



**INSURANCE REGULATION IN JAMAICA: A CASE STUDY OF  
THE JAMAICAN EXPERIENCE**

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## **Introduction**

During the mid 1990's (circa 1996 – 1999), Jamaica's financial sector experienced a period of instability in which the Government of Jamaica had to intervene to assist several financial institutions, some of them "large" (five were life insurance companies, one was a general insurance company while eleven were commercial banks and merchant banks) from a severe liquidity and solvency crisis. During 1996, a group of chief executive officers of life insurance companies approached the government for help with what they described as liquidity problems.

Preliminary analysis showed that what was positioned as a liquidity problem based on a mismatch of the maturities of assets and liabilities, was in fact a problem of insolvency of varying degrees. Even more significantly, it became clear that the difficulties were not confined to the insurance sector but the banking sector was also affected. Insurance companies in conglomerates, given their connection under the group umbrella, were severely affected through inter-company lending, as they advanced funds to other group companies which were short of cash. Diagnostic reviews of troubled institutions in 1997 unearthed several factors contributing to the sector's turmoil, *viz*:

- Absence of or failure to comply with proper internal control procedures.
- The troubled banks showed a high incidence of fraud and irregularities indicating weaker controls.
- Poor risk management and inadequate portfolio diversification.
- Poor regulatory and supervisory framework was present in Jamaica.

The combined threat was a loss of approximately \$341 billion (US\$10 billion) (sum assured) affecting almost 500,000 policyholders in the insurance sector while over two million depositors were at risk. It was decided that the risk to the economy of the collapse of the banking and insurance sector was unacceptable. The bailout of financial institutions cost approximately 40 percent of GDP, which suggested that Jamaica's financial sector crisis was one of the costliest, in terms of its fiscal burden (see figure 1). The Jamaican crisis was resolved relatively quickly<sup>1</sup> but was accompanied by an increase in the stock of public sector debt. The debt burden is widely viewed as a major constraint on the provision of public goods and services while at the same time crowding out private investment and slowing the rate of economic growth.

### **New Regulatory Regime**

The crisis, however, also led to an improvement in regulation and supervision of the financial sector. The Financial Services Commission (FSC) was created through the Financial Services Commission Act to oversee the regulation of Jamaica's insurance, pension and securities industries. The FSC, a self-financing regulatory body, was given wide ranging powers to supervise, investigate and sanction entities falling under its jurisdiction. Bearing in mind the factors behind the crisis, the FSC's supervisory practices initially placed a significant amount of weight on prudential supervision; focusing on the quality of internal controls, risk management and corporate governance within regulated institutions,

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<sup>1</sup> See The World Bank "Jamaica: The Road to Sustained Growth" Country Economic Memorandum, December 2003.

separate and apart from the expected focus on the solvency status of these entities. Market conduct regulation was initially deferred.

As part of the reforms arising out of the crisis, the Insurance Act (1971) was repealed in 2001 and replaced by a new Insurance Act (and Regulations) which introduced standards for solvency, investments, accounting, corporate governance and elements of market conduct such as claims settlement.

Within the new legislations, several new provisions aimed at maintaining the solvency of the insurers were introduced. Examples of these provisions are:

- The mandatory appointment of an actuary. This was to ensure that technical reserves were properly calculated and the treatment standardised.
- Stronger requirements relating to auditors and the introduction of an insurance accounting standard.
- Investment and loan regulations.
- The introduction of the new solvency standards, the Minimum Asset Test (“MAT”) for general insurance companies and the Minimum Continuing Capital and Surplus Requirement (“MCCSR”).
- Unlike the old Act, there are now penalties for breaches of the Insurance Act and Regulations outside of cancellation of registration.
- An examination of each company quarterly and annually to determine whether the company is complying with the provisions of the

Insurance Act and to determine whether the company is in sound financial condition using the CAMELS<sup>2</sup> framework.

The new Act also required that all persons who manage or control an insurance entity should be fit and proper. The FSC interprets this to mean that all members of the senior management team, all directors and shareholders owning 10% and higher of a company's share capital must satisfy the fit and proper test.

### **FSC's Mandate**

The legislation<sup>3</sup> under which the FSC was established made it clear that the FSC's mandate was to protect the interest of policyholders. The Insurance Act also stipulates that the directors and officers of an insurance company must act in the interest of policyholders. Is there then a conflict between the owners of capital and the policyholders? There need not be, as the regulator's task of protecting the policyholders results in the direct protection of the company through various prudential and market conduct standards. The company is required to demonstrate and provide evidence to the regulator that proper and acceptable risk management systems are in place to protect the company. A company with these features should provide comfort to shareholders and policyholders alike.

