by the insurance supervisory authority if potential conflicts of interest are to be avoided and the public is to continue to have confidence in the latter's independence. The role of the supervisory authority in relation to such products should be solely to comment on any issues arising regarding prudential conduct, in line with its mandate.

It is important that compulsory classes of insurance are introduced carefully and in accordance with international principles, and also that any requirements imposed under insurance company law dovetail with those imposed by other laws. Because insurers are likely to find compulsory insurance products attractive for the reason indicated above, there is a risk that there will be a number of sudden new entrants to the market. It is therefore **essential** that an effective system of insurance supervision is in place before they are introduced. The insurance supervisor should draw up a list of insurers in the market permitted to write compulsory insurance classes, which should be subject to strict capital and reinsurance requirements. The market for such products should then be shared between these insurers, almost certainly with the amount of such business that can be written by any one insurer made subject to a cap. It might be desirable to make membership of the Insurers Association of Armenia a precondition for being able to write compulsory classes of insurance.

A key decision that needs to be taken with regard to compulsory **third party motor** insurance is whether the cover should be for just bodily injury or also property damage to the vehicle. Advantages of bodily injury only are:

- less cover, hence cheaper and more widely affordable;
- reduces risk of fraudulent claims, which are more likely for property damage.

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Disadvantages are:

- less cover, hence weakens social benefit, and property damage is an increasing social problem in Armenia;
- policyholders may not realise they are not covered for property damage at the time of purchase and hence are disappointed when they make a damage claim;
- less cover, hence cheaper and less positive impact on gross market premiums.

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In Georgia, cover is restricted to just bodily injury (average premium only around US$12 per annum) but experience with this has not been entirely favourable due to the second disadvantage above, and on balance we suggest that extending cover to also include property damage is probably sensible in Armenia, with insurers being required to tackle dubious property damage claims head on the best they can.

To fulfil its social role, the level of cover provided should be high enough to provide real benefit. This implies cover for property damage of no less than the average value of the average car – say US$5k – and probably rather more (we understand that the average level of cover in Russia is around $US12k). On this basis, it has been suggested to us that the average annual premium should be around US$30, which should be affordable when compared to vehicle running costs. Voluntary top-up insurance above this level of cover should be encouraged.

Consideration should be given to the introduction of some kind of bonus or malus scale to help improve risk management, and to the creation of a bad risks pool. The government should also seek to reduce the overall level of risk by improving road conditions and tightening up on both driving tests and annual road tests, and tackle corruption relating to the latter, to ensure the existence of insurance cover.

In terms of **timing**, we recommend that compulsory third party motor insurance should be introduced first, followed by workmen's compensation/employers' liability insurance. However, we recommend that neither of these should be introduced until insurance supervision has been significantly strengthened through the provision of relevant training to the insurance supervisor (see section 4.4.3.2) and preferably until after the independent supervisory authority recommended in section 4.4.1 has been established. Any introduction of compulsory property insurance against fire and earthquake for larger commercial premises should wait until actual experience with the other compulsory classes has been assessed.

5.2.7.3 Impact on the market

We estimate that the introduction of compulsory third party motor insurance should increase gross market premiums by some US$3m, a reasonable proportion of which should be able to be retained in the country.

It is difficult to estimate the impact that the introduction of compulsory workmen's compensation/employers' liability insurance might have on the market, although this is likely to be modest initially due to the current very high rates of unemployment (see section 3.3.1).

To the extent (which we expect to be substantial) that compulsory classes of insurance increase public awareness of the benefits of insurance, their introduction should also have a positive knock-on effect on sales in the rest of the market.

5.2.8 Capital levels and retentions

Increasing gross market premiums in Armenia would be an achievement in itself, as this would reflect increased use of insurance with its associated social benefits, increase the profits made by insurers in ceding business, and help grow the economy. But if insurers were also able to increase their retentions, which are currently very low due to modest levels of paid up share capital (see section 3.11.7), this should allow them to increase their profits further, as well as reducing the outflow of money abroad through reinsurance.

The logical conclusion from this is that it is desirable for insurers to increase their levels of paid up share capital. However, only a few of them appear to be giving this serious consideration at present (see section 3.11.7), implying the need for the government to raise **minimum capital requirements** from their existing level. However, in considering by how much, it is necessary to strike a balance between making the increase large enough to have a significant positive impact on capacity in the market and not so large that sound insurers are forced out of the market unnecessarily, thereby reducing the level of competition against the interests of policyholders. It is also desirable that the increase be made in stages, as the hoped for increase in gross market premiums materialises, to ensure that this is proportionate and justified.

