

Recommendation	Term	Authorities' Response
Banking Regulation and Supervision		
<ul style="list-style-type: none"> Full authority to grant and revoke bank licenses based on technical elements, should be vested in the INAF. 	MT	The final authority to grant and revoke licenses should remain with the government.
<ul style="list-style-type: none"> INAF should be empowered to undertake all types of remedial actions, including issue an orderly resolution of a problem bank and the revocation of a financial institution's license. 	MT	The authorities accept that it's necessary to strike a balance between INAF's technical decision and the approval of the government for revocation of financial institutions' license.
<ul style="list-style-type: none"> Connected Lending: INAF should ensure that credits to insiders and related interests are not granted at preferential rates and that transactions to insiders, such as credits to the members of a bank's Board of Directors, are required to be approved by the Board. 	ST	INAF is considering issuing a communication on this matter.
<ul style="list-style-type: none"> INAF should intensify its efforts to enter into a formal agreement with the banking authorities of foreign supervisors that will allow full compliance of Andorra as a home and host country supervisor. The INAF should share with the home country supervisor information about the local operations of the foreign banks, provided its confidentiality is protected. 	ST	The authorities reaffirm their intention to enter into a formal agreement with the banking authorities of foreign banks.
Regulation and supervision of Collective Investment Schemes		
<ul style="list-style-type: none"> Review the draft law on CIS to: (i) ensure proper and disclosed basis for asset valuation, pricing and redemption; and (ii) strengthen provisions on disclosure to allow evaluation of the suitability of a CIS for a particular investor. 	ST	The authorities intend to work on this as soon as possible.
<ul style="list-style-type: none"> The government should table the draft law on CIS in the General Council with a view to its adoption as soon as possible. 	MT	Draft laws have been sent to the financial sector entities for comments. This law is a priority for the government.
Regulation and Supervision of Insurance Companies		
<ul style="list-style-type: none"> The MF should require external auditors to produce a complementary report on policies, systems and processes of insurance companies, including internal controls, and strengthen its oversight capacity. 	ST	Efforts will be concentrated to implement this recommendation in the short term.
<ul style="list-style-type: none"> Transfer the responsibility for supervision of insurance companies to INAF with sufficient supervisory staff to carry out this responsibility. 	MT	Once the new insurance law is approved, this responsibility will be carried out by INAF.
<ul style="list-style-type: none"> A new insurance law should be tabled in the General Council, codifying, inter alia, prudential requirements and requirements with regards to internal controls, conduct of business, policy holder protection, public disclosure and international cooperation requirements. 	MT	The MF will prepare a draft law during 2006, in conformity with the International Association of Insurance Supervisors (IAIS) principles. This law is a priority for the MF.

INTRODUCTION

1. An IMF team conducted an evaluation of the regulation and supervision of the financial system. The team:

- Assessed bank regulation and supervision based on the compliance with the Basel Core Principles for Effective Banking Supervision (BCP);
- Reviewed the regulatory and supervisory framework for the insurance sector, but given its small size, an assessment of compliance with IAIS principles was not conducted;
- Reviewed the regulatory and supervisory framework for CIS on the basis of the corresponding section of the International Organization of Securities Commissions (IOSCO) standards, but an assessment of compliance of these standards was not conducted; and
- Reviewed the overall arrangements and practices for cross-sector and cross-border cooperation and information exchange.

2. In addition the report includes an initial review of anti-money laundering and combating the financing of terrorism (AML/CFT) practices conducted on the basis of information provided by the authorities and discussions with UPB and INAF senior staff. The mission had access to the preliminary results of the mutual evaluation conducted by the Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL) in October 2005, but a ROSC on compliance with AML/CFT standards will only be prepared once the final results of this evaluation are issued, in mid-2007, according to the authorities' expectations.

3. The mission evaluated the degree to which the authorities have implemented recommendations contained in the 2002 Module 2 report. In addition, the mission discussed with the authorities the details of Andorra's participation on the Information Framework-Financial Activities in International and Offshore Financial Centers. The authorities have agreed to participate in this initiative, and expect to submit annual information by early 2007.

I. FINANCIAL SYSTEM OVERVIEW

A. Background

History of Andorra's offshore financial center

4. Andorra's financial system is relatively young. The first bank—Banc Agrícola Comercial d'Andorra—was established in 1930 to service the local population and the Spanish immigrants working at the recently established Hydroelectric Company. At that time

Andorra's economy was essentially dedicated to agriculture and commerce. During the next two decades, Andorra's banking system serviced this population by taking deposits and granting loans to finance agriculture and commerce, and its expansion was rather limited. Andorra emerged as a regional financial center during the 1950s, when Spain experienced a period of capital flight and Andorra eliminated all taxes on banking operations (1951). Capital inflows mostly from the Catalunya region fostered the expansion of the banking sector. Most of Andorra's currently existing banks were created during that decade (Appendix I).

5. The banking system was self-regulated until 1993, when the financial system law was issued and the Institut Nacional Andorrà de Finances (INAF) was established as a technical institution to supervise financial companies and to propose to the government the regulations pertaining to the financial system. Until then the Andorran Bankers' Association (ABA), created in 1960, had effectively acted as a self-regulatory body, issuing guidelines that were followed by Andorran banks.