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<sup>2</sup> Under the CAMELS assessment framework, a company's risk profile is assessed according to the following areas of exposure: Capital, Asset Quality, Reinsurance, Actuarial, Management, Earnings, Liquidity, and Subsidiaries.

<sup>3</sup> The Financial Services Commission Act, 2001

## **Monitoring**

Monitoring is achieved principally through examinations which may be either off-site, on-site or both. Usually, on-site examinations are targeted at specific areas of a company's operations in response to concerns that may have arisen from the results of an off-site examination or other source of information. Off-site examinations are conducted on filings which are made quarterly in addition to the annual filing based on audited financial statements and certified by the companies' auditors. The FSC's response to the results of company examinations are governed by a supervisory ladder. The FSC's supervisory ladder comprises 4 stages: Stage 0 (*Normal/No Problems*); Stage 1 (*Early Warning*); Stage 2 (*Risk to Financial Viability or Solvency*); and Stage 3 (*Future Financial Viability in Serious Doubt*). The ladder identifies the conditions giving rise to each stage and specifies the regulatory actions that should be taken. An example of the supervisory ladder for the general Insurance industry is provided in appendix 1. At present every company is given a rank on the regulatory ladder. All life insurance companies are ranked at stage "0".

At the outset three companies were required to make capital injections in order to comply with the new solvency requirements.

Unlike the old Insurance Act which had no substantial provisions relating to corporate governance, the present Insurance Act and Regulations placed a strong emphasis on corporate governance. The present Act and Regulations stipulate measures that will improve the insurers' corporate governance and aim to reduce malpractices that frequently occurred under the old regime. For example, insurers must form statutory committees such as Audit,

Investment and Loan and Conduct Review committees to oversee the corporate affairs of the company. The committees must be comprised of a majority of independent directors. Independent directors are persons who are not directors or employees of the company or any of its affiliate companies. These committees are required to submit reports to the regulator. Also the present Act and Regulations place restrictions on related party transactions and companies are required to identify conflict of interest situations and put in place measures to counteract them. Transactions among related parties must be priced at fair value and must be reported to the FSC.

### **Challenges**

The shift from a passive low-keyed regulatory environment to this active and vigorous regime did not initially find much favour with certain elements within the industry. There were complaints about the increased cost of regulation and that some of the new requirements were unnecessary. There was an outburst against the fees to be levied and a public issue developed over it. Concerns over this matter, however, was quickly laid to rest as the basis for the fee was transparently discussed and agreed with the industry.

The young FSC organisation also faced early challenges due to lack of resources and expertise in regulation. The situation was recognised and steps were taken to correct the situation through recruitment and training of staff.

The FSC, having satisfactorily faced its early challenges, prioritised prudential regulation. The prudential regulatory objective has been met in

that the monitoring of each company has been assigned to specific analysts and the companies are being monitored under a risk-based regulatory framework. At least six on-site examinations are done during each year. The FSC, having achieved the objective is about to pay more attention to Market Conduct regulation.

### **Market Conduct**

The present Act and Regulations have substantial provisions relating to market conduct. They contain provisions that prohibit the release of any statement, advertisement or document in any form that is misleading. There are also provisions against unfair trade practices and actions that may be deemed as such practices. An example of unfair practice would be a misrepresentation of the benefits, advantages, premiums, conditions or terms of any policy.

The FSC acts decisively against market conduct breaches. Information on breaches is gleaned from a number of sources: (1) examination findings (2) customer complaints and (3) independent investigation. The investigation and enforcement action against market conduct breaches is functionally separate from mainstream insurance supervision and resides within a Legal, Investigation and Enforcement Division. Policyholders and members of the public may complain to the FSC which receives and investigates such complaints. Where the complaints are valid, the FSC seeks redress on behalf of the complainant as long the matter will not require a court hearing.

The FSC

- hears and investigates complaints from insurers and intermediaries concerning fellow players in the industry.

- if required, may enforce compliance to the relevant Acts by the use of sanctions, penalties and legal actions.

## **Enforcement**

The new legislation strengthened the regulatory powers of the FSC by including stiff penalties for breaches. Each breach is punishable by a substantial fine or imprisonment or both if the offenders were to be convicted after prosecution. But the legislation also provides for the FSC to offer to the offender the opportunity to discharge his/her liability to conviction by the payment of a fixed fine as an alternative to prosecution.

