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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

SUPERVISORY STANDARD ON THE EVALUATION OF THE REINSURANCE COVER OF PRIMARY INSURERS AND THE SECURITY OF THEIR REINSURERS

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Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

This standard provides guidance to supervisors in assessing how insurers manage their reinsurance arrangements. It discusses the policies and procedures that companies should have in place and supervisory approaches for evaluating the adequacy of each company's reinsurance cover.

The IAIS recognises that currently there are significant differences in supervisory approaches taken by member jurisdictions with respect to reinsurance. For example, reinsurers in some jurisdictions are directly supervised; other jurisdictions rely on rating agencies in assessing the security of a reinsurer. Some supervisors maintain a register of those reinsurers authorised to underwrite reinsurance in their jurisdiction, while others evaluate reinsurers actually writing business in their jurisdiction. Some jurisdictions require reinsurers to post collateral, covering the likely liabilities (or liabilities plus a margin) of the reinsurer, with the ceding companies

This standard acknowledges the differing practices but does not purport to favour one regime over another.

In addition, in recent years reinsurance has evolved with the introduction of many new products. These are commonly known as alternative risk transfer (ART) products. The IAIS intends to issue a separate paper on this subject, however, it believes that much of the guidance provided in this standard will also apply in the case of ART products.

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1. Introduction

1. Insurance companies assume risk on behalf of policyholders. They mitigate these risks by acquiring insurance with reinsurers. Through the use of reinsurance, an insurer can reduce risk, stabilise its solvency, use available capital more efficiently and expand underwriting capacity. Reinsurance helps an insurer obtain a desired, prudent risk profile.[1] However,

[1] The risk profile of a financial undertaking reflects the relation between the risks run by the financial undertaking and its financial strength.

irrespective of the reinsurance obtained, the primary insurer normally remains contractually responsible for paying the full claim amounts to policyholders.

2. Reinsurance may be provided by pure (or professional) reinsurers or by primary insurers also authorised to write reinsurance.

2. Types of reinsurance arrangements

Traditional

3. Most risk assumed by reinsurers is based on traditional contracts, which are normally either “treaty” or “facultative”. Under treaty contracts, the reinsurer automatically participates in certain sections or portfolios of the insurer’s business (treaty contracts are also referred to as automatic reinsurance or automatic capacity). Facultative contracts allow the reinsurer to participate on an individual, risk-by-risk basis.

4. Contracts may be proportional or non-proportional. Proportional reinsurance is a form of reinsurance in which the premiums and claims of the insurer are shared proportionally by the insurer and the reinsurer. In non-proportional reinsurance an insurer pays a risk premium to a reinsurer and the reinsurer assumes a share of the insurer’s obligations in excess of a certain amount which could be limited by another, larger, amount. Thus the reinsurance cover can be built up in layers. Typically, for non-life insurance, reinsurance contracts last one year and cover specified lines of business. Life reinsurance contracts are usually indefinite and contain a termination provision for new business only.

ART

5. Insurance risk may be transferred to reinsurers and other counterparties by using ART techniques, such as financial reinsurance and securitisation. Securitisations commonly utilise either a “protected cell” or a “Special Purpose Vehicle” to effectuate the transfer of insurance risk from the ceding company. To date, most securitisations have been fully funded, which means that the proceeds of the securitisation fully cover the risk securitised.

6. Similar cover can also be provided by other types of ART contracts some of which are provided by reinsurers. ART cover may be obtained on a multi-line, multi-year, and holistic basis, and can be retrospective or prospective. Contracts can provide protection against different operational and financial risks. For example, some ART contracts, like traditional reinsurance contracts, protect a primary insurer’s solvency.

7. In some ART contracts the transfer of insurance risk is secondary to the transfer of financial risks, such as credit, liquidity or market risk. While called financial “reinsurance”, most jurisdictions regard that such contracts provide valid reinsurance cover only to the extent they imply a real transfer of insurance risk. However, such contracts do play a part in the company’s risk management; but they should not be considered to mitigate insurance risk unless there is a genuine transfer of this risk. In some cases the only intention of the cedent is to

obtain a favourable impact for financial reporting, but ART contracts should not be used in order to distort true and fair reporting.