6. Throughout its 75 years of banking history, Andorra has not experienced a banking crisis. One banking institution failed in 1968 (Sobanca), and the remaining banks stepped up to honor its liabilities in order to preserve the confidence in the system. Andorran banks have traditionally maintained high levels of liquidity and capital as a way to signal their capacity to overcome problems in the absence of regulation and supervision. However, this prudent behavior remained generally unchanged after regulation and supervision were implemented.

Previous assessments

7. The 2002 report covered an assessment of compliance with BCP and with AML/CFT standards, as well as a review of the insurance and securities sectors. The assessment concluded that supervision in Andorra was generally adequate with respect to material activities of the financial system, although the report provided several areas for improvement.⁴ It was noted that Andorra had a high level of compliance with the BCP,⁵ which represented around 95 percent of all financial sector activities. A high level of compliance with international standards for AML was also found. Given the limited size of the insurance and securities systems relative to the overall financial system, full assessments of compliance with the IAIS and the IOSCO standards were not carried out.

8. In order to improve compliance with international standards for banking supervision, the assessors recommended to: (i) clarify responsibilities and strengthen the autonomy of the agency responsible for bank supervision, the INAF; and (ii) improve cooperation and

⁴ Andorra: Assessment of the Supervision and Regulation of the Financial Sector, August 2002.

⁵ Compliance was found in 14 principles, large compliance in 13 principles, material noncompliance in 2 principles, and 1 principle was deemed not applicable.

exchange of information with the home supervisor of subsidiaries of foreign banks. The independence of INAF was limited by the requirement for prior approval and/or consent of the finance minister and the *Comissió Superior de Finances* (CSF) for virtually all actions of INAF, including approval of regulation, administrative sanctions and authorization of on-site inspections by INAF. In turn, cooperation with home supervisors of foreign banks was restricted by limits on the ability of INAF to enter into agreements with foreign supervisors and limits on the ability of foreign supervisors to conduct on site examinations (see Appendix II for details).

9. The 2002 report found the regulatory framework for insurance, based on a 1989 law, to be in need of improvement on the supervisory arrangement, prudential regulation and international cooperation. It was recommended that: (i) supervision of insurance be included within the functions of INAF, which will entail a modification to the insurance law and other enabling legislation; (ii) that INAF work to develop a common chart of accounts for insurance providers (e.g., companies and delegations); and (iii) that INAF define complementary audit instructions for external auditors in a manner consistent with actions taken for banks. Regarding collective investment funds and other asset management activities, the assessors recommended that securities legislation, then in the process of being drafted, bolster INAF's mandate for protecting investors and promoting market transparency.

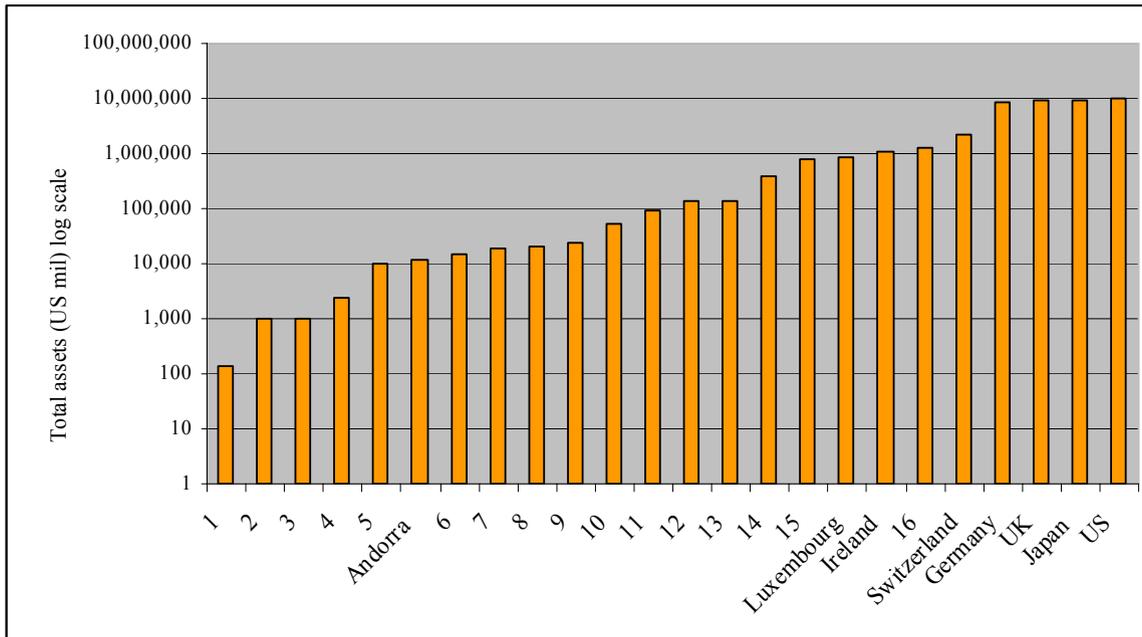
10. The mission found that the authorities have implemented many of the 2002 recommendations on banking regulation and supervision, but are yet to implement most of the recommendations on the insurance and securities sectors. The charter of INAF, approved in 2003, strengthens INAF's independence and capacity for cross-border cooperation and information exchange. Since then, INAF has issued additional information and evaluation requirements for banks' external auditors (*Informe Complementari d' Auditoria*), increased the number of supervisory staff with four new hirings, started to train inspectors in order to commence some onsite inspections toward the end of 2007 and, taken steps to seek agreements with foreign supervisors. Legislation to establish the framework for the operation of investment funds managers and other asset managers has been drafted but is yet to be submitted to Parliament for approval. A new insurance law has been drafted but not tabled in the previous legislature.