Detailed recommendations on minimum capital requirements, and the associated issues of reserving, asset valuation, matching, solvency, reinsurance and premium adequacy are set out in section 5.4.

5.2.9 Insurance and accountancy/audit professionals

To facilitate the healthy development of the insurance market in Armenia, it is important that the current lack of professionals trained in insurance and related matters, such as accounting and actuarial, in the market (see section 3.11.8) be addressed.

In response to this, the **government** should:

- survey existing training and qualification programs for relevant specialists, including accountants and auditors, actuaries, surveyors and asset valuers, loss adjustors, investment managers and underwriters, and where gaps are identified seek to fill these;
- encourage the formation of local professional associations of such specialists, with strict codes of conduct and severe penalties for transgressions;
- anticipate, and seek to facilitate, the supply of appropriately qualified people in line with the anticipated need for such people;
- in recognition of their currently inadequate supply, drop the requirement in the draft new Law for all local insurers to employ a qualified actuary for the time being (see section 5.9.9).

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Insurers should:

- secure technical training for their staff on insurance and related matters, including accounting and (for a few) actuarial. Such training might be obtained from a number of sources:
    - Yerevan State University and the Institute of National Economy are developing accountancy training programs based on the ACCA curriculum, and Yerevan State University is also developing a 2-year actuarial training program, both financed by USAID. Subject to the quality of these courses being satisfactory (the content of these should, and we assume is, western and not Russian), staff of the insurer should

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be encouraged to attend them. We understand that the EU University in Yerevan may also, now or in the near future, be able to offer suitable courses in insurance;

  - self-training should be undertaken by staff of the insurer being encouraged to take out available correspondence courses in insurance, and in particular at least the early parts of the CII curriculum. The "core reading" issued by the UK Faculty and Institute of Actuaries provides useful actuarial material suitable for self-study;
  - training on insurance and related matters should also be obtained from external consultants, the insurer's reinsurer(s) (where relevant), and the Insurers Association of Armenia (see below).

  Day release should be offered to staff for study purposes, and financial rewards given to those passing exams;

- actively seek to recruit new staff with insurance and related skills if possible, to allow transfer of these skills to other staff. We recommend that CII qualification should be a preferred requirement for these. We also suggest that insurers actively consider work placements from, for example, AISEC (a French organisation specialising in exchange visits), as these too are helpful in transferring relevant skills;
- seek to become fully familiar with the new Law and its associated regulations, the obligations these place on insurers and brokers, and the powers and obligations they confer on the supervisory authority;
- in the next few years, buy in such professional advice as they require from abroad, e.g. loss adjustors from Russia.

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Members of the **Insurers Association** of Armenia should lead the way in obtaining such training, including on reinsurance, and sharing their knowledge with others. This should be done in a formal way by means of training seminars, etc. A specific budget should be made available for this, with the Association seeking to obtain such financial assistance as is required. Such training activity is carried by the equivalent body in a number of other CIS countries.

The **insurance supervisor** should take similar steps for its staff (see section 4.4.3.2).

Brokers may wish to become providers of investment management advice, and if so should obtain relevant training beforehand.

5.2.10 Data

The government should take responsibility for ensuring that appropriate mechanisms are in place to facilitate the provision of good quality data relating to financial loss to insurers. This is necessary to enable insurers to price their products appropriately, reflecting the risk being underwritten; develop new products and establish adequate reserves; and to avoid the negatives listed in section 3.11.9.

The **insurance supervisor** should prepare the annual report recommended in section 4.4.3.9, which should be published and hence be available to all insurers and the public. This should include statistical data on the insurance market, including data for individual insurers and classes of business. It should include as a minimum, for each insurer:

- total assets;
- total liabilities;

- written premiums, for each of the most important classes and in total, net and gross of reinsurance;
- claims paid, for each of the most important classes and in total, net and gross of reinsurance;

and ideally all the data items listed in section 4.4.3.4, together with at least some of the ratios listed in that section. The level of disclosure should be increased in time. Such a report is already produced by the supervisory authority in Georgia.