3. Reinsurance strategy and management procedures

Board of Directors

8. Every insurer should have a reinsurance strategy, approved by the company's Board of Directors, that is appropriate to the company's overall risk profile. The reinsurance strategy will be part of the company's overall underwriting strategy. The Board should review the reinsurance strategy annually (in the case of life insurers, possibly less frequently). In addition, the reinsurance strategy should be reviewed when there have been changes in the company's circumstances, its underwriting strategy, or the status of its reinsurers.

9. The reinsurance strategy should define and document the insurer's strategy for reinsurance management, identifying the procedures for:

- the reinsurance to be purchased;
- how reinsurers will be selected, including how to assess their security;
- what collateral, if any, is required at any given time; and
- how the reinsurance programme will be monitored (i.e. the reporting and internal control systems).

10. The Board should ensure that all legal and regulatory requirements are met. It should set limits on:

- the net risk to be retained; and
- the maximum foreseeable amount of reinsurance protection to be obtained from the approved reinsurers.

Senior management

11. Senior management should document clear policies and procedures for implementing the reinsurance strategy set by the Board of Directors. This includes:

- setting underwriting guidelines that specify the types of insurance to be underwritten, policy terms and conditions, and aggregate exposure by type of business;
- establishing limits on the amount and type of insurance that will be automatically covered by reinsurance (e.g. treaty reinsurance); and
- establishing criteria for acquiring facultative reinsurance cover.

In order to avoid uncovered risks, the terms and conditions of the reinsurance cover should be compatible with those of the underlying business.

12. Limits on the net risk to be retained should be set either per line of business or for the whole account. The insurer may also set limits per risk or per event (or a combination thereof).

The limits must be based upon an evaluation of its risk profile and the cost of the reinsurance. In particular, the insurer should have adequate capital to support the risk retained. Some insurers may use the results of dynamic financial analysis techniques[2] (using the reinsurance cover as one of the variables) as input into these operating decisions.

13. The insurer should maintain an up-to-date list of reinsurers[3] that it has approved. For each approved reinsurer the appropriate level of exposure should be specified. To do this, the insurer should evaluate the ability and willingness of the reinsurer to fulfil its contractual obligations as they fall due (i.e. its security). Such assessment is required whether collateral is posted or not. The assessment should take into account the effects of any collateral the reinsurer has posted in favour of other insurers. The insurer's credit guidelines should describe the system for controlling exposures to each reinsurer.

14. To improve the security of the overall reinsurance cover, insurers may choose to use a number of different reinsurers. Diversification may also be achieved by using certain ART techniques.

15. Generally speaking, if no requirements are placed on the choice of reinsurer or on the posting of collateral, the fewer the number of reinsurers used, the more an insurer should pay importance to the security of its reinsurers. If a company takes advice on the strength and security of a reinsurer, then it should satisfy itself that the advice given is sound. Similarly, if reinsurance cover is acquired through an intermediary, the company should evaluate the operational risk associated with the transaction.

16. Senior management should ensure that the management information system in place meets all Board requirements with respect to reporting frequency and level of detail. In addition, there should be adequate systems of internal control to ensure that all underwriting is carried out in accordance with company policy and that the planned reinsurance cover is in place. The underwriting control systems should be able to identify and report on a timely basis where underwriters infringe authorised limits, breach company guidelines or otherwise assume risks exceeding the ability of the company's capital base and reinsurance cover to service.

Internal control

17. There should be internal control systems in place to ensure that claims are reported to the appropriate reinsurer and that reinsurance claims payments are being promptly collected. The underwriting control may include an actuarial assessment of the risk and whether it has been transferred as presumed. This assessment may also include a review of the reinsurance

[2] Dynamic financial analysis evaluates an expanded universe of possible scenarios through computer modelling, as opposed to the traditional approach that involves interpreting historical trends and ratios (i.e. static). With the power of a computer, a user can simulate multiple scenarios based on specified set of constants and probabilistic estimates for key variables, such as reinsurance pricing and coverages, premium volume, pricing adequacy, underwriting profit/loss, investment returns, reserve adequacy, catastrophes and cost of capital. The resulting distribution of these variables can then be used to influence management's operating decisions.