11. INAF's independence has been strengthened by (i) establishing it as the authority responsible for the Andorran financial system and suppressing the role of CSF as a superior authority; (ii) establishing a clear process for the approval by Congress of INAF's budget; (iii) allowing INAF to conduct on-site examinations as needed, without any prior approval; and (iv) allowing it to issue all types of sanctions, with the exception of those graded as very serious, which are issued by the MF, at the proposal of the INAF. Additionally, this charter allows INAF to enter into agreements with foreign supervisors.

B. Financial Institutions and Markets

12. Compared with other jurisdictions that provide financial services, Andorra is a small financial center (Figure 1) dominated by banks. The financial services sector produces 15 percent of GDP and employs some 1,523 persons accounting for 3.6 percent of all jobs as of 2005. It is the highest paying sector in the Andorran economy, with average salaries above twice the national average.

Figure 1. Andorra: Size of the Banking Sector in Selected Financial Centers, end-2004 1/ 2/



Source: Data submitted for the Information Framework initiative and country authorities.

1/ The jurisdictions reporting under the initiative have been numbered in order of banking asset size.

Numbered jurisdictions provided data to the Fund on a confidential basis. Data on named jurisdictions were obtained from public sources.

2/ The data have been plotted on a logarithmic scale because of the wide dispersion in asset size among jurisdictions.

13. The financial system comprises 7 banking institutions, 1 specialized financial credit institution, 7 collective investment entities, 4 wealth management companies and 28 insurance companies, 15 of which are branches of foreign insurance companies authorized to operate in Andorra. The 7 banks operating in Andorra are part of 5 banking groups. These banking groups generally own 1 collective investment entity and a life insurance company. Andorran banks can only own up to 25 percent of nonlife insurance companies and most banks do so. However, the shareholders of one of the banks have a participation in a nonlife insurance company besides the shares held directly by the bank; so this banking group effectively controls fully a nonlife insurance company. Bank related entities conduct 99 percent of the life insurance business (measured by gross premiums) and 99 percent of the

collective investment business. In sum, the financial system is dominated by banking groups that control all the institutions accounting for the quasi-totality of their markets.

14. The Andorran financial sector has experienced significant changes over the past five years (Table 1). First, as in other jurisdictions, the low interest rate environment caused a shift in customer's portfolios, away from bank deposits and into financial instruments offering higher returns and asset management, with the obvious consequence of shifting on-balance sheet to off-balance sheet products. In this context, bank deposits remained mostly flat, while assets managed by banks and collective investment entities grew by 12.8, and 16.0 percent yearly average respectively from 2000 to 2005. Second, since July 2005 Andorra started the retention of EU taxes on savings income earned by EU residents.⁶ The prospect of higher taxes induced EU customers of Andorran banks to seek alternatives to savings instruments by moving into other financial instruments, including life policies offered by life insurance companies controlled by Andorran banks. As a result, life insurance premiums grew from 61 million euros in 2004 to 1.8 billion euros in 2005.⁷

Banking system

15. The Andorran banking system is small and highly concentrated. Andorra has 7 licensed banks which offer traditional banking services through a network of about 55 branches, including both locally and foreign owned entities. Banking total assets and customer deposits amounted to 11.3 billion euros and 9.3 billion euros in 2005, respectively. About 2.7 billion euros out of 8.9 billion euros of total loans in 2005 were loans to nonresidents,⁸ mostly from Europe and North America, and a significant share of deposits from nonresidents, primarily from the European Union (EU).⁹ Andorran banks have branches in Bahamas and Uruguay and a representative office in Panama, but these operations represent a very small share of the business of the banking groups.

16. The system is based on a universal banking model, without losing sight of specialized banking services. Andorran banks can, therefore, offer all banking services, including credit operations, asset management and investment counseling, liability operations (current, savings and term accounts), stock transactions, financial analysis and other banking services (credit cards, transfers, standing orders, etc.). Insurance companies controlled by banks also carry out the majority of the life insurance business.

⁶ EU Directive 2003/48. Tax retention of 15 percent of savings income earned by EU residents applies from July 1, 2005. The tax rate increases to 20 percent on July 1, 2008 and to 35 percent on July 1, 2011.

⁷ The 2005 premiums include the transfer of assets into capitalization schemes, an event that is not likely to be repeated in 2006.