As well as producing this annual report, the insurance supervisor should also be proactive in providing relevant statistical data to the public and the insurance industry. It should give particular priority to the collection and distribution of data that can be used for estimating future financial loss, and hence for the pricing of products and reserving. For example, if this is not already provided in the annual report, it should provide details of numbers of claims (and of policies in force so that claims frequency can be determined), average claim amount and maximum claim amount for each of the most important classes of business for the market as a whole.

It should research and publish a list of centres of data analysis that have relevance to private insurance to ensure that the existence of these is known to insurers and other interested parties.

It should also seek to publish more detailed statistical information based on actual claims data which it has previously collected from insurers and collated. It should be proactive in researching whether insurers in Armenia would be prepared to submit such data in this way. If not, it should suggest instead that insurers submit data in an agreed format to an independent third party, which would be responsible for analysing it and passing the results back to the insurance supervisor for publication. This is likely to have the advantage that insurers would be willing to provide more detailed (and hence potentially more useful) data to such a third party than they would to the insurance supervisor.

The **Insurers Association** of Armenia should be proactive in encouraging such data collection, and cooperate with the insurance supervisor to the maximum extent possible in this regard.

The **government** should ensure maximum cooperation and coordination between different ministries with regard to data collection. It should also address the current severe shortcomings in national statistics (see section 3.3).

5.2.11 Investment opportunities

There is a limit to what can be done to alleviate the currently extremely limited investment opportunities in Armenia (see section 3.11.10) in the next few years. The government should focus on continuing to strengthen the regulation and supervision of the banking sector to improve its overall creditworthiness, and on maintaining stable economic policy to minimize currency devaluation risk, to seek to increase public trust (see section 6.2.5).

In the medium term, with increased trust, consideration should be given to the issuance of long term government bonds. In the longer term, the government should have the objective of the establishment of a functioning stock market.

5.2.12 Policyholder protection scheme

In our view, an insolvent insurer policyholder protection scheme is not justified by the size of the insurance market at present, and should not be introduced in the next 5 years. There are

many more developed insurance markets in the world which do not operate such a scheme, and so far the few insurers that have closed in Armenia have all managed to run off their business in an orderly fashion. Such a scheme would also inevitably create moral hazard because it would raise the prospect of policyholders being at least partially indemnified from losses caused by failing insurers, which is not easy to counter. Instead, the focus should be on raising minimum capital requirements and improving the effectiveness of insurance regulation and supervision, to minimize the risk of future insolvencies.

In the longer term, it might be appropriate to include insurance in a suitably designed wider financial services sector protection scheme. We recommend that this is considered as part of the review after 5 years recommended in section 6.2.1.

5.2.13 Other measures

We list below are some further measures that could potentially be taken to assist the development of the insurance market in Armenia, which the government may wish to consider:

- entering into double taxation agreements with more countries, and considering more general reforms, to make it more conducive for local insurers to begin writing business abroad as well as in Armenia;

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- requiring insurance in the following classes in the following circumstances:
    - professional indemnity insurance for brokers, auditors and actuaries;

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    - aviation insurance for internal flights and flights to other CIS countries, both hull (for Russian aircraft) and liability (as a condition for over-flying and landing);
    - marine cargo insurance on major exports;
    - general third party liability for large public premises;
    - environmental liability insurance for major industrial plants (Azerbaijan is currently considering making this class of insurance compulsory, see section 3.11.6);
- piloting a feasibility study into the development of agricultural insurance to cover both animal health and crop damage (we understand that some initial work in this area may have already been undertaken by the Agricultural Cooperative Bank of Armenia, with financial backing from the EU);

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- in the event that the mandatory medical insurance fund financed by a 3% insurance tax on employed persons to provide medical benefits on a nationwide basis recommended by USAID (see section 3.11.5) proves unsuccessful, considering a variation of this in which some state funding is retained but the purchase of voluntary private medical insurance is also encouraged. The latter could be targeted initially at large factories, for example. To make this alternative viable, price standards would be required. This alternative is consistent with a trend in other CIS countries towards private medical insurance in conjunction with a reorganisation of the social fund to target only those who cannot afford insurance. In Georgia, for example, gross written premiums for private medical insurance now account for some 23% of the insurance market and total over US$3m, a figure comparable to such premiums for the entire insurance market in Armenia (see section 3.4);
- taking steps towards introducing privately funded pensions, as recommended in the past by USAID (see section 3.11.5);

- depending on its level of success in continuing to strengthen the regulation and supervision of the banking sector to improve its overall creditworthiness, and maintaining stable economic policy, encouraging the use by banks, and the provision by insurers, of credit insurance;
- taking such steps as it can to encourage the establishment of a domestic reinsurer (though perhaps wholly or mainly foreign owned) when sufficient market capacity exists to make this a viable proposition.

