

Report of the 20th A2ii – IAIS Consultation Call

Reinsurance

26 January 2017



The A2ii consultation calls are organised in partnership with the IAIS to provide supervisors with a platform to exchange experiences and lessons learnt in expanding access to insurance.

The 20th Consultation Call, held on 26 January 2017, addressed the topic of reinsurance. The topic was selected following a request from the IAIS Executive Committee and Latin American supervisors. Four calls were held: two in English, one in French and one in Spanish.

Marcelo Ramella (Deputy Director of Financial Stability at the Bermuda Monetary Authority and Chair of the IAIS Reinsurance Taskforce) and Christelle Lacaze (Autorité de contrôle prudentiel et de résolution, ACPR, France) explored important questions around the supervision of reinsurance and reinsurers, including issues around the enforcement of contracts, fronting and contract oversight, among others. Supervision of reinsurance was also examined in relation to relevant IAIS Insurance Core Principles (ICPs) and Standards, namely ICP 13. A case study from the Insurance Regulatory and Development Authority of India was presented, and country experts Joseph Owuor (Kenyan Insurance Regulatory Authority) and Patricio Espinoza (Superintendency of Securities and Insurance Chile) shared their jurisdiction's experience with regulating reinsurance. The Canadian Office of the Superintendent of Financial Institutions (OSFI) also shared Canada's regulatory framework for reinsurance.

What is reinsurance?

While the precise definition of reinsurance may vary across legal frameworks, most simply put, reinsurance can be thought of as insurance for insurers (B-to-B business). Just as firms and individuals buy insurance for perils they do not wish to bear, primary insurers purchase reinsurance for risks they do not want to fully retain.¹ In conducting their business, reinsurers pursue similar business models as primary insurers. They contract with the primary insurer (or cedant) to reimburse any future claim the primary insurer may have against the payment of a premium today. In order to meet future claims, reinsurers apply many of the same insurance techniques and models for risk selection as primary insurers and follow the same insurance accounting principles. Just like primary insurers, reinsurers are pre-funded through premium payments and pursue similar general approaches to asset liability management. As primary insurance and reinsurance are businesses with a high degree of similarities, the IAIS views that in general supervision of insurers and reinsurers should be aligned, but nevertheless consider the distinctive features of each activity.

Reinsurance is a contract of indemnity between two parties, the insurer (cedant) and the reinsurer, to protect the insurer against part of its risk in return for a premium. In essence, reinsurance is insurance for insurers.

Types of reinsurance contracts

There are three broad types of reinsurance agreements, fundamentally differing in terms of the contractual structure of the risk ceded:

→ **Facultative reinsurance**

- An individual clearly defined risk, typically yielding a big potential pay-out, is ceded between the

¹ Reinsurers can also purchase reinsurance, which is called retrocession.

insurer and reinsurer. Facultative agreements are usually complex and tailor-made contracts that are additional to a previous scheme or treaty. An example would be covering the risk of a fire breaking out at a large power plant. It is important that supervisors understand the specific characteristics of such case-by-case agreements.

→ **Treaty reinsurance (obligatory)**

- A bundle of risk (a 'book of business') is automatically ceded to the reinsurer, who must accept the risk. Home owner's and auto insurance, policies that bundle multiple risks (e.g. theft, fire, etc.) are examples of treaty coverage. For such agreements, the reinsurer will not check every single policy in the treaty but rather agree to accept all policies the primary insurer is placing in the market. This entails an important element of trust and a sound relationship between the insurer and the reinsurer.

→ **Facultative obligatory reinsurance**

- A bundle of risk (a 'book of business') could be ceded to the reinsurer. The insurer has the option of transferring this risk under specific conditions which the reinsurer cannot refuse. This type of contract is seen when the relationship between the insurer and the reinsurer is already well established and when a good trading relationship exists. This entails an important element of trust and a sound relationship between the two entities.

Forms of reinsurance transfer of risk

There are also two broad categories in terms of how reinsurance is contracted. This distinction is important as each form requires different types of supervision.