⁸ The remainder were loans to residents.

⁹ Figures on resident and non resident deposits are expected to be available starting on 2007.

Table 1. Andorra: Financial Structure
(In millions of euros)

Sector	2000	2003	2004	2005	Annual Growth Rates	
					05/04	05/00
Banks						
Number	8	8	7	7		
Banks Assets	11,252	10,078	10,061	11,328	12.6	0.1
Loans	9,378	7,878	8,006	8,921	11.4	-1.0
Deposits ¹ (1)	9,565	8,177	8,114	9,289	14.5	-0.6
Assets under Management (2)	10,541	14,301	16,383	19,235	17.4	12.8
Total Assets under Management (1) + (2)	20,106	22,478	24,496	28,524	16.4	7.2
Collective Investment Schemes						
Number of CIS						
Managers			7	7		
Number of Funds	94	127	142	158	11.3	10.9
Private Funds	85	109	113	125	10.6	8.0
Public Funds	9	18	29	33	13.8	29.7
Total Assets under Management	4,039	5,991	7,829	8,495	8.5	16.0
Private Funds	3,049	4,382	5,308	6,716	26.5	17.1
Public Funds	990	1,609	2,521	1,779	-29.5	12.4
Private Asset Managers						
Number	4	4	4	4		
Total Assets under Management		n.a.	215	274	27.4	
Insurance Companies 2/						
Total Assets (Life + Nonlife)	163.5	178.0	418.2	2036.4	386.9	65.6
Life						
Number	7	7	7	8		
Gross Premiums	17	42	61	1758	2763.7	151.7
Net premiums	14	28	47	1739	3607.8	163.7
Nonlife						
Number	20	20	20	20		
Gross Premiums	35	51	60	50	-16.5	7.6
Net premiums	28	40	43	38	-11.1	6.4

Source: Institut Nacional Andorrà de Finances and Ministry of Finance.

1/ Includes customer deposits and deposits from financial institutions.

2/ Insurance companies that conduct both life and nonlife business are listed under the predominant sector.

17. The system has significant links to Spain, albeit these links have decreased. With the sales of BBVA's participation in the Inter-Mora bank to the Andorran shareholders in early 2006, currently, only three of the seven banks authorized to operate in Andorra have Spanish participation. These banks account for about 45 percent of assets and deposits of the banking system, down from around 71 percent in 2001. In September 2006, the Caixa d'Estalvis i Pensions de Barcelona (*la Caixa*) announced the sale of its shares in Credit Andorra to the Andorran shareholders of this bank. Once this operation is finalized only one Spanish Bank, amounting to about 4 percent of assets and deposits of the banking system will remain operating in Andorra¹⁰ (Table 2).

Table 2. Andorra: Banking System Ownership Structure, as of December 2005

(In millions of euros)

Banks by Controlling Shareholder	Assets	Percent of Total	Deposits	Percent of Total	Capital	Percent of Total	Employees	Percent of Total
Majority Andorran	6,273	55.4	5,211	56.1	701	52.6	664	57.7
Andbanc	2,084	18.4	1,648	17.7	333	25.0	283	24.6
Banc Internacional 1/	2,189	19.3	1,820	19.6	203	15.2	227	19.7
Banca Mora 2/	1,123	9.9	996	10.7	100	7.5	–	–
Banca Privada d'Andorra	877	7.7	747	8.0	66	4.9	154	13.4
With Spanish participation	5,055	44.6	4,078	43.9	631	47.4	486	42.3
CaixaBank	1,022	9.0	819	8.8	142	10.6	126	11.0
Credit Andorra	3,578	31.6	2,858	30.8	459	34.5	284	24.7
Banc Sabadell	455	4.0	402	4.3	30	2.3	76	6.6
Total banking system	11,328	100.0	9,289	100.0	1,333	100.0	1,150	100.0

Source: Institut Nacional Andorrà de Finances.

1/ Banc Internacional has majority Andorra ownership since March 2006.

2/ Banca Mora is fully owned by Banc Internacional and information on employees corresponds to the total for both banks.

18. The significant change in ownership structure poses challenges for both, the banks and the INAF. While the new shareholders of Credit Andorra have made clear their intention to maintain the high risk management standards, the INAF needs to be specially vigilant to

¹⁰ Since 2005 Credit Andorra owns 100 percent of Caixa Bank.

ensure that all banks are prepared to adequately manage the potential risks, including the possibility that the customer base of some Andorran banks contracts after the change in ownership structure. The authorities and the banks' representatives regard this risk as unlikely.

19. The banks are highly capitalized and liquid, far beyond the minimum 10 percent¹¹ and 40 percent¹² required by prudential regulations (Table 3). Profits are strong and have improved over time due, mainly, to higher fees and commissions income, which reflects the shift to off-balance sheet activities. Most nonbank credit exposure remains to the domestic economy, with a loan-to-deposit ratio high at 96 percent and 76 percent of total loans granted to Andorran residents.

