Nepal Insurance Authority
Risk- Based Supervision Framework

1. Purpose

This Supervision Framework describes the objectives, principles and approach adopted by Nepal Insurance Authority ("NIA" or "Beema Pradhikaran") to support its risk-based supervision of the regulated institutions. This framework applies to the insurance (including micro-insurers) and reinsurance companies regulated by NIA. The supervision approach taken for the insurance intermediaries and other insurance service providers, is not addressed in this document. The document will help the (re)insurers understand what is required of them as well as what they can expect from the supervisors during the supervision process. References in this document to insurers shall apply to reinsurers as well as micro-insurers unless otherwise explicitly stated.

2. Objectives

The Insurance Act, 2079 (2022) sets out following objectives for Nepal Insurance Authority:

- contribute to improved management practices and regulation of the insurance sector enhancing confidence in the insurance industry;
- ensure quality and reliable service to public through healthy competition within insurance industry, and
- regulate insurance industry in an effective manner for ensuring protection of rights of insured.

To achieve its objectives, NIA aims to ensure protection of the interests of the current and future policyholders (i.e., insured) through prudential supervision; transparent and fair treatment of customers (conduct supervision) delivered through the safety and soundness of the regulated (re)insurance companies and stability of the Nepalese Insurance Sector.

In addition, NIA also has the mandate to develop the market which includes insurance literacy programs, insurance related training, insurance market expansion and development of specific insurance sectors (e.g., microinsurance and agricultural insurance).

3. Principles

The five key principles followed by NIA in its supervisory approach that shall be applied to all insurers:

1. Judgement-based: NIA shall rely on the judgement of the supervisors which will be supported by the relevant data, observations and analyses, and through engagement with the board and senior management of the insurers.
2. Forward looking: NIA shall assess the insurers against current risks as well as future emerging risks so that early timely intervention can take place.

3. Focus on key risks: NIA shall focus on material risks arising from the activities of the insurers that could have detrimental impact on the policyholders' protection, focusing resources and activities to areas of greatest risks.
4. Assessment of the whole institution: NIA shall adopt a holistic approach to assess the composite risk (i.e., risk profile) of an insurer. To perform this task, reliance shall be placed on the total balance sheet approach with the assessment of inherent risks and the mitigation and oversight of these material inherent risks.
5. Principle of Proportionality: NIA shall apply 'Principles of Proportionality' in its approach to supervision. Application of proportionality shall be based on the impact, size and complexity of the insurer and the level of risks posed by such insurer to policyholders, the insurance sector or the financial system as a whole. This principle gives the supervisor the flexibility to tailor its intensity of supervision or the application of the supervisory requirements on insurers in order to achieve NIA's objectives. Insurers with high risk profile will be subject to more intensive supervision in comparison to insurers with low risk profile.

4. Other Considerations

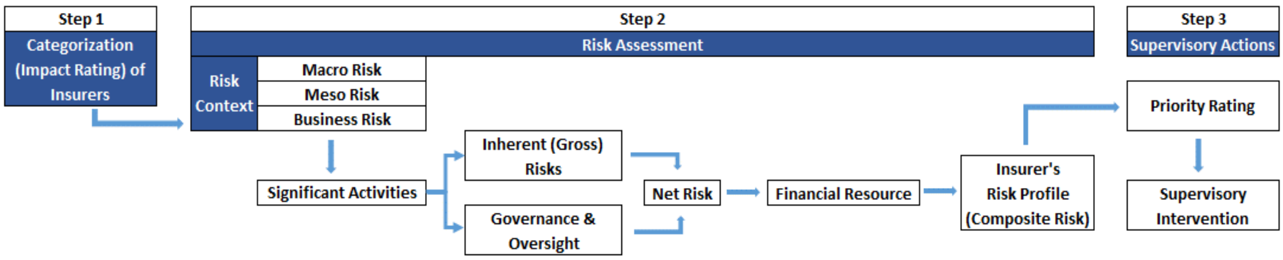
Factors to consider while meeting the objectives:

- Board of the insurer has the ultimate responsibility, and the senior management has a crucial role in maintaining adequate risk oversight of an insurer's business activities. To that effect, the Board is required to possess adequate knowledge, skills, experience and the ability to delegate authorities to the right personnel to perform day to day operations of the company. Key personnel within an insurance company shall have relevant qualifications, skills and experience to perform the required duties.
- NIA shall intervene early to resolve issues of problematic insurers (or heightened risk insurers) in the market. The definition of problematic companies shall be taken from the Insurance Act, 2079.
- Insurers are expected to meet all of the governing regulatory requirements. Insurers need to demonstrate they have processes and controls to comply with the regulations and for the insurers to notify the regulator if they are non-compliant.
- NIA aims to follow international best practice in its supervisory approach, where possible, while giving consideration to the current features of the Nepalese insurance market.
- NIA shall rely on the works of other professionals, in particular, auditors and actuaries as such reliance is based on the understanding that these professionals will follow proper standards and practices set out by their professions. If NIA believes that particular auditors or actuaries have in fact, not followed applicable standards and practices, then the NIA may revise the risk profile of the institution accordingly.

5. Risk Assessment Framework

NIA will follow the following risk assessment framework in conducting its risk-based supervision.

Diagram 1: Risk Assessment Framework



5.1 Categorization (Impact Rating) of Insurers

- Step 1 involves grouping insurers into 4 categories depending on their significance of having an adverse impact on NIA achieving its supervisory objectives (i.e., prudential, market conduct and market development).
- The implication of impact rating of insurers into different categories at an initial stage will determine the level of supervision required and help prioritize the baseline level of supervisory resources, i.e., higher intensity of supervision and hence, a larger resource allocated to insurers that pose greater risks.
- Categories used are: (1) Very Significant Impact; (2) Significant Impact; (3) Moderate Impact; and 4) Minimal Impact.

Very Significant Impact	Insurer poses very significant risks to the interests of a large number of policyholders, the insurance sector and the financial system as a whole.
Significant Impact	Insurer poses significant risks to the interests of a large number of policyholders and the insurance sector.
Moderate Impact	Insurer poses some risks to the interests of a large number of policyholders or the insurance sector.
Minimal Impact	Insurer poses some risks to the interests of a certain group of policyholders.

- NIA shall consider both qualitative factors and quantitative measures to allocate insurers into different impact rating categories. The criteria used for categorization are as follows:

No	Criteria	Assessment of
1	Size	Insurer’s relative scale of activities and importance in the insurance industry (e.g., number of insured; market share by premium volume; gross technical provision)
2	Substitutability	Ability or feasibility of other entities to provide substitute for an insurer’s products or functions or services without causing significant disruptions in the market.
3	Complexity	Complex nature of an insurer’s structure and business model.

- The impact rating assessment shall take place at the beginning of each risk-based supervision cycle.

- Supervision cycle is defined to be three years. However, risk-based supervision is considered to be a continuous process and hence, the statutory 3-year supervision cycle effectively means that every institution gets an examination at least once every three years.
- The impact rating for an insurer shall not be affected by the priority rating assigned to that insurer at the end of the previous risk-based supervision cycle.

5.2 Risk Context

- External Risks: assessment of external risks facing the insurers will consider both macroeconomic risks and sector-wide (meso-economic) risks.
- Business Risks: assessment of the risks arising from significant business activities (i.e. line of business, unit or process) conducted by the insurer in order to achieve its business strategy. This will analyze business model, risk appetite, peer comparisons etc.

5.3 Significant Activities

Significant activities of the insurer shall be identified. They will be determined based on how the insurer organizes the company to manage and meet its business objectives as well as how the insurer structures its enterprise-wide processes. These are the activities if not managed well, can have unfavorable consequences to the insurer of not meeting its objectives and leading to material loss to the insurer. These significant activities can be identified as a line of business or enterprise-wide function or process.