[3] Cf. The OECD Recommendation of the Council on Assessment of Reinsurance Companies, C(98)40/FINAL.

contracts. The Board of Directors should receive regular and comprehensive reports on the effectiveness and performance of the claims system and the reinsurance protection. Companies' internal control systems should be subject to regular audit examination.

4. Supervisory regime for insurance business (reinsurance cover and security)

18. The supervisor should verify that the Board of Directors has established an overall strategy framework – addressing, *inter alia*, underwriting and reinsurance. To evaluate reinsurance cover, reinsurer security and collateral that may be posted, the supervisor should have, or have access to, sufficient expertise. Usually the supervisor takes a risk-based approach – ensuring that the company has appropriate policies, systems and procedures in place and focusing more detailed examination work on areas posing specific and significant concern.

19. Before granting a license, the supervisor must be satisfied with the company's planned risk management and reinsurance strategies, and accompanying policies. When examining the business plan of an insurance company, the supervisor must evaluate if the proposed reinsurance covers maximum foreseeable loss. In the business plan the company must describe how, and to what extent, future policies will be reinsured. The supervisor should evaluate whether reinsurers offer sufficient security. In most cases, this evaluation could be enhanced or improved by the exchange of information between supervisors.

20. Companies should maintain adequate reinsurance cover at all times. Supervisors should regularly evaluate the reinsurance cover and risk profile of the insurers. While many reinsurance treaties operate on an annual basis, some treaties especially for life business and some ART contracts can operate for many years. In such cases, supervisors will wish to be assured that the reinsurer offer sufficient security to act as a long-term counterparty

21. Supervisors must receive sufficient and relevant information on the reinsurers used and the reinsurance cover arranged. Relevant information may include:

- reports describing the reinsurance cover, reinsurance programmes or treaties; and
- financial statements, including the result of reinsurance, any amounts outstanding from reinsurers and the effect of ART techniques, including financial reinsurance.

Supervisors should be able to review the quality and validity of information submitted.

22. The information may be submitted in the form of:

- copies of contracts and amendments;
- copies of slips and cover notes;
- supervisory returns; or
- written contract descriptions and summaries.

Information obtained by supervisors in the process of assessing a company's reinsurance cover should be kept confidential.

23. Using this information and other relevant information received during on-site inspection, the supervisor should evaluate:

- the prudence of the company risk profile including an evaluation of any risk concentration, i.e. an aggregate exposure with the potential to produce losses large enough to threaten the insurer's financial health or its ability to maintain core operations;
- compliance with the company's reinsurance strategy;
- the sufficiency of the reinsurance cover and the insurance company's financial strength, in particular under extreme, but plausible loss scenarios;
- the sufficiency of the reinsurance security, taking into consideration a wide range of factors including financial strength, whether reinsurers are properly supervised and whether or not collateral is posted, cf. para. 13 above; and
- the appropriateness of any ART techniques, such as securitisation, used.

24. In making these evaluations the supervisor should consider the overall risk profile of the insurer. The supervisor should be aware of the security and adequacy of the reinsurance or ART coverage for long-tail business (where claims development is slow) and the top layers of catastrophe programmes (where amounts involved can be large).

25. The choice of reinsurance cover is a business decision made by management within the overall reinsurance strategy of the insurer. However, where insufficient or inappropriate reinsurance cover affects the company's ability to pay policyholders' claims, the supervisor must enter into discussions with the management of the company. The supervisor should have the legal and administrative power necessary to take remedial action in *inter alia* cases of insufficient reinsurance cover, insufficient reinsurer security, non-compliance with company reinsurance strategy, insufficient collateral (where applicable) or use of non-admitted (i.e. non-authorised) reinsurers.

26. Remedial action should include the power to disallow credit in whole or in part for reinsurance when calculating solvency requirements or technical provisions on a net basis or when determining the coverage of gross technical provisions by reinsurance recoverables. As well, the supervisor should be able to require the insurer to:

- obtain additional reinsurance cover;
- provide additional capital;
- establish additional technical provisions; and
- have additional collateral posted, if applicable.

Such action should be taken according to transparent principles and be based on objective criteria.

27. The supervisor may choose to provide insurers with comparative risk information, for example in the form of benchmarking data or comparisons. This information allows management to evaluate the quality of the reinsurance cover in comparison with market standards and to decide if its risk profile is acceptable and prudent.