Table 3. Andorra: Banking System Indicators
(In percent)

	2000	2003	2004	2005
Capital Adequacy Ratio	32.3	32.4	31.7	28.8
Return on Asset	2.8	2.8	3.1	3.4
Return on Equity	26.2	19.8	20.0	21.4
Liquid assets over total assets 1/	45.2	46.4	40.7	36.2
Liquidity ratio 2/	84.0	77.0	75.1	66.2
Fees and commissions as a percent of total revenue	25.8	38.6	44.3	45.1

Source: Institut Nacional Andorrà de Finances.

1/ Assets maturing in less than one month are considered liquid.

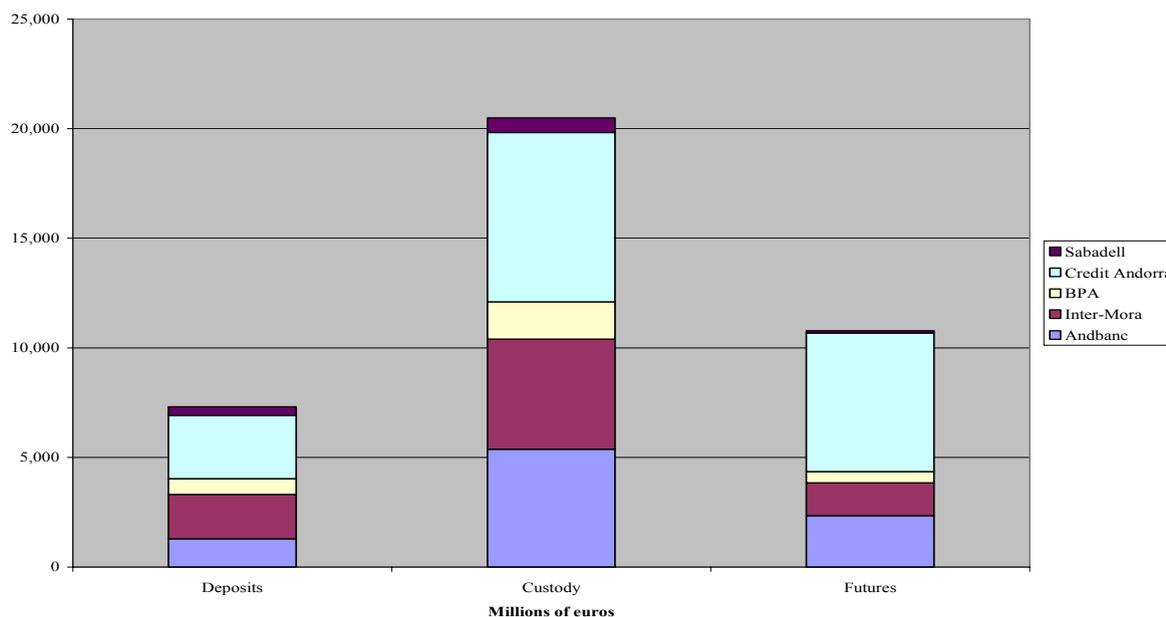
2/ Liquid assets in percent of short term liabilities

20. A significant increasing portion of off-balance sheet items is mainly driven by the growth of securities and other instruments in custody (16.2 percent growth in 2005) and derivatives operations (61.1 percent growth in 2005). Securities in custody amounted to 20.4 billion euros in 2005, nearly thrice the amount of customer deposits, and derivatives operations amounted to 10.8 billion euros (Figure 2). Bank managed third party' assets and assets of investment funds held in custody by banks amounted to 19.2 billion euros. The significant growth of derivatives operations corresponds to currency hedging instruments to cover customers' exposure to currency risk. Parallel to this pattern there has been a slow decline of on-balance sheet items.

¹¹ Minimum Capital to Risk Weighted Assets (CAR) as defined in Basel 1.

¹² Andorran banks are required to hold liquid assets for at least 40 percent of short-term liabilities.

Figure 2. Andorra: Deposits, Securities in Custody, and Derivatives, as of December 2005
(In millions of euros)



Source: Institut Nacional Andorrà de Finances.

Insurance sector

21. The insurance sector is small relative to the banking sector. The core insurance activity is comprised of a local market for nonlife business and a life insurance segment. Insurance business has traditionally been largely confined to activities conducted with Andorran residents. The home market—70 000 residents—while prosperous, is small and reportedly close to saturation. However, since 2005, life insurance business is picking up and a nonresident life insurance segment has emerged as, in advance of the entry into force of the EU Directive on the Taxation of Savings, funds were transferred from bank deposits to life insurance contracts integrating a savings component.

22. Aggregate gross premiums written, life, and nonlife insurance, were over 1.8 billion euros in 2005 (Table 4). This was an unusual year, as the significant transfer of funds from banks to insurance companies resulted in a substantial, one time, increase in life insurance gross premiums written to close to 1.8 billion euros in 2005. In 2004, a “normal” year, life insurers (premiums of 61.5 million euros) and nonlife insurers (premiums of 60.5 million euros) shared the market equally. While Andorran insurers conduct no direct business abroad, if the 2005 performance in life insurance sets off a trend, an important nonresident segment of the domestic market is likely to develop. Reinsurance, not available locally, is usually contracted with key international reinsurers.