The FSC has other enforcement alternatives as follows:

- Undertaking from board of directors
- Cease and desist order
- Directions

In the case of insolvency the FSC, in addition to the measures above, may put a company under “temporary management” or apply to the court for an order to liquidate the company.

All actions taken by the FSC may be appealed to an Appeals Tribunal which may confirm or overturn the FSC’s decision

## **The Way Forward**

The aim of the FSC is to maintain the spirit of co-operation and trust which has developed between the FSC and the industry and the consultation and collaboration process will continue.

The FSC will continue its regulatory role as a prudential regulator and is in the process of developing guidelines and rules in respect of market conduct regulation which will join prudential regulation in the spotlight.

The solvency standard for general insurance companies will be changed over time to a risk-based standard similar to what obtained for life insurance companies. A discussion paper has already been circulated to stakeholders for comment. In this vein also the FSC is working with the industry to seek risk models for catastrophe that are appropriate to the Jamaican situation. General insurance companies will in time be required to use these models to determine their needs in respect of catastrophe reinsurance cover.

The risk factors for the MCCR are being reviewed after consultation with the industry and other stakeholders.

The FSC has concluded the first phase of a project to introduce a compensation scheme for the insurance industry. Work on the second phase will commence shortly.

In a move to underline the importance of corporate governance in the management of the industry the FSC embarked on a project to develop guidelines to strengthen corporate governance within the FSC and the industry. The existing corporate governance rules will be strengthened with additional requirements, including rules concerning the duties and competence of directors. The risk management systems in the companies will also be targeted.

On an on-going basis the regulations are being reviewed for amendments. Some have already been amended and others have been earmarked for amendment.

Jamaica, like our other sister islands, recognises the reality of the CSME and the need for convergence (if not total harmonisation) in the regulatory framework in the Caribbean region. We are ready to work with our colleagues in the other territories to meet this challenge.

**APPENDIX 1**  
**SUPERVISORY GUIDE APPLICABLE TO GENERAL INSURANCE**  
**COMPANIES:**  
**THE SUPERVISORY LADDER**

**STAGE 0: NO PROBLEMS/NORMAL ACTIVITIES**

**Company Assessment**

Company outside normal ranges on no ratios. All financial parameters appear to be low risk. Capital levels are excellent for type of business being written. Profitability has been good to excellent. Investments are conservative and no liquidity problems are foreseen.

**FSC Activities/Intervention for Stage 0 Companies**

1. Normal monitoring. On-site examinations will be short form, focus on discussion with management.
2. Registration of the new companies:
  - Review and assess all relevant documents and information
  - Make recommendations to Commission.
3. Review and assess wide range of applications and requests for regulatory consents required by statute including:
  - Corporate reorganizations
  - Changes in ownership
  - Acquisitions of other financial institutions
  - Transfers of business
  - Changes in classes of insured risks
  - Withdrawals from the Jamaican insurance market
4. Ongoing monitoring of companies based on information obtained from statutory filings, financial reports and other sources:
  - Assess financial condition and operating performance
  - Verify compliance with statutory and other regulatory requirements.
5. Periodic on-site examinations of companies as required by statute:
  - Inform management and board of directors of findings
  - Request that management provide copy of report to external auditors
  - Require that concerns be addressed by company
  - Monitor remedial measures if required.

## **STAGE 1: EARLY WARNING**

### **Company Assessment**

Deficiency in policies or procedures or the existence of other practices, conditions and circumstances that could lead to the development problems described at Stage 2. Situation is such that it can be remedied before it deteriorates into a Stage 2 problem.

Company outside normal ranges on not more than 2 ratios, which can be satisfactorily explained. All financial parameters appear to be low risk. Capital levels are excellent for type of business being written. Profitability has been good to excellent. Investments are conservative and no liquidity problems are foreseen.

### **FSC Activities/Intervention for Stage 1 Companies**

- Normal monitoring. On-site examinations will be short form, focus on discussion with management.
- Company and/or Board notified of concerns and requested to take measures to rectify situation.
- Monitoring of remedial actions may involve requests for additional information and/or follow-up examinations.
- FSC may require that company's external auditor enlarge scope of examination of company's financial statements or that external auditor perform other procedures, and prepare a report thereon. FSC may assign cost of external auditor's work to company.
- FSC may require external review of company's actuarial methods and assumptions.