→ **Proportional:** a fixed proportion of risk is shared between the cedant and reinsurer

- Risk is shared by certain percentages that are set upfront between the insurer and reinsurer. For example, in a treaty reinsurance contract on home owner's insurance, the primary insurer may wish to retain 20% of the risk and cede 80%, or vice versa. Premiums and claims will thus be shared on a proportional basis based on the agreed quota that the treaty has established. The insurer typically retains a certain amount and there is an upper limit on how much the reinsurer takes.

→ **Non-proportional:** the reinsurer pays all losses exceeding a specific limit for a risk or event, usually up to a limit

- The insurer and reinsurer will agree on an attachment point and trigger after which the reinsurer will pay. An upper limit is also specified. Considering fire insurance at a power station, an insurer and reinsurer will agree upon a value below which the insurer will retain the risk and once exceeded, the reinsurer will cover, up to a certain limit after which the policy is exhausted and the reinsurer's liability ceases.

Why do insurers buy reinsurance?

- **To increase the underwriting capacity of the primary insurer:** when an insurer purchases reinsurance they draw upon someone else's capital base. They are thus in a position to have more capacity to continue underwriting themselves.
- **To stabilise earnings:** insurers have a certain level of risk tolerance. They may not want to exceed a certain loss ratio and thus purchase reinsurance coverage for calculated scenarios exceeding the limit.
- **To secure catastrophe protection:** for example, in nations exposed to natural catastrophes, insurers will tend to buy reinsurance to protect themselves against catastrophic events that can trigger mass pay-outs. In such cases, insurers typically purchase reinsurance on a non-proportional basis.

- **To enter or exit certain businesses:** it is common that when an insurer enters a line of business they are not familiar with, they will buy reinsurance as a means to allow themselves to learn the business. Insurers may likewise purchase reinsurance to exit a business; however, while transferring economic risk they are still legally held liable to policyholders.
- **To take advantage of a reinsurer's expertise:** for example, when selling insurance cross-border or establishing a subsidiary, an insurer may choose to cede to a reinsurer with expertise in the business to learn about the new market. Reinsurers are often in possession of a wealth of historical data that can help insurers understand the businesses they are entering, either in a new country or in a new line of business altogether.
- **To facilitate the operation of complex insurance groups:** often, large insurance groups use intra-group reinsurance to optimise their capital allocation and risk management as well as to enter new markets. Such groups may set limits to their various subsidiaries so that if a subsidiary exceeds a limit they must purchase reinsurance from one of the group's internal reinsurers.

Regulation and Supervision of Reinsurance and Reinsurers

Reinsurance is an important risk-management tool. However, ceding reinsurance risk can introduce a number of new risks – operational, legal, counterparty and liquidity alike. The combination of these new risks can make reinsurance a very complex and challenging business to implement effectively, thereby requiring sound supervision and regulatory practices.

International standards around the supervision and regulation of reinsurance and reinsurers rely primarily on IAIS Insurance Core Principle #13², which has six standards.

Insurance Core Principle 13: Reinsurance and other forms of risk transfer

The supervisor sets standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction.

ICP 13 calls for supervisors to set standards on the use of reinsurance, requiring insurers to properly control their reinsurance and risk transfer programmes and to thoroughly report on them. In analysing the relationship between reinsurance and financial stability, the IAIS recognises the broad similarities in how reinsurers and primary insurers conduct their business. Nevertheless, while insurers and reinsurers are expected to be treated the same, the IAIS encourages supervisors to take into account some features unique to reinsurance when supervising reinsurers in their jurisdiction. For example, the IAIS assumes that the business relationship in the reinsurance enterprise is between sophisticated players, and thus that the level of information asymmetry characteristic of primary insurance and consequent consumer protection required from the supervisory body is not present in reinsurance.

ICP 13 is currently under review by the IAIS Reinsurance Taskforce. A revised version is expected to be presented to the IAIS Financial Stability and Technical Committee later on in the year.

² IAIS (2011) Insurance Core Principles, Standards, Guidance and Assessment Methodology – 1 October 2011.

Standard #1

The supervisor requires that cedants have reinsurance and risk transfer strategies appropriate to the nature, scale and complexity of their business, and which are part of their wider underwriting and risk and capital management strategies.

The supervisor also requires that cedants have systems and procedures for ensuring that such strategies are implemented and complied with, and that cedants have in place appropriate systems and controls over their risk transfer transactions.