23. Life insurance products are primarily sold through Andorran companies, controlled by Andorran banks. Nonlife products are sold through nonbank Andorran companies or through branches of foreign insurance companies, primarily from France and Spain. In 2005, there were seven life insurance companies, all controlled by Andorran banks, and six nonlife insurers, one of them controlled by a banking group and its shareholders. There were also 15 branches of foreign insurers, covering about half of the nonlife insurance market. There are no insurance groups in Andorra.

Table 4. Andorra: Insurance Sector, as of December 2005
(In millions of euros)

	Gross Premiums (2005)		Number of companies
	Mill Euros	Percent	
Life Insurance	1,758.1	100.0	
Companies related to Andorran Banks	1,739.8	99.0	6
Other Andorran companies	12.9	0.7	1
Branches of Foreign Insurance companies	5.3	0.3	1
Nonlife Insurance	50.4	100.0	
Companies related to Andorran Banks	n.a.	n.a.	0
Other Andorran companies 1/	26.3	52.2	6
Branches of Foreign Insurance companies	24.1	47.8	14

Source: Andorra Ministry of Finance.

1/ Includes an Andorran insurance company controlled by shareholders of a banking group.

Securities markets and collective investment schemes

24. Andorra has no stock exchange and its securities activities are highly integrated with the banking activities. Activities are limited to funds management and investments carried out by banks and collective investment management firms (Table 5). Private asset management firms are also present, though the volume they operate is very low (about 274 million euros in 2005). Most of the investment services in the principality are provided by banks. The investment service sector includes seven managers of CIS and four private asset management firms. These are regulated by the financial system law and supervised by INAF, but there is no legislation specific to securities, laws of general application and INAF directives apply.

Table 5. Andorra: Securities Market, as of December 2005

(In millions of euros)

	2000	2003	2004	2005
Number of Funds	94	127	142	158
<i>Of which,</i>				
Public	85	109	113	125
Private	9	18	29	33
Total Assets of Funds	4,039	5,991	7,829	8,495
<i>Of which,</i>				
Public	3,049	4,382	5,308	6,716
Private	990	1,609	2,521	1,779

Source: Institut Nacional Andorrà de Finances.

C. Legal and Institutional Framework

25. The INAF is the supervisor for the financial sector, including banks and nonbank financial companies, while insurance supervision is the responsibility of the MF. The UPB, created in 2001, has exclusive jurisdiction over money laundering investigations and supervision in Andorra.

26. The INAF is a public financial institution established in 1989 with legal personality, and operational and budgetary independence, according to a new charter passed in 2003. The INAF is under the direction of a *Consell d' Administració*, a Board of six members appointed by the principality's *Consell General* (CG) at the proposal of the MF, for a period of six years, half of which have terms staggered every three years. In addition, the Institute has a Director General—appointed by the government—and a Deputy Director General who have a six-year term.

27. The INAF has direct responsibility for the ongoing supervision of the financial system, except the insurance sector, and the day-to-day monitoring of the condition of all financial institutions, and has powers to carry out these responsibilities. It can, for instance, issue mandatory directives (*Comunicats*), access all information necessary to conduct its work, conduct on-site examinations, impose corrective actions and sanctions on supervised entities and enter into agreements with foreign supervisors. However, the INAF does not make the final decision with regards to granting and revoking licenses in the financial sector or to imposing sanctions graded as very serious, which are a responsibility of the MF. While the MF has effectively followed the INAF's advise and these limitations have so far not caused problems in Andorra, it would be advisable to empower the INAF to make these decisions. Aligning the entry, sanctioning and exit decisions with the responsibility for

supervision in the financial system, would allow the government to establish a stronger and clearer accountability framework.

28. The legal framework for financial institutions, excluding the insurance sector, is based on five main laws of general application to the financial sector. These are: (i) the law regulating the financial system (1993); (ii) the law governing the operational powers of the various components of the financial system (1996); (iii) the law governing the disciplinary system of the financial sector (1997); (iv) the law regulating the basic administrative rules of the banking institutions (1998); and (v) the charter of the INAF (2003). These laws have been supplemented by the INAF directives (*Comunicats*), which contain fiduciary, prudential and conduct of business requirements and govern the supervision of bank and non bank financial institutions. Draft laws updating the regulatory framework for non bank financial institutions have been elaborated by the INAF. These draft laws transpose the provisions of existing directives of the INAF and strengthen them by including provisions inspired on legislation recently promulgated in key foreign jurisdictions. The new law would contain comprehensive and detailed provisions on company establishment, evolution and closing; accounting, auditing and reporting; fiduciary and prudential duties, business conduct and regulatory and market disclosure and supervision. The CIS draft law appears to be Euro-compatible, in particular as regards the EU Markets in Financial Services Directive¹³ and the related EU legislation. Reportedly, these bills are to be tabled soon in the General Council (Parliament).