5.4 Inherent Risk

- Inherent Risk refers to the natural level of risk (i.e. exposure to loss), defined as a probability of material loss, arising from the activities pursued by the insurer to meet its business objectives. Material loss shall be determined based on the size, nature and risk profile of the insurer.
- The inherent risks are also considered as “Gross Risks” as they reflect the level of risks before being controlled or mitigated by risk management strategies (i.e., before the application of management actions to mitigate/ manage/ avoid risks). The inherent risks will not be affected by the size of the activities.
- Key inherent risks are identified for each significant activity.
- The key gross inherent risks are grouped into 9 categories:
    1. Insurance Risk
    2. Market Risk
    3. Credit Risk
    4. Operational Risk
    5. Strategic Risk
    6. Compliance Risk (Legal and Regulatory)
    7. Conduct Risk
    8. Money Laundering & Financing of Terrorism
    9. Climate Risk
- The definition of each inherent risk is provided in Appendix A.

- The level of each Gross Inherent Risk is assessed as Low, Medium Low, Medium High and High based on NIA's judgement.

Gross Inherent Risk Rating	Interpretation
High	In the absence of substantial and urgent remediation, there is a very high probability of loss that will impair capital leading to potential damage to policyholders within twelve months.
Medium High	In the absence of remediation, there is a significant probability of loss that will impair capital, possibly leading to damage to policyholders in the foreseeable future.
Medium Low	There is some need for action in a limited number of areas but the likelihood of losses leading to damage to policyholders is small.
Low	No significant remediation is required and losses leading to damage to policyholders are very unlikely.

- The reference to the remediation in the above table reflects the mitigating actions (i.e., risk management actions) that the insurer needs to take to reduce the impact from the inherent risk. It does not refer to actions taken by the insurer to reduce the inherent risk itself.
- The gross inherent risk assessment includes the direction of the inherent risk: Increasing/ Stable/ Decreasing. This will reflect the change in the view of the prospective assessment of gross inherent risks.

5.5 Governance and Oversight

- This assesses the ability of the insurer to manage and control inherent risks appropriately.
- The assessment is carried out for two control levels: Operational Management and Oversight Functions.
- Operational Management: this will assess the ability of the 1st line staff to apply proper controls and processes to manage or mitigate inherent risks arising from carrying out its day-to-day activities and ensure the alignment with the insurer's risk appetite and risk policies.
- Oversight Functions: this will assess the performance ability of the oversight functions (Board, Senior Management, Risk Management, Compliance and Internal Audit) to perform appropriate mitigation and oversight of the key activities and the risks arising from those activities.
- The evaluation is based on the assessment of:
  a) the characteristics or attributes of operational management and oversight functions to ensure they are appropriate for the given nature, complexity and risk profile of the insurer's business (this evaluation examines the underlying structures, frameworks, policies and practices); and
  b) the effectiveness of the performance of operational management loss mitigation and oversight functions.
- For each significant activity, operational management and oversight functions are assessed by NIA as Strong, Effective, Need Improvement or Weak.

Rating	Interpretation (comparison against the given nature, complexity and risk profile of the insurer's business)
Strong	The characteristics of the function exceeds expectation against what is considered necessary by NIA. The function has consistently demonstrated highly effective performance. The function's characteristics and performance are superior to sound industry practices.
Effective	The characteristics of the function meet expectation against what is considered necessary by NIA. The function's performance has been effective. The function's characteristics and performance meet sound industry practices.
Need Improvement	The characteristics of the function generally meet expectations against what is considered necessary but requires improvements to some significant areas. The function's performance has generally been effective, but there are some significant areas where effectiveness needs to be improved. The areas needing improvement are not serious enough to cause supervisory concerns if addressed in a timely manner. The function's characteristics and/or performance do not consistently meet sound industry practices.
Weak	The characteristics of the function do not meet expectations against what is considered necessary by NIA or the function's performance has demonstrated serious instances which require immediate actions to improve effectiveness. The function's characteristics and/or performance regularly or repeatedly fail to meet sound industry practices.