Standard 1 of ICP 13 calls for supervisors to require insurers to have clear risk transfer strategies in place and to manage and control these strategies soundly. Cedants must be clear in their risk appetite and rationale for ceding risk, how they select reinsurers and in their strategy to manage and govern the cessions, among other things. It is up to insurers to develop their own strategies, limits and business mixes; however, supervisors must assess and challenge insurers when necessary to ensure that the content of their reinsurance strategy is sound and consistent with their overall risk management and capital management strategy.

There are various ways in which supervisors can regulate adherence to this standard in practice. For example, the Australian Prudential Regulation Authority (APRA) has a dedicated standard (Prudential Standard GPS 230) articulating what is expected from the insurer and requiring a Reinsurance Management Strategy document whereby the insurer has to outline their reinsurance strategy, how it is controlled, governed and the way the Board is involved. This statutory document gives an insight into the insurer's reinsurance strategy and management and APRA can therefore challenge whatever is unclear. APRA also asks for yearly statements updating the status of an insurer's reinsurance arrangements. APRA requires insurers to annually file a declaration that the contracts are in place and are legally binding. Canada (Guideline B-3) and Hong Kong (Guidance Note on Reinsurance, No. 17) also adopt similar regulatory approaches.

Standard #2

The supervisor requires that cedants are transparent in their reinsurance arrangements and the associated risks, allowing the supervisor to understand the economic impact of reinsurance and other forms of risk transfer arrangements in place.

What constitutes risk transfer often differs according to the accounting rules in each jurisdiction. It is important that supervisors are able to understand the substance of the risk transferred in reinsurance agreements, some of which can be especially complex, in order to soundly regulate the reinsurance market. In practice, supervisors should be in a position to have full access to the documentation of individual contracts so that the risk ceded can be clearly identified beyond dispute. There are certain red flags that supervisors can pick up on to judge the extent to which a reinsurance contract is transferring risk. For example, when premiums appear to be too high against the exposure taken, when there are unreasonable commissions to the reinsurer, when there are commutation clauses allowing the reinsurer to terminate the risk transfer without prior notice, if the reinsurance contract makes reference to another contract that may change the rules of the game, or if there are many undefined terms and provisions. A common and simple supervisory approach is to straightforwardly ask for a declaration from the insurer about the risk transfer.

Standard #3

The supervisor takes into account the nature of supervision of reinsurers and other counterparties, including any supervisory recognition arrangements in place.

Reinsurance is by nature a global business. Reinsurers diversify their risk by buying and selling reinsurance across borders. This raises questions around their solvency and soundness. Supervisors must thus try to engage in more formal agreements with the supervisor in the reinsurer's jurisdiction of origin. This can be done through various supervisory tools such as unilaterally accepting another country's reinsurance regime, through bilateral agreements (e.g. Memoranda of Understanding), multilateral agreements or by various structural agreements such as Equivalence under the EU's Solvency II. The NAIC in the United States, for example, has a Qualified Jurisdiction process whereby they assess the soundness of the supervisory framework of various countries and compile a list of 'qualified' jurisdictions that are recognised for reinsurance regime equivalency purposes. The more cross-border supervisory cooperation, the more efficient resource allocations can be gained.

Standard #4

The question of binding documentation requirements for reinsurance contracts is a question of national contract law. However, the supervisor requires that parties to reinsurance contracts promptly document the principal economic and coverage terms and conditions agreed upon by the parties and finalise the formal reinsurance contract in a timely fashion.

Often insurers and reinsurers spend some time negotiating the terms and conditions of the contract and tend to agree only in the last stages before contract renewal. Such an agreement is documented in a reinsurance summary or 'slip', which covers the main financial and coverage terms, and the full contract is finalised later. It is paramount that supervisors ensure there are not unnecessary delays in finalising formal contracts and pressure insurers to produce official documentation in a timely manner. Some jurisdictions provide hard deadlines (e.g. APRA gives 2 months for the principal economic terms and 'slip' and 6 months for the contract); others do not set dates at all. Attestation from insurers can be requested as a matter of regulation even if hard data has not been put together.

Standard #5

The supervisors assess whether cedants control their liquidity position to take account of the structure of risk transfer contracts and likely payment patterns arising from these.