29. There is consensus that the legal framework for the insurance sector requires substantial renewal, in line with EU regulations and the principles of the IAIS. Currently, this sector is solely regulated by a 1989 Law (*Llei de regulació de l' actuació de les companyies d' assegurances al Principat*). No prudential or conduct of business regulations have been issued to supplement this law. It should be noted that the charter of the INAF mandated presentation in early 2004 to the Parliament of regulations for the integration of insurance supervision in INAF.¹⁴ A law on regulation of insurance was drafted in late 2003. It requires however, a substantive review to make it consistent with the IAIS principles before it is tabled in Parliament. Reportedly, this is among the legislative priorities of the new government.

30. Financial institutions, with the exception of insurance companies, follow accounting rules issued by INAF. The Chart of Accounts -*Pla Comptable*- was issued in 1999 and became mandatory for the first time for fiscal years ended December 2000. These accounting rules were inspired by the Spanish prudential rules in force at the time. A revision is merited in the context of the International Financial Reporting Standards (IFRS), now in use by all major financial centers in Europe. There are no accounting standards mandated for insurance

¹³ Directive 2002/87/EC of the European Parliament and the Council of December 16, 2002.

¹⁴ INAF Law, Second transitional provision.

companies in Andorra. The uneven implementation of accounting practices creates problems of comparability of financial statements within the insurance sector. An accounting draft law is being studied by the government, with the aim to adopt and implement IFRS in all Andorran companies. A draft law is expected to be ready for submission to Parliament in 2007. INAF is in favor of all banks adopting IFRS as soon as the draft legislation is passed by the CG and to adapt prudential regulations as needed to narrow the accounting choices made available to banks by the international accounting standards.

II. STRENGTHS AND VULNERABILITIES OF THE FINANCIAL SUPERVISORY AND REGULATORY ARRANGEMENTS

A. Cross Sectoral Issues

The role of external auditors in the financial system oversight

31. The effectiveness of the INAF supervision is highly dependent on the work of external auditors. The INAF is currently developing its on-site supervisory capabilities, which are to be operational by end-2007, once training of new its staff is completed. In the meantime, this function is carried out by external auditors. Even with the new hirings, INAF's staff is very lean (12), and additional hirings are recommended to implement an effective on-site oversight function, that relies less on the external audit firms to conduct complementary audits on its behalf.

32. Detailed INAF directives require external auditors to make an evaluation of a wide range of areas, which are reported annually in the IC. These areas include: (i) compliance with accounting and prudential rules; (ii) report of significant events; (iii) consolidation of financial statements; (iv) organization and management; (v) internal control processes; (vi) validation of prudential reports filed with the INAF; (vii) management of credit, market, liquidity, country, operational, and legal risks; (viii) follow up of issues raised in previous reports; and (ix) general conclusion and recommendations. The IC has been in effect since year 2001 for banks, and since 2005 for nonbank financial institutions. In a tripartite meeting carried every October by INAF senior staff, with the external auditor and the bank management, the IC is discussed and corrective measures are required if INAF deems they are needed.

33. It appears that supervisory expectations laid out in the requests of the IC do not always match those of external auditors'. Auditors have indicated to mission staff that to opine on some themes (i.e., internal controls and risk management controls, assessment and management of market and operational risks, structured products and derivatives, adequacy of an entity's administrative structure, etc.) they would require benchmarks or best practices defined by the supervisor to which contrast the banks' current practices against; and that, further, their understanding was that they were not to provide an opinion about each one of the areas for which the supervisor had a request in the IC. Several IC read by the mission and discussions conducted with several international audit firms indicate that, in some instances,

auditors limited their work to verify that the entity complied with its policies and procedures without necessarily assessing whether these are adequate. Moreover, some external auditors of non bank financial entities stated to the mission that they provided the information requested in the IC based solely on the audit work conducted during the annual audit of the entity's financial statements.

34. In order to enhance the effectiveness of the work conducted by external auditors, it is recommended that INAF: (i) integrate dispersed audit regulations into a single norm and framework; (ii) clarify its expectations with the auditors, as much as needed; (iii) ensure that its requests are specific and clearly defined and that they describe the standards against which the entity's performance can be measured, so that the auditor can report whether or not they have been achieved; (iv) reach some understanding with the external auditors regarding the concept of materiality, as needed; (v) revisit the frequency of the requests made to auditors and consider the adoption of rotation plans or different frequencies (higher and lower) of current requests and agree on a work program over a certain period of time; (vi) ensure high standards of bank auditing (independence in appearance and fact, proper licensing and good standing, relevant professional experience and competence, subject to quality assurance programs, compliance with ethical requirements); and (vii) consider the hiring of independent audit firms to make an assessment of the quality of a specific bank audit, as needed.

B. Sectoral Findings

35. This section summarizes the findings in the assessment of standards and codes for banking and in the review of the regulation and supervision of the CIS and insurance sectors. It also includes an initial review of AML/CFT practices, based on information provided by the authorities and discussions with UPB and INAF senior staff and external auditors. The mission had access to the preliminary results of the mutual evaluation conducted by MONEYVAL in October 2005, but a ROSC on compliance with AML/CFT standards will only be prepared once the final results of this evaluation are issued, in mid-2007, according to the authorities' expectations.