- The assessment also includes the direction of the quality of the operational management and oversight functions: Improving/ Stable/ Deteriorating. This will reflect the change in the view of the prospective assessment of the operational management and oversight functions.
- Sound industry practice and the effectiveness are defined by NIA on the basis of international best practice while giving consideration to the current features of the Nepalese insurance market.

5.6 Net Risk

- The level of Net Risk for each significant activity is assessed following consideration of the effective control mechanism and of oversight and governance in managing and mitigating inherent risks arising from the insurer's activities.
- The overall Net Risk shall be determined based on the relative importance or materiality of the significant activities.
- The level of Net Risk for each significant activity as well as for the overall Net Risk derived will be rated as: Low, Medium Low, Medium High and High.

Net Risk/ Overall Net Risk Rating	Interpretation
High	In the absence of substantial and urgent remediation, there is a very high probability of loss that will impair capital leading to potential damage to policyholders within twelve months.
Medium High	In the absence of remediation, there is a significant probability of loss that will impair capital, possibly leading to damage to policyholders in the foreseeable future.

Medium Low	There is some need for action in a limited number of areas but the likelihood of losses leading to damage to policyholders is small.
Low	No significant remediation is required and losses leading to damage to policyholders are very unlikely.

- The Net Risks and the Overall Net Risk assessments also include the direction: Increasing/ Stable/ Decreasing. This will reflect the change in the view of the prospective assessment of net risks and the overall net risk.

5.7 Financial Resources

- The three key aspects of financial resources that shall be considered are: Capital, Earnings and Liquidity.
- This aims to assess whether the insurer has adequate financial resources to absorb losses if the risks to the insurers materialize either during normal or stressed conditions.
- With regards to capital assessment, considerations are given to:
  a) Capital Adequacy with consideration for insurer's risk profile and risk appetite, and in terms of: i) the quality of capital (i.e., its ability to absorb losses during normal and stressed scenarios); ii) transferability of capital (i.e., capital from one fund can be used to absorb losses from another fund); iii) company's ability to raise capital in the capital market; and iv) capital support from the parent companies towards foreign ventures and/or to subsidiaries of foreign companies.
  b) Capital Management Policies and Practices: this assesses whether the insurer has appropriate policies and practices in place that reflect the nature, size and risk profile of the insurer.
  c) Insurer are required to meet regulatory capital requirement at all times.
  d) Consideration will also be given to differences between regulatory capital requirement and economic capital requirement.
- Liquidity resources are assessed with regards to the ability of the insurer to meet its cash flows requirement under normal and stressed scenarios. Liquidity assessment will also be based on: a) Liquidity Adequacy, and b) Liquidity Management Policies and Practices.
- Earnings assessment will be based on quantity, quality and volatility of the earnings.
- The level of capital, earnings and liquidity will be rated as Strong, Acceptable, Need Improvement and Weak.

Rating		Interpretation (for a given nature, size and risk profile of the insurer)
Strong	**Capital**	Capital adequacy is strong and is above expectation and will have positive trend over next 12 months. Capital management policies and practices put in place are appropriate, and have been and remains to be effective.
	Liquidity	Liquidity adequacy is strong and will remain consistently above the level required by NIA. The insurer has proper and appropriate policies and practices as well as effective liquidity management.
	Earnings	Insurer have had consistent earnings performance and it has significantly contributed to long term viability of the company. There is no reliance on