Although liquidity has traditionally been seen as a substantive risk in the banking sector, not the insurance sector, this view has evolved in recent years. With a prolonged period of low interest rates liquidity risk has become more salient, as many insurers have increased their share of investments in illiquid assets. Insurers, like other financial institutions, are moving their assets to more illiquid investments that yield higher returns. Supervisors must respond to this phenomenon by ensuring that the insurer is not only solvent but liquid and able to pay out claims when they fall due. Insurers will rely, often heavily, on the reinsurance recoverable from the reinsurer to pay claims. From a supervisory perspective, good practice would be to ensure that insurers stress test their liquidity and that reinsurance is included in the overall assessment.

Standard #6

Where risk transfer to the capital markets is permitted, supervisors are able to understand the structure and operation of such arrangements and to assess issues which may arise.

In some instances, the full risk exposure of the insurer is ceded to a structure that is funded by the capital market. While most jurisdictions do not permit such transactions, in countries that do supervisors should be able to understand the structure and operations of such arrangements to ensure the financial stability and soundness of the agreement. For instance, such structures are typically very lean and operate under the provision that the entire exposure will be fully funded. Supervisors must thus determine whether there are enough funds to pay for the full exposure for the entire duration of the risk. Further, these funds are invested rather than lying idle in cash. Supervisors should thus understand what kinds of investments the funds have been placed in to ensure that they will be sufficient and available at the time of claims payment. Moreover, about half of risk transfers to the capital market are done on a so-called parametric trigger, which stipulates ex-ante that pay-out will be made upon the occurrence of a 'triggering' event. Such agreements may introduce basis risk, or the risk that the insurer will have to pay the claim even if the triggering event has not been verified. The supervisor should be able to understand the parametric triggers in practice and assess the basis risk involved.

Other Relevant IAIS Standards for the Supervision of Reinsurance

- **ICP 14 'Valuation' – Standard 14.6.2:** addresses considerations on the credit standing of a reinsurer when assessing the solvency of a ceding (re)insurer and how it fits into the enterprise risk management of the insurer.
- **ICP 16 'Enterprise Risk Management (ERM) for Solvency Purposes' – Standard 16.7.5:** requires supervisors to in turn require cedants to address credit risk from reinsurers as part of the cedant's ERM.
- **ICP 17 'Capital Adequacy' – Standard 17.7.3:** addresses capital charges on the cedant, related to the insurer's reinsurer's security, be it through ratings, claims payments or through other quantitative data.
- **ICP 20 'Public Disclosure' – Standards 20.6 and 20.7:** on an insurer's disclosures of its reinsurance programme, for example through quantitative data around gross or net exposures, profit and losses, assets and liability around reinsurance recoverables, or reinsurance reserves.

Case Studies: India, Kenya, Canada and Chile

INDIA

India is an emerging market currently experiencing rapid economic growth. GDP growth has, in turn, led to an expansion of the insurance market which has raised premiums and increased the need for insurers to purchase reinsurance.³ There are currently 30 general insurance companies, 2 reinsurance companies and 7 foreign reinsurers operating in India, with 361 foreign reinsurers participating in the Reinsurance Programme of the India reinsurance market. To transact reinsurance business, reinsurers, domestic or foreign, are permitted to open their offices in Special Economic Zones. Despite the presence of a handful of local reinsurance companies, often the local capacity and expertise to conduct the enterprise is lacking.

Regulatory Approach to Reinsurance

Developing a local capacity in reinsurance is an important consideration for the Insurance Regulatory and Development Authority of India (IRDAI). The objectives of IRDAI, in the context of reinsurance, are to maximise retention within the country, develop adequate local capacity, secure the best possible reinsurance protection at a reasonable cost and to simplify the administration of the reinsurance business.

Obligatory Cession and Retention

To bolster the domestic reinsurance sector, IRDAI requires a set percentage of obligatory cessions, the value of which is determined annually with the approval of the Indian government. Moreover, IRDAI ensures that insurers and reinsurers retain business commensurate with their financial strength, quality of risk and volume of business; that the retention of reinsurance is justified; and that insurers and reinsurers operating in the country are not merely fronting for a cross-border reinsurer. While such policies have some validity in relation to growing local capacity, tying down the purchase of reinsurance just to local reinsurers may yield risks around the ability of the ceding parties to adequately diversify the risk they are ceding or access competitive prices.