Banking

36. The assessment found a high level of compliance with the BCP and a notable improvement with respect to the 2002 assessment. Andorra is compliant with 21 principles and largely compliant with 8 principles. The only principle that is still materially noncompliant is Principle 25, on the supervision of foreign bank establishments. Under INAF's charter Andorra is now able to sign agreements for cooperation and information exchange with foreign supervisors, but INAF's efforts in this regard have not yet been effective. Restrictions on the access of supervisors of foreign banks to nominative information of the banks' customers prevented an agreement with the BE. Looking forward, the INAF should step up its efforts to sign agreements with foreign supervisors, to develop its

on-site supervisory capacities and to improve the effectiveness of the oversight delegated to external auditors. Additionally, it is advisable to empower the INAF to make the final decisions regarding granting and revoking bank licenses and issuing all types of sanctions; and to improve disclosure of the INAF's activities and financial statements (details in Appendix III).

Collective investment schemes

37. There are at present no regulations specific to the CIS sector. However, several statutes of general application to the financial system apply. In carrying out its mandate in that context, INAF issued several mandatory Directives, which at present govern CIS supervision, pending elaboration and promulgation of a CIS specific statute. A new CIS regulation law has been drafted and is, reportedly, among the government's legislative priorities. It would comprehensively and specifically substantiate the CIS regulatory and supervisory regimes, and address CIS creation, modification and termination; fiduciary and prudential obligations; accounting, auditing, regulatory reporting; market disclosure and conduct of business procedures and practices. It might need enhancement as regards CIS specific bases for asset valuation, pricing and redemption of CIS units, as well as disclosure to retail investors.

Insurance

38. The regulation and supervision of insurance companies is insufficient, and in view of its increasing importance, efforts to strengthen them should be stepped up. Currently supervision is carried out by the MF, but there is no area solely dedicated to insurance supervision in the MF; these tasks are carried out by the tax department within the MF. Supervision consists mainly of analyzing audited financial statements. There are no suitable regulatory arrangements. Prudential and conduct of business regulation are limited. There are no international cooperation provisions or practices. It is essential that the government implement in the short run the provision included in INAF's charter, regarding the transfer to INAF of the responsibility for supervising this sector, increase insurance oversight capacity and give priority in their legislative program to a new insurance regulation law.

Anti-Money Laundering/Combating the Financing of Terrorism (preliminary analysis, pending the issuance of the final MONEYVAL report)

39. Andorra's legal framework in anti-money laundering and combating the financing of terrorism is largely based on the Law on International Criminal Cooperation and Combating Laundering of Money or Valuables Resulting from International Crime issued in 2000. The law provides for formalized international mutual cooperation on criminal matters; creates and empowers the UPB with exclusive jurisdiction over money laundering investigations and supervision; provides comprehensive customer due diligence and record keeping, and sets

detailed suspicious transaction reporting requirements. The law may be supplemented by technical communications issued by the UPB. The INAF has been divested of a role in this area.

40. During 2005, a team of the Council of Europe's MONEYVAL visited Andorra. The mission had access to the preliminary results of the third visit conducted by the team from October 17–21, 2005, and the assessment was generally favorable, finding that Andorra had continued to make progress in the area of AML/CFT; but it also pointed out to several aspects in need of further improvements.

41. The UPB has conducted on-site inspections in banks, nonbank financial institutions and insurance companies. Since end-2002, the UPB has requested external auditors to report on a range of issues that include, inter-alia, procedures and systems in place in banks to assess fit-and-proper of key staff; internal control systems and procedures; suspicious transactions reported by employees to bank management; training given to employees on money laundering and financing of terrorism; opinion on the overall efficiency of procedures aimed to prevent and detect money laundering activities.

42. Legislation that should modify the 2000 law has been drafted and is pending Parliament approval. This legislation would adapt Andorra's AML/CFT regime to the revised Financial Action Task Force Recommendations and address some issues raised by MONEYVAL by (i) specifically addressing activities related to financing of terrorism; (ii) expanding the definition of supervised entities and individuals; (iii) making UPB *Comunicados Tecnicos* binding for supervised entities; and (iv) better identifying an entity's customers and empowering the UPB to impose sanctions, except those considered very grave that should still rest on the central government.

43. The UPB does not consider that numbered accounts are an obstacle to the authorities considering that banks comply with the know-your-customer requirements. It charges external auditors with specific due diligence requests on these accounts as well as on other areas of concern. Regarding Politically Exposed Persons, the draft legislation does not contain any particular obligation or mention, however the *comunicados tecnicos* of UPB and the Ethical Code issued by INAF refer to these.

C. Cross-Border Cooperation and Information Exchange

44. The laws governing financial institutions contain provisions to maintain the secrecy and confidentiality of information obtained by the supervisors, as well as to provide gateways for the exchange of information. Revealing confidential information is a violation of the professional secret and, as such, is penalized by the law (Article 191 of the Penal Code).

45. Both INAF and UPB are empowered to enter into cooperation agreements with foreign authorities.