## **STAGE 2 RISK TO FINANCIAL VIABILITY OR SOLVENCY**

### **Company Assessment**

Situations or problems that, although not serious enough to present an immediate threat to financial viability or solvency, could deteriorate into serious problems if not addressed promptly, as evidenced by:

- Company outside normal ranges between 3 and 5 Early Warning Ratios.
- Risk Ratio is between 2.5 and 3.5
- Concern with underwriting controls and pricing, as loss ratios consistently in top quartile relative to other companies writing similar types of business.
- Expense ratio above average
- Investment income higher (or lower) than most other companies.
- Several speculative investments which should be replaced.
- Unable to generate consistently acceptable ROE.
- Solvency test being met but the margin is not very significant.
- Capital levels are somewhat low.
- Investments generally sound but some strengthening of investment portfolio is recommended.
- Concerns about potential liquidity problems.
- Management not focused on running the company; business plans have lacked detail.
- Financial reporting has been weak with incorrectly completed registers.
- Although serious problems have not yet developed, we are concerned about lack of financial controls, especially in the reinsurance area: copies of agreements not signed, reinsurance accounting not up to date.
- Some consumer complaints indicate that claims payments have been slow and inefficient.
- Technical reserving for claims should be improved as at the present time this area is handled by inexperienced staff.
- Investment management also weak as no professional advice is being obtained.
- Any of these areas of concern could lead to serious problems and move the company to "Stage 3" risk rating.

### **FSC Activities/Intervention for Stage 2 Companies**

- Meet with board of directors to explain concerns, demonstrate extent to which the company has moved away from Level 1 group of insurers.
- Require business plan for next two years indicating how problems identified are to be rectified.
- Business plan monitored monthly or quarterly for progress.
- Increase financial analysis review and track all indicators closely.
- Monthly or bimonthly meeting with company officers to track and confirm progress. Discuss specific business strategies as suggested by nature of problems. For example, getting out of certain lines of business, making changes in distribution network, upgrading investment portfolio.
- If Risk Ratio is too high, reduction in premium volume or more capital may be required in the near future.
- If company is close to Risk Stage 3, consideration will be given to enforcement actions such as limiting the amount of new business that can be written, stipulating date for capital contribution or other enforcement action.
- Company is placed on regulatory "watch list"; management, board of directors and external auditor are formally notified.
- FSC send a "watch list" progress report at least monthly to Minister; report is discussed in regular meetings with Minister.
- Company may be discussed at Financial Regulatory Council.
- FSC commences contingency planning.

## **STAGE 3: FUTURE FINANCIAL VIABILITY IN SERIOUS DOUBT**

### **Company Assessment**

Situations or problems described at Stage 3 are at a level where they pose a material threat to future financial viability or solvency unless effective corrective measures are applied promptly:

- Company outside normal ranges on 6 or more early warning ratios.
- Risk ratio is in excess of 3.5 to 1.
- Highly unprofitable underwriting.
- Significant understatement of claims liabilities.
- Speculative investments have harmed overall performance.
- Negative return on equity.
- Considerable reliance on reinsurance and reinsurers may be experiencing financial problems.
- Management has not demonstrated ability to bring problems under control.
- Capital is close to being impaired.

### **FSC Activities/Intervention for Stage 3 Companies**

- Management, the appointed actuary, board of directors and external auditor of company are informed of problems.
- Business plan must reflect appropriate remedial measures that will rectify problems within time frame so as to avoid triggering impaired viability or impaired solvency procedures (see Stage 4).
- Monitoring of company may be further enhanced as to frequency of reporting requirements and/or the level of detail of information submitted so as to monitor progress of remedial measures.
- Follow-up examinations may be carried out as required.
- A special audit may be required from an auditor or consultant other than the company's own external auditor if FSC is of the opinion that it is required. FSC may assign cost of work of auditors or consultants to company.
- Immediate imposition of supervisory enforcement actions such as possibilities mentioned at Stage 2.
- Amount of new business written may be required to be scaled back or even stopped.
- Business plan accompanied by signed undertaking that actions will be carried out.
- New capital urgently required and shareholders advised of the time frame to provide.
- Any improper investments to be disposed of immediately.
- Minister advised of Stage 3 situation and possible actions that may be required.
- The FSC may direct company to increase its capital or assets.
- Depending on circumstances, business restrictions may be enhanced or additional ones imposed on the company.
- Depending on circumstances, pressure may be exerted on management and board of directors to restructure company or to seek out an appropriate prospective purchaser.
- FSC develops contingency plan for taking rapid control of the assets of the company if changes in circumstances so warrant.
- Company is discussed at Financial Regulatory Council.