6 SUMMARY OF RECOMMENDATIONS

The following table provides a summary of the recommendations made in this report. These have been categorised in terms of both importance and urgency. **Importance** is ranked as **1 = essential; 2 = important; 3 = recommended**. **Timescale** is ranked as **U = urgent (straight away); S = in short term (within 2 years); M = in medium term (within 5 years); L = in longer term (after 5 years)**.

	Recommendation	Section	Importance	Timescale
	Relating to the structure of insurance regulation and supervision			
1	Amend the draft new Law to provide for the establishment, no later than 31 December 2005, of an adequately resourced, independent, stand-alone insurance supervisory authority, which should have responsibility for the supervision of insurance.	4.4.1	1	U
2	Amend the draft new Law to provide for the creation a policy advice unit within the Ministry of Finance and Economy, which should have responsibility for advising the government on the development of state policy on insurance, with particular reference to the development of the insurance industry, the promotion of competition within it, the maintenance of sound principles of insurance regulation, and the promotion and delivery of public education on insurance matters.	4.4.1	1	U
3	Consider all other amendments to the draft new Law recommended in section 4.4.1 and make these as appropriate.	4.4.1	2	U
4	Put in place appropriate regulations and/or internal procedures relating to the insurance supervisory authority as recommended in section 4.4.1. These should address, in particular, the following issues.	4.4.1	1/2	S
5	The constitution and governance structure of the insurance supervisory authority should be clearly defined and be as described in section 4.4.2.1.	4.4.2.1	2	S
6	The insurance supervisory authority should be operationally independent in the exercising of its functions and powers but accountable for the actions it takes in fulfilling its mandate to those who delegated responsibility to it, namely the government and parliament. Its institutional relationships with the government, parliament and the judiciary should be as described in section 4.4.2.2.	4.4.2.2	1	S

	Recommendation	Section	Importance	Timescale
7	The insurance supervisory authority should be partly financed by a levy on insurers, set as a percentage of the gross premiums, excluding those relating to compulsory classes of insurance, written by the insurer. It should be required to submit to the Ministry of Finance and Economy each year a proposed total budget for the coming year (together with an estimate of the projected levies for that year) for approval, and to the extent that the levies above are inadequate to provide this budget, additional resources should be provided by the Ministry of Finance and Economy. It should be required to prepare a set of financial statements, which should be audited by an independent auditor.	4.4.2.3	2	S
8	The insurance supervisory authority should have clear, transparent processes and procedures for making supervisory decisions. It should have the power to take immediate action when necessary, such as in an emergency situation, and its decision making lines should be structured so that this can be achieved in practice. Appropriate procedures should be put in place to achieve this as described in section 4.4.2.4.	4.4.2.4	2	S
9	Initial staffing of the insurance supervisory authority should be as described in section 4.4.3.2, with the level of staffing kept under close review as the insurance market evolves. It is also highly desirable that several new staff with insurance and related skills be recruited immediately if possible. Staff should be made subject to both a strict code of conduct and to conflicts of interest restrictions. Salaries should be substantially increased to make them at least competitive with those paid in the private sector, and particularly by insurers.	4.4.3.2	2	S