Control around Reinsurance Arrangements

IRDAI analyses reinsurance arrangements on the following aspects in close alignment with ICP 13:

- Limits and parameters considered to aid retention
- Reports of actual and projected premium income
- Structure of proportional arrangements (including treaty capacity, retention limits, commission, etc.)
- Structure of non-proportional arrangements (including cover limits, deductibles, reinstatement provisions, etc.)
- Adequacy of catastrophic accumulations and its protection (catastrophe management)
- Actual and projected reinsurance cost

Insurers and reinsurers must submit proposed and final reinsurance arrangements in advance for the forthcoming year.

³ Gross domestic premiums and reinsurance premiums stand at USD 15bn and USD 3bn, respectively.

Cross-Border Reinsurers

As a growing market, India has been steadily opening its market and allowing cross-border cessions, subsidiaries and branches into the country in an effort to bring in expertise and the capacity of the international market. To ensure that cross-border reinsurance is handled properly, IRDAI stipulates certain parameters around the way the reinsurer is supervised both in India and in the country of origin (ICP 13, Standard #3).

Cross-border reinsurers must satisfy the minimum eligibility criteria to participate in the Indian reinsurance market:

- Must be regulated and supervised by its home regulator and supervisor
- Financial strength, management quality and technical reserving methodologies to be monitored by the home regulator
- Have at least have a BBB rating by Standard & Poor, or an equivalent rating in the previous three years
- Solvency/capital adequacy not less than as stipulated by the home regulator/supervisor
- Satisfactory claims performance in the last three years

Cross-border reinsurers that do not satisfy the above criteria may be allowed to operate with special approval by IRDAI.

KENYA

Legal Framework on Reinsurance in Kenya

Reinsurance business in Kenya is governed by Insurance Act Chapter 487 as well as through other regulations and guidelines. Relevant components of the Act include:

- **Section 8:** gives the Insurance Regulatory Authority (IRA) power to examine all reinsurance treaties and contracts entered into by insurance companies and to give directions on the suitability of such agreements.
- **Section 20:** restricts reinsurance business with insurers not registered under the Act without prior approval of the Commissioner.
- **Section 29:** establishes the requirement for firms to craft appropriate reinsurance arrangements by making it compulsory for insurers to have arrangements approved by the IRA and outlining the conditions for such approval.

Guideline on Reinsurance Arrangements in Kenya

In April 2013, the IRA issued a prudential guideline on reinsurance arrangements with the intent of bringing the reinsurance sector in Kenya in line with ICP 13. The guideline put a great deal of emphasis on the

role of an insurer's Board of Directors (BoD) and management in the arrangement of reinsurance contracts. Some of the key principles introduced entail that:

- Each insurance firm is to have a documented Reinsurance Management Strategy, approved by the BoD;
- The strategy takes into account the insurer's business model, levels of capital and business mix; and
- That the responsibility for developing and agreeing on a strategy rests with the Board and management of the insurer

The Guideline specifically requires:

- The insurer's BoD to set limits on the net risk to be retained and aggregate for the company the maximum foreseeable amount of reinsurance protection to be obtained from approved reinsurers
- Management to document clear policies and procedures for implementing the reinsurance strategy set by the BoD
- The BoD to review the reinsurance strategy at least biennially and whenever there have been material changes in the company's circumstances
- The insurer to transact business with reinsurers having a minimum credit rating of BBB (by Standard & Poor or an equivalent credit rating agency)
- An insurer to have processes in place to ensure that it has accurate and complete reinsurance documentation at the inception date of its reinsurance contracts
- The insurer to control its liquidity position by taking into account the structure of the risk transfer contracts and their likely payment patterns
- The insurer to have in place specific processes to approve, monitor and confirm the placement of each facultative risk

The guideline prohibits the following practices:

- Insurers entering into reinsurance arrangements whereby no insurance risk is transferred from the primary insurer to the reinsurer
- Insurers transferring the entire risk to a reinsurer, unless approval is granted by the IRA
- Fronting arrangements, unless approved by the IRA

The enactment of the Guideline on Reinsurance Arrangements has assisted insurers and the IRA to ensure reinsurance contract clarity and certainty; adhere to the requirements of ICP 13; and conform to other key IAIS principles relevant to reinsurance, such as credit ratings when assessing solvency and capital charges related to the insurer's security.