		non-recurring sources of income to enhance earnings. Earnings outlook for the next 12 months continues to be positive.
Acceptable	**Capital**	Capital adequacy is appropriate and meets expectation and do not have concerns over adequacy level over next 12 months. Capital management policies and practices put in place are appropriate and have been and remains to be effective.
	Liquidity	Level of liquidity is adequate and will consistently meet the level required by NIA. The insurer has appropriate and effective liquidity management policies and practices.
	Earnings	Insurer have had satisfactory earnings performance, producing returns needed to ensure its long-term viability. Insurer do not rely on non-recurring sources of income to enhance earnings. Although there is some exposure to earnings volatility, the outlook for the next 12 months remains positive.
Need Improvement	**Capital**	Capital Adequacy is appropriate most of the time while meeting the minimum regulatory capital requirements at all times. However, the level of capital adequacy is uncertain over next 12 months. Capital management policies and practices put in place are appropriate but ineffective.
	Liquidity	Level of liquidity is not always adequate, although meeting the minimum level set by NIA. The insurer has appropriate liquidity management policies and practices but are not effective.
	Earnings	Insurer have had inconsistent earnings performance, with returns that may, at times, be inadequate to ensure its long-term viability. Insurer may occasionally depend on nonrecurring sources of income to show a profit. The earnings outlook for the next 12 months is uncertain.
Weak	**Capital**	Capital adequacy is not appropriate, marginally meeting minimum regulatory capital requirements and the level of capital adequacy likely to deteriorate over next 12 months. Capital management policies and practices put in place are not appropriate.
	Liquidity	Level of liquidity is not adequate and does not meet the minimum level set by NIA. The insurer does not have appropriate liquidity management policies and practices.
	Earnings	Insurer has consistently recorded operating losses or earnings that are insufficient to ensure its long-term viability. It may be heavily dependent on non-recurring sources of income to show a profit. Negative earnings outlook for the next 12 months is expected.

- The assessments also include the direction of the quality of capital, earnings and liquidity: Improving/ Stable/ Deteriorating. This will reflect the change in the view of the prospective assessment of the quality of the capital, earnings and liquidity.

5.8 Composite Risk

- Insurer's composite risk (i.e., overall risk profile) is determined by assessing whether there is an adequate level of financial resource available for the given level of overall Net Risk. No amount of capital can be considered as a substitute for poor risk management practices of the insurer. A higher level of capital will only be viewed as a temporary measure while the risk management practices are being improved.

- The Composite Risk rating will determine Priority Rating for the insurer and this will guide the level of intensity of supervisory intervention.
- The composite risk is categorized into four Rating: Low, Medium Low, Medium High and High.

Composite Risk Rating	Interpretation
High	In the absence of substantial and urgent remediation, there is a very high probability of loss that will impair capital leading to potential damage to policyholders within twelve months.
Medium High	In the absence of remediation, there is a significant probability of loss that will impair capital, possibly leading to damage to policyholders in the foreseeable future.
Medium Low	There is some need for action in a limited number of areas but the likelihood of losses leading to damage to policyholders is small.
Low	No significant remediation is required and losses leading to damage to policyholders are very unlikely.

- The Composite Risk assessment will also include the direction of the composite risk: Increasing/ Stable/ Decreasing. This will reflect the change in the view of the prospective assessment of the Composite Risk.

6. Risk Matrix

- Once the Composite Risk Rating has been determined, Priority Rating for each insurer is derived (see definition below in Section 7). The insurer will be notified of any regulatory concerns that will require remediation. As the Composite Risk Rating and Priority Rating are primarily developed as supervisory tools, and if disclosed out of context can be misused or have potential negative impact on an insurer, both information will be kept confidential by the supervisors. (Note: The insurer is also required to keep its Composite Risk Rating confidential; it may not be used in any marketing material or disclosed outside the organization without the written consent of NIA)
- The Risk Matrix summarizes the outcome of all the assessments carried out under Step 2 of the Risk Assessment Framework (see Diagram 1). This provides an overall conclusion made by NIA regarding the holistic risk assessment and hence, the overall risk profile of an insurer.
- The final decision shall be backed by NIA's detailed documentation of the analysis including the rationale or expert judgements for coming up with conclusions for various steps.
- The template of a Risk Matrix for an insurer is shown in Appendix B.