	Recommendation	Section	Importance	Timescale
10	There is an acute need for training of staff of the insurance supervisory authority on several fronts, including training on the new Law specifically, management training for senior staff, training on sound supervisory practice generally and on specific aspects of it, professional and technical training for at least some staff on insurance and related matters, including accounting and (for a few) actuarial, and training on information technology. This should be provided as a priority, e.g. using the sources suggested in section 4.4.3.2.	4.4.3.2	1	U/S
11	The organisational structure and general practice of the insurance supervisory authority should be as described in section 4.4.3.3.	4.4.3.3	2	S
12	The insurance supervisory authority should monitor the financial position of insurers by means of the processes described in section 4.4.3.4. There is a need for both immediate and longer term technical training to facilitate this, which should be provided.	4.4.3.4	2	U/S
13	The insurance supervisory authority should actively seek to extend its existing on-site inspection process beyond mechanical checking of compliance with regulations and examination of contracts and claims to also cover some of the other items described in section 4.4.3.5 including in particular corporate governance, strategic planning and systems and controls as soon as possible, obtaining relevant technical training as appropriate.	4.4.3.5	2	S
14	The insurance supervisory authority should assess licence applications in accordance with the principles and practices described in section 4.4.3.6. There is a need for external technical assistance with this task in the short term, which should be provided.	4.4.3.6	2	S
15	The insurance supervisory authority should take appropriate intervention action against individual insurers where necessary in accordance with the principles and practices described in section 4.4.3.7.	4.4.3.7	2	S

	Recommendation	Section	Importance	Timescale
16	The work currently undertaken by the methodology unit of the existing insurance supervisor on developing state policy on insurance should transfer to the separate policy advice unit within the Ministry of Finance and Economy. Such policy work as remains within the insurance supervisory authority should be firmly focussed on delivering sound supervision and protecting the public interest and include the unit's other existing functions.	4.4.3.8	1	U
17	The insurance supervisory authority should prepare an annual report for the Ministry of Finance and Economy covering among other things the discharge of its functions during the year and providing statistical data on the supervised entities, which should be laid before parliament and published. It should also hold an annual public meeting to allow discussion of this.	4.4.3.9	2	S
18	The policy advice unit within the Ministry of Finance and Economy should have the responsibilities, and operate in the way, described in section 4.4.4. It should be created as soon as possible and in any event by the time of the establishment of the independent insurance supervisory authority.	4.4.4 and 4.4.5	2	S
	Relating to supervisory legislation generally			
19	There is a need for maximum flexibility whilst the insurance market develops, and consequently the new Law should confine itself to setting out broad principles with detailed provisions placed in regulations made under it. Because regulations can be changed by the insurance supervisory authority without the need for recourse to parliament, this allows provisions to be phased in our out as necessary with relative ease, and the insurance supervisory authority to respond quickly to events if needed.	5.2.1	1	S/M/L

	Recommendation	Section	Importance	Timescale
20	Any form of self regulation by the insurance industry in Armenia should be ruled out at least in the shorter term. However, centralised control should also be kept to a minimum. Instead, the aim should be to create an environment in which insurers are subject to sound prudential standards enforced by an effective, independent insurance supervisory authority, whilst at the same time being placed under pressure to be competitive.	5.2.1	1	S
21	Consider all amendments to the parts of the draft new Law covering authorisation of insurers recommended in section 5.3.2.2 and make these as appropriate. In particular, a licence should be granted only for those classes of business included in the application; where an insurer wishes to commence writing new classes, it should submit an application for an extension of its licence; and the contents of the business plan required as part of the application should be reviewed.	5.3.2.2	2	U
22	Consider all amendments to the parts of the draft new Law covering prudential requirements recommended in section 5.4.2.2 and make these as appropriate. In particular, the "basic economic norms" in Article 31(1) of the draft new Law should be replaced by a simpler and more effective set of "minimum financial standards"; and Article 31(6) should be amended to refer to a violation of any of these and extended to additionally require an insurer to submit to the insurance supervisory authority an action plan as described in that Article if its assets exceeds its liabilities by less than 5% of those liabilities, or would do so following any proposed distribution (in whatever form) to shareholders.	5.4.2.2	1	U
23	Put in place appropriate regulations relating to the specific prudential requirements recommended in sections 5.4.2.3 to 5.4.2.9. These should address, in particular, the following issues. The requirements imposed by these regulations should be progressively strengthened as the insurance market develops.	5.4.2.2	2	S/M