CANADA

In 2010, the Office of the Superintendent of Financial Institutions (OSFI) issued a principles-based guideline, closely aligned with ICP 13, detailing the expectations for insurers around effective reinsurance practices and procedures. While regarded as authoritative, the guideline does not have the force of law. Guideline B-3⁴ set out four key principles for insurers to abide by:

1. **Insurers are responsible for having their own comprehensive and sound reinsurance risk management policy.** The policy, which is to be overseen by the Board of Directors and implemented by senior management, should reflect the scale, nature and complexity of the insurer's business and regard the firm's risk appetite and tolerance. The policy should document all elements of the insurer's approach to managing reinsurance risk and thereby include the objective for seeking reinsurance, risk concentration limits and the practices and procedures for managing these risks. The policy must also detail the roles and responsibilities for the positions that are charged with implementing the policy as well as the process for ensuring it is regularly updated.
2. **An insurer should perform a sufficient level of due diligence on its reinsurance counterparties on an ongoing basis.** A cedant should perform its own due diligence on the financial strength of its reinsurance counterparties rather than relying solely on third party recommendations (e.g. rating agency assessments or broker analyses).
3. **The terms and conditions of the reinsurance contract must be clear and unambiguous.** The insurer should have processes and procedures in place to ensure that the reinsurance agreement is comprehensive, in writing and that the binding insurance contract is executed. Ideally this should be done prior to the effective date of the reinsurance coverage.
4. **Ensure there are insolvency clauses to clarify that the reinsurer must continue to make full payments to an insolvent cedant without any reduction resulting fully from the cedant's insolvency.**

Administration of Guidance

OSFI requires insurers to maintain and to provide upon request their reinsurance risk management policy as well as a complete description of all reinsurance arrangements, including levels of reinsurance, the due diligence performed on counterparties and the proportion of cessions to other entities. If an insurer fails to adhere to the principles outlined, OSFI may not grant capital or asset credit for reinsurance, or use discretionary legislative authority to adjust the capital requirements for the target solvency ratios to compensate for reinsurance risk that is not or may not be wholly effective or reliable. OSFI monitors insurers very closely through regular reporting and periodic on-site examinations. Canada also has a legislated approvals requirement for insurance companies that wish to reinsure with a related party that is not regulated by OSFI. This additional level of scrutiny requires insurers to get the superintendent's prior approval before reinsuring with the related party by submitting an application demonstrative that they have done the appropriate due diligence on the reinsurance counterparty.

⁴ OSFI Guideline B-3 can be found here: http://www.osfi-bsif.gc.ca/eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/b3_let.aspx

CHILE

Regulation on Reinsurance in Chile

In Chile, General Standard No. 139 sets out the requirements for companies operating as reinsurers, both domestic and foreign. The regulation stipulates that:

- For national reinsurers, a minimum capital of USD \$4.8m as of January 23, 2017 is required
- Foreign reinsurers may operate in Chile only if they maintain an international risk rating equal to or greater than BBB
- The reinsurance arrangement may be made directly by the designated entities or through reinsurance brokers that are registered in the Register of Foreign Reinsurance Brokers⁵ of the Superintendency of Securities and Insurance (SVS)

Standard No. 325 on risk management sets out general guidelines on what should be considered proper management of reinsurance. Some aspects that should be considered in the management of reinsurance are: a) selection of reinsurance and b) maintenance and application of reinsurance contracts.

Supervision of Reinsurance in Chile

The SVS supervises reinsurance operations based on compliance with the requirements and procedures defined in the aforementioned regulatory framework. The SVS monitors compliance with, for example, the BBB risk classification that the foreign reinsurer must have. Additionally, the SVS supervises the soundness of insurers' risk management by evaluating the risk ceded against the general solvency of the insurer.

New Regulation on Reinsurance

The SVS recently published a regulatory development report (for public comments) on reinsurance management and reinsurance programmes/contracts. The regulatory change establishes five principles of sound reinsurance management via the review, approval and control of an adequate reinsurance management policy by the Board in addition to establishing annual reporting requirements for reinsurance contracts (June of each year).