7. Supervisory Intervention

NIA has been given the power by the Insurance Act, 2079 to take timely and corrective measures ("supervisory intervention") against the insurers who fail to comply with sound business practices or regulatory requirements. The assigned Priority Rating of an insurer will guide the level of intensity of supervisory intervention that will be required.

The Insurance Act, 2079 provides the basis for which a number of corrective measures that NIA can take against insurers either as an early warning mechanism or in an extreme scenario, resolution action.

The table below shows the alignment between the Composite Risk Rating and Priority Rating:

Composite Risk Rating	Priority Rating
Low	Priority Rating 1: Routine Supervision
Medium Low	Priority Rating 1: Routine Supervision
	Priority Rating 2: Emerging Risk
Medium High	Priority Rating 2: Emerging Risk
	Priority Rating 3: Escalated Action
High	Priority Rating 3: Escalated Action
	Priority Rating 4: Formal Remediation
	Priority Rating 5: Resolution/ Liquidation

The Guide to Supervisory Intervention Framework provides details of the circumstances that could potentially lead an insurer to a different priority rating and the types of intervention that an insurer can expect from NIA. Supervisory resource allocation will increase for the highest priority rated insurers.

Appendix A: Definition of Inherent Risks

The table below provides description of gross inherent risks.

No	Gross Inherent Risk	Definition
1	Insurance Risk	Life insurance risk is the risk of financial loss or adverse change in the value of insurance liabilities resulting from changes in the level, trend or volatility of the risk drivers/ biometric/ decrement rates. The risk drivers covered under life insurance category are: mortality, longevity, morbidity, expenses, lapses and catastrophe risks. Non-life insurance risk is the risk of loss resulting from inadequate pricing, making wrong judgments in the selection, approval and retention of risks to be insured or under-estimation of insurance policy liabilities. The risk drivers covered under non-life insurance category are: claims, reserving and catastrophe risks.
2	Market Risk	Market risk is the risk of adverse financial impact resulting from fluctuations in the level or volatility of prices of financial instruments and other financial market factors including interest rates, equity price, property price, foreign exchange rates.
3	Credit Risk	Credit risk is defined as the potential loss arising from a borrower or counterparty failing to meet its obligations in accordance with the agreed terms.
4	Operational Risk	Operational risk is the risk of loss to the insurer due to failure of people, processes or systems.
5	Strategic Risk	Strategic risk is the risk of loss to the insurer from potential failures or errors in strategic planning and/or implementation, either due to internal or external events, leading to the insurer not achieving its core objectives.
6	Compliance Risk (Legal and Regulatory)	Compliance risk is the risk of loss to the insurer due to failing to comply with the legal and regulatory requirements.
7	Conduct Risk	The conduct risk is the risk of loss or poor outcome or unfair treatment towards the current and future policyholders or adverse consequence to the insurance market due to improper business conduct or business malpractice or unwillingness to comply with regulatory market conduct requirements by the insurer and/or its representatives.
8	Money Laundering & Financing of Terrorism	The risk that illegal funds and assets are converted into legitimate funds and assets using insurer as the vehicle.
9	Climate Risk	Climate risk means the risks posed by the exposure of an insurer to physical, transition and/or liability risks caused by or related to climate change.

Appendix B: Risk Matrix

Risk Matrix

Nepal Insurance Authority

Name of Institution			
Lead Supervisor			
Team		Prepared	
Reviewed by		Reviewed	

	Inherent Risk										Oversight Functions						Net Risk		
Significiant Activities	Insurance Risk	Market Risk	Credit Risk	Operational Risk	Strategic Risk	Compliance Risk (Legal & Regulatory)	Conduct Risk	ML + FT Risk	Climate Risk	Operational Management	Board	Senior Management	Risk Management	Compliance	Internal Audit	Total Risk Management	Net Risk	Direction	Importance/ Materiality
***** *Last Line* *****																			
						TOTAL RATINGS													

Capital		
Earnings		
Liquidity		
Overall/ Composite Risk Rating		

Supervisory Strategy	