	Recommendation	Section	Importance	Timescale
24	The minimum issued and fully paid up share capital requirement under Article 30(1) of the draft new Law should be increased progressively over the next 5 years in accordance with the schedule set out in section 5.4.2.3 but subject to these being reviewed in the light of actual development of the market.	5.4.2.3	1	U
25	Reserving requirements should be introduced as described in section 5.4.2.4.	5.4.2.4	2	S
26	Asset valuation rules should be introduced as described in section 5.4.2.5.	5.4.2.5	2	S
27	Matching requirements, covering the matching of assets to technical reserves and complementing the general safety, diversification and liquidity requirements in Article 29(2) of the draft new Law, should be introduced as described in section 5.4.2.6.	5.4.2.6	2	S
28	Solvency requirements should be introduced resting on the four pillars described in section 5.4.2.7, and regulations put in place with regard to maintaining liquidity of the insurer's net assets as outlined in that section.	5.4.2.7	2	S
29	Consider the issues regarding reinsurance raised in section 5.4.2.8 and in particular the imposition of a restriction on the value that can be placed on the reinsurers' share of technical provisions asset in the balance sheet where the gross liabilities are reinsured to a reinsurer with a credit rating below a specified level as outlined in that section.	5.4.2.8	3	S
30	Consider the issues regarding premium justification raised in section 5.4.2.9 and make any changes to the draft new Law as appropriate in the light of these.	5.4.2.9	3	U
31	Consider all amendments to the parts of the draft new Law covering financial reporting recommended in section 5.5.2.2 and make these as appropriate. In particular, financial statements should be prepared using international accounting standards, and interim financial statements provided for by Article 32(1) should be required on a quarterly basis.	5.5.2.2	2	U
32	Put in place appropriate regulations relating to the format and content of financial statements submitted by insurers as outlined in section 5.5.2.2.	5.5.2.2	2	S

	Recommendation	Section	Importance	Timescale
33	Consider all amendments to the parts of the draft new Law covering intervention recommended in section 5.6.2.2 and make these as appropriate. In particular, the introduction of additional intervention powers, exercisable on appropriate grounds selected from those listed in Article 45(1) to be specified and aimed manly at providing for preventative action, should be considered, as listed in point 5 in that section.	5.6.2.2	2	U
34	Amend the draft new Law to include provisions relating to the transfer of business from one insurer to another reflecting the principles described in section 5.7.2.1. The new Law need only include a short Article stating that such transfers are subject to approval by the insurance supervisory authority, with the procedure to be followed in this regard set out in regulations made under that Article. Such regulations should address the issues listed in section 5.7.2.2.	5.7.2.2	1	U/S
35	Amend the draft new Law to include provisions relating to liquidation and winding up, which should address the issues listed in section 5.8.2.2.	5.8.2.2	1	U
36	Consider all amendments to the draft new Law recommended in section 5.9 and make these as appropriate. In particular, insurance business should be classified according to the classes of business listed in section 5.9.5 for the purpose of both licensing and financial reporting; the requirement for an in-house actuary should be dropped for the reasons explained in section 5.9.9, with emphasis instead being placed on requiring insurers to use proper accruals accounting; and specific provisions should be introduced relating to changes of control of insurers and changes to their managers as outlined in section 5.9.12.	5.9	½	U
37	A further review of Armenian insurance supervisory legislation should be conducted after 5 years to appraise the changes made to it by then and to make recommendations for any further changes considered necessary at that time in the light of the development of the insurance market to that date.	5.2.1	2	M

	Recommendation	Section	Importance	Timescale
	Relating to development of the insurance market			
38	Increase public awareness of insurance in Armenia. The Insurers Association should play a role in this, taking steps to raise the profile of insurance generally, and to advertise its benefits to the public in particular, making a specific budget available for this and seeking to obtain such financial and technical assistance as is required. The policy advice unit within the Ministry of Finance and Economy should prepare a plan for public education, aimed particularly at schools, businesses, farmers and other appropriate outlets. As well as publishing an annual report and holding an annual meeting to allow public discussion of this, the insurance supervisory authority should also be proactive in releasing to the public directly such other reports or information as it considers necessary for the purpose of increasing public awareness of insurance and should allocate a specific budget for this.	6.2.2	2	M
39	Maximise affordability of insurance in Armenia. The government should be as proactive as possible in developing the insurance market. The policy advice unit within the Ministry of Finance and Economy should promote competition within the insurance industry. Cartel-like behaviour should be eliminated as far as possible. Whether foreign insurers should be permitted to write risks in Armenia through a branch should be considered, but this should probably not be allowed, at least for the time being, despite the increase in competition that these could theoretically bring, for the reasons explained in section 6.2.3. Competition aside, the government should also seek to take the steps outlined in that section.	6.2.3	2	M
40	The government should take all steps that it can to fight corruption, continuing the positive developments that have already taken place, including the specific measures listed in section 6.2.4. Individuals should also bear increased personal responsibility for the situation in the country, including curbing their personal inclination towards corruption and being more willing to report instances of corruption perpetrated by others.	6.2.4	2	M