- **Principle 1:** The insurance company has an appropriate and comprehensive reinsurance management policy, approved and subject to Board supervision and implemented by senior management.
- **Principle 2:** The insurance company has a credit risk management policy associated with reinsurance counterparties.
- **Principle 3:** The insurance company has procedures and control systems to ensure that the terms of reinsurance are contained in a formal contract, with clear and binding terms and conditions.
- **Principle 4:** The eventual insolvency of a ceding insurer should not affect the performance of the reinsurance contract.
- **Principle 5:** The insurance company has policies for the use of reinsurance brokers and procedures or control systems in place to monitor their operations.

⁵ Reinsurers do not have a formal registry in Chile.

Questions and Discussion



How is reinsurance treated under the Solvency II Directive of the European Union?

Under Solvency II, reinsurance is treated as a prime risk mitigation technique. There are very clear provisions around what constitutes risk transfer in relation to reinsurance. The clarity on risk transfer around the fact that risk transfer has to be beyond dispute is very clearly stated. There are certainly plenty of provisions around how the soundness of the reinsurer is being handled in order to address the credit for reinsurance that is being provided to the insurer. There is an entire section around reinsurance as a risk mitigation technique not so much in the Directive, as it is a very high level policy document, but in regulations from 2015 Section 10, Articles 208 to 215. These articles stipulate issues such as collateral arrangements, guarantees and the status of counterparties. It is an entire transfer as well on risk transfer to the capital markets. Chapter 15 of the solvency regulations of 2015 look to risk transfer to the capital market. The provisions around the reinsurer, the risk transfer and the security provided by the reinsurer to the insurer are all regulated in Solvency II.



What is the rule of insurance-linked securities (ILS) for raising the capacity of reinsurance?

'Insurance-linked securities' (ILS) is a broad term used to define the type of securities that are sold in the capital market to fund reinsurance risk. The recent increase in capacity in the reinsurance market can be partially attributed to the increased prevalence of such securities. As ILS are by definition reinsurance transactions, supervisors must be able to understand the structure and operations of such risk transfer arrangements. For example, it is important that supervisors understand whether the entity assuming the risk is a licensed reinsurer, if it is managed properly and if its governance and risk management are sound. Annually, the IAIS publishes the Global Insurance Market Report which, among other things, updates on the risk transfer to the capital market and surveillance of the sector.



What are the risks to the insurer from engaging in fronting arrangements? Are there any rules governing fronting in any jurisdictions?

'Fronting' tends to be an informal term that is often used in trade lexicon, rather than being defined in law. Fronting is neither inherently good nor bad. Bermuda, for example, is a jurisdiction where many big industrial or commercial multinational firms have set up a captive insurer. These captives underwrite insurance risks located cross-border; at times, the captive will use fronting arrangements due to local regulations requiring certain risks to be placed with the local carrier. Fronting within the captive business is not uncommon. As supervisors, the focus should be on scrutinising the reinsurance contract to understand the context and motive behind fronting in relation to the entities' risk and capital management strategy, instead of labelling the process itself. Statutory provisions or practices vary across jurisdictions. Some countries prohibit fronting altogether, while others set limits on how much cession can be passed on to the reinsurer. Nevertheless, the most fundamental practice is to understand the contract itself so ensure that it is validly transferring risk and that it has a genuine purpose in the risk management of the ceding as well as assuming party.



How can regulators determine whether the reinsurance treaty contract limit is adequate and if the 'right' contract has been chosen?

It is up to the insurer to determine their own risk appetite and tolerance. According to what the limits and tolerances of the firm are, there will be a set amount of insurance risk that will be retained and a set amount that will be ceded. There would not be a fixed absolute amount to be ceded, and regulators should be discouraged from setting an absolute amount as it could create moral hazard. Rather, it is up to

firms to develop their own risk management strategy, which the supervisor can then inspect and determine if the risk tolerance and limits that appear in the strategy are reflected in the contract or not. Some may want to keep a higher limit and some insurers may want to opt for lower limits. Supervisors should not dictate a right or wrong level, but determine whether the retention and limits are consistent with the strategy and the objectives that the firms have set for themselves. If there is doubt, then the doubts should be clarified and supervisors should challenge senior officers and management about the inconsistencies identified.