	Recommendation	Section	Importance	Timescale
41	The government, the insurance supervisory authority and insurers should all take steps to increase public trust in the insurance industry, including the specific actions listed in section 6.2.5.	6.2.5	2	M
42	The government should continue to demonstrate the greater level of commitment to develop and reform the insurance market that has been evident in the last couple of years. The Insurers Association should have a role in lobbying the government and parliament for such commitment and co-ordination between both government ministries and technical advisors.	6.2.6	2	M
43	The government should make third party motor insurance compulsory, but paying close regard to the comments in section 6.2.7.2. Consideration should be given as to whether cover should extend to property damage as well as bodily injury, but it probably should do so for the reasons explained in section 6.2.7.2. The level of cover provided should be high enough to provide real benefit. However, this step should not be taken until insurance supervision has been significantly strengthened through the provision of relevant training to the existing insurance supervisor as recommended in section 4.4.3.2 and preferably until after the independent supervisory authority recommended in section 4.4.1 has been established.	6.2.7.1	1	S
44	The government should also make workmen's compensation/employer's liability insurance compulsory, but this should be done only after third party motor insurance has been made compulsory.	6.7.2.1	2	M
45	Insurers should increase their levels of paid up share capital to allow them to retain more of the business they write.	6.2.8	2	M

	Recommendation	Section	Importance	Timescale
46	The current lack of professionals trained in insurance and related matters, such as accounting and actuarial, in the market should be addressed by the government and insurers taking the steps described in section 6.2.9. Members of the Insurers Association should lead the way in obtaining relevant technical training, including on reinsurance, and sharing their knowledge with others, making a specific budget available for this. The insurance supervisory authority should take similar steps for its staff. Brokers wishing to become providers of investment management advice should obtain relevant training beforehand.	6.2.9	2	M
47	The government should take responsibility for ensuring that appropriate mechanisms are in place to facilitate the provision of good quality data relating to financial loss to insurers. The insurance supervisory authority should prepare the annual report recommended in section 4.4.3.9, which should be published and hence be available to all insurers and the public. This should include statistical data on the insurance market, including data fir individual insurers and classes of business, as outlined in section 6.2.10. The insurance supervisory authority should also be proactive in providing relevant statistical data to the public and the insurance industry. It should research and publish a list of centres of data analysis that have relevance to private insurance, and seek to publish more detailed statistical information based on actual claims data that it has previously collected from insurers and collated. The Insurers Association should be proactive in encouraging such data collection and co-operate with the insurance supervisory authority to the maximum extent possible in this regard. The government should ensure maximum co-operation and coordination between different ministries with regard to data collection, and also address the current severe shortcomings in national statistics.	6.2.10	2	S/M

	Recommendation	Section	Importance	Timescale
48	The government should continue to strengthen the regulation and supervision of the banking sector to improve its overall creditworthiness and maintain stable economic policy to minimize currency devaluation risk to seek to increase public trust. In the medium term, consideration should be given to the issuance of long term government bonds. In the longer term, the government should have the objective of the establishment of a functioning stock market.	6.2.11	3	M/L
49	An insolvent insurer policyholder protection scheme is not justified by the size of the insurance market at present, and should not be introduced in the medium term. Instead, the focus should be on raising minimum capital requirements and improving the effectiveness of insurance regulation and supervision to minimize the risk of future insolvencies. In the longer term, it might be appropriate to include insurance in a suitably designed wider financial services sector protection scheme.	6.2.12	3	L
50	Consideration should be given to the further measures listed in section 6.2.13 to assist the development of the Armenian insurance market. These include piloting a feasibility study into the development of agricultural insurance to cover both animal health and crop damage; making other classes of insurance compulsory in specific circumstances; and taking steps to encourage the development of a domestic reinsurer.	6.2.13	3	M/L
51	A further review of the Armenian insurance market should be conducted after 5 years to appraise the development that has taken place by then and to make recommendations for any further structural changes to the market considered necessary at that time in the light of this.	6.2.1	2	M