? **What are the main clauses of a reinsurance contract to be negotiated?**

This depends on the party involved. For a contractor, this would entail the structure of the contract, the reinsurance terms and their alignment with the conditions of the underlying risk. It is important that the quality of the relationship of trust with the reinsurer is analysed. The start date and coverage period are also taken into account to avoid gaps in coverage. As a jurist, trigger clauses, exclusions and exit clauses are crucial and often not negotiated under pretexts of low probability. However, the clauses of confidentiality, alternative dispute resolution, revision and the law applicable to the contract should also be considered. As a controller, solvency clauses and the prudent valuation of provisions are important considerations for the financial health of a business. Rules on sanctions and the scope of the contract should also be taken into account. As an actuary, the terms of charging (capacity expansion, per year or per event) and reserves (historical data available and expected loss) are a decisive factor for an adequate transfer of risk. The accounting and payment procedures (currency, periodicity, expenses, etc.) are crucial, mainly with new partners for the optimisation of liquidity management. The reinsurer will be interested in the possibility of obtaining information on the risk (history, reporting of claims amounts, possibility to intervene and audit the company). It is important to keep in mind that principles such as good faith and fortune tracking clauses will also govern the contract.

? **Given the international nature of reinsurance, do supervisory authorities sign agreements to allow for the exchange of information?**

Supervisors are required to exchange information to optimise their regulation, obtain a global view of reinsurance entities and avoid heavy and duplicate controls. In this sense, the supervisor can enter cooperation agreements both on the banking and insurance sides. The important elements in the drafting of these Memoranda of Understanding are: 1) The confidentiality of information transmitted between supervisors, in particular penalties for breaches of confidentiality (relating to both agents and retired employees); 2) The elements exchanged (amounts of provisions, level of solvency, possible sanction or measures taken) and regular information; 3) The possibility of auditing jointly and the detailed process of information exchange; and 4) The concept of “prior consent”: no information is transmitted to a person outside the agreement without the prior consent of the other supervisory authority. In order to establish such an agreement with another supervisory authority, it is necessary to ensure that processes are in place to ensure confidentiality within the authority. At the regional (e.g. European Union) and international (IAIS) levels, multilateral agreements are also concluded.

? **How could an insurer choose reinsurance?**

The first question that the insurer must ask is what is the risk that they want to reduce. Once defined, their risk preferences and appetite make it possible to identify lines of activity and types of risk that they do not wish to retain. They will have to consider the types of risk they wish to transfer (frequency, peak), the financial impact of such a decision, and how this choice can fit into its underwriting policies, risk management and investment policies. It is thus important that the insurer is aware of the risk before considering what an appropriate price for coverage is.

? **What is the difference in regulatory treatment of two reinsurers from different jurisdictions?**

The contract approach in the reinsurance sector is generally very standardised around the world. Reinsurance is sometimes considered as a type of insurance and in other cases, such as is in the case of France, as a specific sector. The supervisor will have to take into account the entirety of the supervisory regime applied to reinsurers since they represent a substantial counterpart for the insurer. The financial stability of many institutions is promoted through this risk reduction mechanism. However, if a country does not carry out a similar control or a sufficiently prudent assessment of the reinsurer's risk and its solvency, it cannot be certain from the outset that the reinsurer is not a risky counterparty. The insurer will then seek to obtain reliable information on the solvency of the reinsurer with regard to the consequences it will have on the financial strength of the ceding company. In the Solvency II regulatory framework, mechanisms for recognising equivalence (Articles 172 for reinsurance contracts, 227 for group solvency calculation and 260 for group supervision) at the European level are an example of taking into account what can be carried from one regime to another with regard to an overall equivalent level of protection of the insured. Different tools such as partial reinsurance coverage, increased counterparty risk or taking into account collateral requirements will also allow the controller to adjust its judgment.

Access to Insurance Initiative
Hosted by GIZ Sector Project Financial Systems
Approaches to Insurance
Deutsche Gesellschaft für Internationale
Zusammenarbeit (GIZ) GmbH
Dag-Hammarskjöld-Weg 1-5
65760 Eschborn, Germany
Telephone: +49 61 96 79-1362
Fax: +49 61 96 79-80 1362
E-mail: secretariat@a2ii.org
Internet: www.a2ii.org

The Initiative is
a partnership
between:



Hosted by:

