Guidance Paper No.

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

DRAFT GUIDANCE PAPER ON FINITE REINSURANCE

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[This document was prepared by the Reinsurance and Other Forms of Risk Transfer Subcommittee in consultation with members and observers.]

Contents

1. Introduction

1. The paper contains guidance regarding the supervision of finite reinsurance that is supported by a number of existing IAIS principles on insurance supervision. The paper outlines the background on the development of finite reinsurance and the uses of this product by insurers. The paper then turns to the issues in finite reinsurance that supervisors should be aware of and identifies the supervisory approaches taken to address these issues. There are detailed examples and further discussion on these topics in the appendices

2. From a supervisory perspective, the issues around finite reinsurance are important because of the credit or allowance for reinsurance that is permitted within a jurisdiction's solvency regime. This credit or allowance is addressed by Principle 11, - Allowance for Reinsurance in the *IAIS Principles on capital adequacy and solvency* (January 2002) that set out the principles that underlie solvency regimes for insurers throughout the world. Furthermore, the supervision of reinsurance (both by direct writers and reinsurers) is addressed in the *IAIS Insurance Core Principles* adopted in October 2003, including:

- Principle 6: Licensing

- Principle 11: Market Analysis
- Principle 12: Reporting to supervisors and off-site monitoring
- Principle 13: On-Site Inspection
- Principle 17: Group-wide Supervision
- Principle 19: Insurance Activity
- Principle 20: Liabilities
- Principle 23: Capital Adequacy and Solvency
- Principle 25: Consumer Protection

In addition, the IAIS has approved the following principles and standard papers concerning reinsurance:

- *Principles No. 6. Principles on Minimum Requirements for Supervision of Reinsurers* (Approved October 2002)
- *Supervisory Standard No.7. Supervisory Standard on the Evaluation of the Reinsurance Cover* (Approved January 2002)
- *Supervisory Standard No 8: Standard on Supervision of Reinsurers* (Approved October 2003)
- *Supervisory Standard No. 9: Disclosures concerning technical performance and risks for non-life insurers and reinsurers* (Approved October 2004)

3. Reinsurance is an important tool in the management of risk globally within the insurance industry. The range of products available has not changed dramatically in the last 25-30 years (apart from securitisation and alternative risk transfer) except for the addition of clauses which restrict/limit/quantify the amount of risk that is transferred. Unfortunately the intention of the contract is not always evident in the contract wording itself and the balance between risk transfer and the resultant effect on capital and reported accounts may get distorted. While the insurer's role is to manage its risks, the supervisor's role is to ensure that the accounting and capital position of the insurer is not compromised.

4. Finite reinsurance (also known in some jurisdictions as financial reinsurance, structured reinsurance, non-traditional reinsurance, loss mitigation reinsurance) is a generic term that, for purposes of this paper, will be used to describe an entire spectrum of reinsurance arrangements that share limited risk for a limited amount of premium. Although there is no accepted global definition of "finite reinsurance," a typical transaction may include, but not be limited to provisions for aggregating risk, for aggregating limits of liability, for aligning the interests of the insurer and reinsurer, and for explicitly recognising the time value of money.[1] A detailed review of the entire contract and any side agreements is necessary to determine if contracts containing such clauses do transfer risk and are in fact reinsurance contracts when considered in their totality.

5. The European Union *Directive on Reinsurance* has the following definition:

"Finite reinsurance means reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract, for a limited but significant amount, together with at least one of the following two features:

(i) explicit and material consideration of the time value of money

[1] Please refer to the IAIS Glossary for a complete definition of existing IAIS terms used in this paper, new terms are referenced in Appendix III and will be added to the IAIS Glossary in due course.

(ii) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer.

6. The American Institute of Certified Public Accountants (AICPA), as provided in a Financial Accounting Standards Board (FASB) Alert from April 2005, "*Accounting by Non-insurance Enterprises for Property and Casualty Insurance Arrangements That Limit Risk*") defines finite reinsurance in the following manner:

"Finite reinsurance contracts are contracts that transfer a clearly defined and restricted amount of insurance risk from the cedant to the reinsurance company, and the cedant retains a substantial portion of the related risks under most scenarios. Nevertheless, under certain finite contracts there may be a reasonable possibility that the reinsurance company will incur a loss on the contract."

7. Usually, one of the following characteristics will be present within finite reinsurance contracts although some of them may be present in traditional reinsurance as well:

- risk transfer and risk financing are combined and the time horizon of money is emphasised in the contract
- assumption of limited risk by the reinsurer (aggregate limit of liability, blended cover)
- transfer of volatility for multiple lines of business for multiple years of account
- inclusion of future investment income in price of contract (recognition of time value of money with funds withheld)
- potential profit sharing between parties
- pricing determined by ceding entities' results and not reinsurance pricing cycle

8. There are some legitimate business purposes for finite reinsurance. Insurers often use these arrangements to protect themselves from such risks as interest rate risk and timing risk. These finite reinsurance arrangements will typically cap the reinsurer's ultimate liability, allowing the primary focus to be on the financing risk rather than insurance underwriting risk.

9. There are a number of desired effects of finite reinsurance, one of which is to insulate the primary insurer from the peaks and troughs of volatile underwriting results during the period of the contract. For this reason, timing risk is at least as important an element of finite reinsurance as underwriting risk. The needs of each primary insurer will be slightly different, and this has given rise to a wide variety of finite reinsurance products. There are two broad categories of finite reinsurance, retrospective and prospective covers. The former will provide protection against a more rapid deterioration of old-year reserves than expected, the latter serves to smooth current and future premiums and claims patterns.

10. Traditional reinsurers have generally used the concept of the "bank" when determining their relationship with a ceding insurer over the years. The "bank" being the net of the premium received less losses paid over the period of the relationship. Over the long term, the traditional reinsurer would expect the ceding insurer to fund its own losses and provide an appropriate risk adjusted return on the reinsurer's capital, which the ceding insurer is effectively using. Reinsurance was regarded as a relationship that in order to survive both parties must over time make money, although there could obviously be instances within that period that either party could bear a significant loss. This is opposed to regarding a reinsurance contract as a very discrete short-term transaction, unrelated and unaffected by any prior mutual experience. This is categorically different from deceptive arrangements that are designed to misrepresent the true financial position of the insurer.

11. Finite reinsurance transactions have received heightened scrutiny from supervisors, media and industry participants. The majority of this interest has been concentrated on a few market participants who have restated prior year earnings to take out the impact of using these agreements. These participants have been scrutinised because of what is believed to be deliberate inappropriate use of finite reinsurance.

12. The IAIS has been actively addressing the issues surrounding finite reinsurance and through this paper is providing supervisory guidance concerning the various types of finite reinsurance arrangements, potential disclosure requirements, analysis of current regulatory treatment, consideration of various accounting guidance in jurisdictions, risk transfer requirements and additional supervisory requirements for material reinsurance transactions. This paper is not intended to prescribe public accounting requirements, although the IAIS is actively participating in the IASB Phase II Insurance Contracts project.

13. Before going into the details of finite reinsurance, it is perhaps useful to describe the purposes of traditional reinsurance and detail some of the history behind finite reinsurance.

2. Functions of reinsurance

14. The general function of reinsurance is to reduce volatility, and thus the uncertainty of the insurer's pricing risks, by pooling. This is done to increase the probability of survival of the insurer over a given time. In purchasing reinsurance, insurers seek to improve their financial performance and security. There are five primary functions of reinsurance:

Capacity

15. Reinsurance provides flexibility for insurers in the size and types of risk and the volume of business they can safely underwrite. It will allow the insurer to enter into new business, expand or withdraw from a class or line of business and/or geographical area within a short period.

Expertise

16. Reinsurers supply assistance to insurers in specialised areas where the insurer may have little or no experience. The qualified members of staff of a professional reinsurer will offer services regarding the production process to new insurers in particular and/or to insurers taking up new business lines or expanding their area of operations to foreign countries.

Stability

17. Properly structured reinsurance programs will assist insurers by limiting wide fluctuations in underwriting results. As a consequence, the limited risk spread will allow the insurer to reduce the required amount of its own funds, and hence the solvency margin. The aspect of security funds is directly related to the increasing importance of the shareholder value by the return on investment.

Financial

18. Reinsurance assists in financing insurance operations as an alternative to increasing an insurer's capitalisation. In this regard, the insurer may have the asset backing of many large reinsurers.

Protection

19. Associated with stability, reinsurance provides for protection against the potential large accumulations that can result from catastrophic events; for example, earthquakes, bush-fires and cyclones.

20. Concerning all of the above listed functions of reinsurance, acceptable finite reinsurance arrangements should fulfil some of these functions; however unacceptable arrangements may not fulfil any of these functions.

3. History of finite reinsurance

21. Finite reinsurance is thought to have started in London during the 1960's. The contracts -- then called "rollover" coverage -- were first used to help Names in Lloyd's syndicates avoid high tax rates by rolling over premiums from year to year. From rollover coverage came "time and distance" policies, again purchased by Lloyd's syndicates to get around restrictions on discounting loss reserves.

22. In the early eighties, when interest rates were historically high, so-called "financial reinsurance" began to flourish. These transactions typically looked more like a loan where the ceding insurer received funds from the reinsurer and then agreed to pay a specific amount over a specific amount of time, which would virtually guarantee that the reinsurer would make a profit over the term of the contract.

23. The hard market of the mid-eighties, where limited capacity and increasing prices dominated the reinsurance industry, alternative risk covers that provided stable protection were in demand. In particular, the increase of liability exposures in the mid-80's greatly enhanced the demand for these products as the duration of losses were greater for liability (casualty) covers than for typical property exposures. Many companies sought these products in order to enhance financial ratios as well as remove a substantial part of the long-tail liabilities that were quickly growing on their balance sheets. Pure financial reinsurance transactions of the 1980's focused more on the timing risk of claims that may be paid over a period of several years or even decades.

24. Due to the cyclical nature of reinsurance markets, these "financial" solutions offered more stable and reliable products than those typically offered only on an annual basis that had to be renegotiated yearly. Many of the transactions that have received scrutiny recently were developed during the soft-market conditions of 1997-2001. Reinsurers had an abundance of capacity that was being underutilised and ceding insurers were enduring intense market competition where under-pricing risks was the norm. This provided an opportunity for ceding insurers to purchase finite reinsurance, which would provide relatively cheap protection against future adverse loss development, or would provide cover against prior losses being under-reserved. It also would provide for the costs of settlement associated with casualty claims.

25. There are also so-called "blended covers" in which a traditional reinsurance cover and a finite cover are blended together within the same contract, to ensure that significant risk shifting is clearly present in the contract. By its nature, financial reinsurance tends to shift

the underwriting approach from classical risk pooling concepts to individual actuarial assessment of the particular risk and related cash flows. Some financial reinsurance has been structured through a set of linked contracts. This has sometimes been done to deceive auditors and supervisors, and is discussed more fully below.

4. Uses of finite reinsurance

26. There are a number of uses of finite reinsurance transactions with various purposes:

- to effect discounting of insurance liabilities in jurisdictions where discounting is not permitted and/or equalisation reserves are not used
- to capitalise on a company's above average underwriting loss experience when traditional reinsurance coverage is too expensive
- to increase underwriting capacity or take larger retention in favourable underwriting environments
- to have the ability to purchase reinsurance protection when an insurer's historic underwriting loss experience is much worse than average, making "reasonably" priced reinsurance unavailable
- to provide reinsurance cover when an insurer wants to exit lines of business
- to protect against potential adverse loss development, including the acquisition of new blocks of business
- to provide surplus relief or capital enhancement in jurisdictions where acquisition expenses are non-deferrable
- to use finite reinsurance contracts inappropriately to manipulate the financial position and present better results or enhance the balance sheet for a number of reasons such as to avoid a ratings downgrade, to avoid non-compliance with creditor lending conditions, or to avoid or delay supervisory intervention
- to smooth reported earnings and reduce volatility in the financial position of the insurer
- to transfer insurer's profits to another jurisdiction or an affiliate (e.g., potentially minimising taxes or engaging in regulatory arbitrage).

There are examples of these various uses of finite reinsurance in Appendix IV.

5. Issues in finite reinsurance

27. The primary issues in finite reinsurance revolve around whether there is adequate risk transfer, the accounting and disclosure and the credit allowed in the solvency regime for reinsurance. Misuse of financial reinsurance has resulted in misrepresentation of the financial position to supervisors, policyholders, investors, creditors and other stakeholders, corporate governance and management accountability.

a. Risk Transfer

28. Risk transfer is a complicated issue. There are a variety of risk transfer agreements ranging from a purely financial arrangement, in which no underwriting or timing risk is transferred to the reinsurer, to a quota share arrangement in which no limitations on risk transfer other than those inherent in the original policies and the reinsurance agreement are applicable to the obligations of the reinsurer.

29. While examples of the "pure financial arrangements" are still to be found in some financial centres, changes made over 10 years ago in accounting rules applicable to

companies using United States generally accepted accounting principles (GAAP) and, more recently, international accounting standards have reduced the incidence of "financial reinsurance" transactions, which transfer no significant amount of risk to the reinsurer.

30. The key issue in finite reinsurance is whether the arrangement satisfies the conditions for insurance risk transfer, which includes two components: underwriting risk and timing risk.

- Underwriting risk is the possibility that losses and expenses recoverable by the cedant from the reinsurer will exceed the consideration received by the reinsurer, thus resulting in an underwriting loss to the reinsurer
- Timing risk is the risk arising from uncertainties about the timing of the receipt and payments of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract. The reinsurer could have a reduction in the expected investment income as a result of accelerated loss payments.

31. Provisions in the reinsurance arrangement that have the effect of deferring the reinsurer's obligation to reimburse covered losses may cause the transaction to fail the timing risk requirement, preventing the application of a credit for reinsurance. Examples of these provisions include "floating" retentions, "last dollar paid" arrangements and multiple year retentions, dual triggers, reinstatement premiums and retrospectively rated premiums.

32. It should be determined whether any separate or side agreements or understandings exist between the reinsurance agreement parties that would serve to reduce, offset or eliminate the reinsurer's obligations. In any such instance, a credit for reinsurance should not be allowed under the reinsurance agreement. Some supervisors have added interrogatories in the annual statutory returns filed by insurers' to determine whether these types of situations exist.

Modelling to determine risk transfer

33. Insurers should undertake an analysis of risk transfer, when necessary, prior to the inception of reinsurance contracts, which should be available to supervisors. Modelling of insurance assets and liabilities, for determining risk transfer in reinsurance arrangements such as finite reinsurance, usually involves cash flow projections of various scenarios. More complex reinsurance arrangements, with greater exposures in the tails of the outcome distributions have driven a demand for greater use of such modelling.

b. Accounting

34. The accounting for a reinsurance arrangement should aim for a true and fair presentation of the nature of the transaction. If a finite reinsurance arrangement contains acceptable risk transfer, it is accounted for as reinsurance, as there is a credit recognised for the risk transfer via a reduction in the capital requirements in the capital adequacy calculation.

35. However if the finite reinsurance arrangement does not meet the criteria for risk transfer, it is accounted for as a deposit or financing transaction. The amounts paid to the reinsurer would be reflected as a loan recoverable on the insurer's balance sheet and the amounts received from the reinsurer would be reflected as a loan payable on the balance sheet. Under certain conditions, amounts received from the reinsurer can reduce the loan recoverable (such as if there is a right to offset).

36. In determining how much credit should be allowed for reinsurance, it is necessary to examine closely the provisions of the reinsurance agreement. Limitations on the maximum

amount recoverable from the reinsurer during any defined period, (e.g., contract year), should serve to limit the amount by which gross losses may be reduced on the cedant's financial statements. Such limitations may take the form of loss ratio caps, per occurrence loss limits, loss "corridors" (a band of loss which must be assumed net by the company before the reinsurer becomes responsible for any further losses under the agreement). The amount of credit allowed should be directly related to the amount of loss recoverable, (i.e., for a "finite" amount of risk transferred to the reinsurer, no more than an equivalent "finite" amount of statement credit should be allowed).

37. An analysis of contract provisions is necessary to determine whether, and to what extent, reinsurance accounting treatment should be allowed. Even if the provisions in the reinsurance arrangement appear to satisfy risk transfer requirements, it is often necessary to perform an analysis of discounted cash flows, using reasonable assumptions as to the ultimate amount of recoverable incurred losses, loss payment patterns and interest rates, to determine whether there is a reasonable likelihood of a significant underwriting loss to the reinsurer. If this cannot be demonstrated, the transaction should be accounted for as a deposit or loan, with no credit given for reinsurance.

38. Supervisors may want to consider whether or not a finite reinsurance transaction be "bifurcated," or "unbundled" so that even where a product as a whole sufficiently transfers insurance risk for insurance accounting purposes, a portion of the transaction that is perceived as not transferring sufficient insurance risk would be disqualified from receiving credit as reinsurance. Such an approach would be implemented regardless of how the various risk elements of the transaction are tied together and whether separate products for these different risks would even be considered viable options in the insurance marketplace.

IFRS 4 International Accounting Standards

39. The International Accounting Standards Board has issued IFRS 4 Insurance Contracts, which outlines specific financial reporting requirements for ceded reinsurance. This focuses on 2 key areas:

- separation of insurance contracts and financial contracts, and separation of financial components and options embedded in insurance contracts; and
- recognition and measurement

40. IFRS 4 introduces a definition of insurance contracts based on the concepts of insured event and significant insurance risk transfer. This definition applies to insurance contracts issued and reinsurance contracts held. IFRS 4 will require some contracts, which have investment and insurance features to be unbundled and accounted for separately. However, as a result of numerous exclusions, this will not be as onerous as originally feared and it is largely only finite reinsurance contracts that will require unbundling in Phase 1. Examples of contracts that could be affected in phase 1 include certain multi-year reinsurance contracts linked to an experience account. This could be extended further in Phase 2.

41. IFRS 4 requires the unbundling and separate measurement of the deposit component bundled in an insurance contract, only if the deposit can be reliably measured and the entity's accounting policies do not recognise all rights and obligations arising from it. This requirement is limited in practice to situations where the insurer or reinsurer has established experience accounts that refund the policyholder or cedant but has not appropriately reflected this obligation in its balance sheet. IFRS 4 also allows the unbundling of deposit components on a voluntary basis if the deposit component can be reliably measured.

42. Embedded derivatives that also meet the definition of insurance contract under IFRS are not required to be separated and fair valued. Options to surrender the insurance contract are exempted from separation and fair value measurement if the option price is a fixed amount or a fixed amount plus interest.

c. Disclosure to supervisors

43. The gross of reinsurance reporting of insurance liabilities gives explicit disclosure of counterparty risk by presenting reinsurance recoverables on the insurer's balance sheet. Jurisdictions that require reporting of policy liabilities net of reinsurance may require separate disclosure of counterparty risk or reinsurance recoverables in the reporting.

44. Supervisors are enhancing their information gathering on finite reinsurance arrangements by requiring explicit reporting of amounts and details on finite reinsurance transactions in the annual supervisory reporting returns. However many of these finite reinsurance arrangements are structured as a series of transactions on a cross-border basis with multiple parties (some may be related) which makes detection and risk assessment difficult for local supervisors. They may involve deceptive behaviour by insurance and other professionals. Effective supervision is enhanced through international cooperation among supervisors and sharing of information about the fitness & propriety of the individuals involved in putting the arrangements together.

d. Other Issues

45. There are a number of additional risks associated with reinsurance transactions other than underwriting risk and timing risk which also exist in finite reinsurance, including but not limited to:

- credit risk – risk of counterparty's inability or unwillingness to meet its contractual obligations (e.g. reinsurer failure)
- balance sheet/market risk – market risk is the risk of changes in market rates or prices (interest rates or foreign exchange rates). Balance Sheet risk is the risk that liabilities and assets are not properly recorded.
- operational risk – risk of loss from failed internal controls or processes, people, systems or external events.
- insurance risk – related to fluctuation of losses/experience and underwriting risk management risk which relates to the company's underwriting procedures.
- liquidity risk – insurer's ability to obtain necessary funds to meet the on and off balance sheet financial obligations.
- legal/regulatory risk - risk of non-compliance with laws, regulations, etc.
- strategic – the risk of not being able to implement appropriate business plans and strategies.
- organisational risk – risk arising from an organisations' associations with others.
- market conduct risk – risk arising from how an insurer conducts itself.

6. Supervisory approaches to finite reinsurance

46. The IAIS Reinsurance and Other Forms of Risk Transfer Subcommittee has received responses from a variety of jurisdictions to a questionnaire concerning supervision of finite reinsurance. From the responses, it appears that there are a range of approaches that supervisors can take in order to ensure that these transactions are being disclosed and accounted for properly. This range of approaches reflects the local market conditions and the general supervisory approach taken within a jurisdiction (for example, some jurisdictions take a no failures approach whereas others try to minimise losses to policyholders in the event of the insurer's insolvency). It should be noted that the supervisory approach to finite reinsurance is currently under review in many jurisdictions.

47. These supervisory approaches include, for example:

- conducting onsite inspections including review of reinsurance programmes, and questioning management on use of limited risk transfer contracts
- requiring annual attestation by senior management regarding whether risk transfer has been appropriately accounted for and side agreements are reflected in the supervisory reporting returns
- requiring explicit reporting on amounts and details on finite reinsurance transactions in the annual supervisory reporting returns
- review of actuarial reports (which include details on reinsurance) and expanding actuary's responsibility to assess the adequacy of the insurer's reinsurance system (including risk transfer, philosophy, and adequacy of documentation)
- requiring all limited risk transfer arrangements to have prior supervisory approval (may be subject to materiality limits in some jurisdictions)
- requiring all reinsurance transactions with related parties to have prior supervisory approval and demonstrate that they are at market terms and conditions
- reviewing annual reinsurance management strategy (that has been signed off by the Board of Directors) regarding the insurer's internal control environment and processes for management review of reinsurance arrangements. Such management strategy is submitted to the supervisor annually
- highlighting Board and senior management responsibilities via supervisory letters to companies regarding importance of rigorous risk management, self-assessment of risk transfer, and accurate financial statement reporting; includes the requirement for the company to report back to the supervisor annually
- conducting investigations into questionable reinsurance arrangements; investigations often include requiring additional accounting and actuarial review
- in one jurisdiction every reinsurance contract is analysed for adequate risk transfer
- in other jurisdictions, a risk- based supervisory approach is taken with regard to the review of reinsurance arrangements for insurers and reinsurers
- requiring auditors and actuaries to "whistle blow" by reporting to the supervisor where management's activities may threaten the solvency of the insurer or where potential fraudulent activities are suspected.

48. The supervisory practices and procedures seem to reflect where a jurisdiction falls along the continuum of supervisory approaches from a principles based approach to a rules based approach, or combination thereof. For example:

- a principles-based approach with emphasis on the responsibility of senior management and the Board. The preference is to ensure that senior management have properly agreed and documented policies and procedures. Supervisory risk assessments are carried out to verify that policies and procedures are properly defined and acceptable. In addition, under regulatory principles, senior management is required to disclose any matter which they believe to be of regulatory significance

- a rules-based approach where the supervisory requirements are more definitive and the supervisory procedures more detailed (such as requiring prior approval of reinsurance contracts). Under this approach, there is less reliance on management and board oversight and more reliance on independent supervisory and government testing.

49. Regardless of the supervisory approach, the main concern with these arrangements is when they are deliberately constructed as a deception or where there is intentional fraud by the company management (e.g., links between related parities or "off contract" arrangements are concealed from the insurer's stakeholders, regulators, and creditors). In this respect, they are no different from any other type of deception, which supervisors cannot necessarily prevent.

50. Many of these finite reinsurance arrangements are structured as a series of transactions on a cross-border basis with multiple parties (some may be related) or can be one complex contract, which makes detection and risk assessment difficult for local supervisors. They may involve deceptive behaviour by insurance and other professionals. Effective supervision is enhanced through international cooperation among supervisors and sharing of information about the fitness & propriety of the individuals involved in putting the arrangements together.

51. One way to give a finite reinsurance arrangement the appearance of risk transfer is to combine it in a single contract with a normal reinsurance arrangement. This is referred to as a "blended cover". When this is done, the two covers should be evaluated separately. It may be that one of them is eligible for reinsurance treatment, and the other is not.

52. The difficulty for the supervisor is in detecting that covers have been combined in this way. It is therefore important to review all reinsurance documentation (placement slips, cover notes, reinsurance agreements and any addenda thereto) as an aid to understanding the structure of the agreements and their underlying commercial reality.

53. Other deceptive arrangements often rely on breaking a finite reinsurance deal into several components. For example, for a fee that can total several million dollars, a reinsurer might create a financing vehicle that allows the insurer to move real or expected losses off its balance sheet. On its face, the finite reinsurance deal has transferred the risk to the reinsurer. However, through side agreements premiums are ceded back to the insurer, which then takes the charges or losses over multiple periods.

54. All these examples involved reinsurance contracts which, taken alone, would have passed any reasonable risk transfer test. But they were accompanied by other agreements, in a variety of forms, which reduced or negated their effect. It was only when the full set of documents was available to supervisors that they could make a proper evaluation of the risk transfer involved. It is therefore important to do more than consider individual reinsurance contracts at face value.

55. It will not always be possible to detect every deceptive arrangement, but the following are indicators to supervisors that there may be a need to dig deeper:

- disparate lines of business included within a single treaty
- contracts which do not appear commercially sensible from the standpoint of the reinsurer. (Are there side agreements which change the sense?)
- contracts placed without following the cedant's normal process and guidelines for reinsurance

- contracts placed very close to the end of the financial year and covering that year or earlier years (Is the aim to disguise a bad result for that year?)
- inconsistencies or gaps in the dating of the documentation. (Has an agreement been backdated to give the appearance that it was reached before the end of a reporting period?)

56. Cooperation between supervisors is essential, but even with co-operation it will not be possible to uncover all cases of deception. It is therefore appropriate to take strong enforcement measures against companies and individuals found to have misled regulators in this area.

57. In order to avoid uncovered risks, the terms and conditions of the reinsurance cover should be compatible with those of the underlying business. Supervisors should have the legislation that will enable criminal prosecution, when warranted. Legislation should affect those who deal in the insurance industry and knowingly, with the intent to deceive, make any false material statement or report or wilfully and materially overvalue any land, property or security:

- in connection with any financial reports or documents presented to any insurance regulatory official or agency or an agent or examiner appointed by such official or agency to examine the affairs of such person, and
- for the purpose of influencing the actions of such official or agency or such an appointed agent or examiner.

58. Even where criminal prosecution is not deemed appropriate, supervisors should not hesitate to use the regulatory tools at their disposal (e.g. fines or bans from holding positions of responsibility) against firms and individuals that engage in conduct of this kind.

59. When reviewing finite reinsurance arrangements supervisors should consider the following:

- which types of risk are actually transferred and how, and why such transfer is commercially sensible for both the cedant and the reinsurer
- whether arrangements may appear as though risk has been transferred, but in reality it has not or there has only been a superficial amount of risk transferred
- what are the types of arrangements that would normally not be allowed to be taken into account in determining the ceding insurer's solvency. For example, retroactive covers, arrangements where the cedant's maximum recovery is less than or only marginally higher than the cedant's premium, or where the reinsurer's liability evaporates in stress situations for the cedant
- understanding the substance rather than the form of the transaction is crucial, especially if it is not clear why the ceding insurer and the reinsurer would enter into the arrangement.

Please refer to Appendix VI for detailed examples of supervisory approaches by various jurisdictions.

Appendix I – Types of reinsurance

Non-life Treaty Reinsurance

60. Reinsurance treaties are usually automatic arrangements in that the company does not have to make specific cessions in order to activate reinsurance protection. Exceptions to this general rule are special acceptances, a procedure by which risks that do not qualify for coverage under the terms and conditions of the treaty may be submitted to the reinsurer for specific underwriting evaluation and determination of any additional premium charge.

61. Treaties are also usually obligatory, in that the cedant is obligated to cede all business defined by the reinsurance agreement, and the reinsurer is obligated to accept all such business, subject to the terms and conditions of the contract. Surplus treaties are sometimes non–obligatory from the company's standpoint as the company may elect not to cede a specific risk, or to cede something less than the maximum cession permitted under the contract provisions.

62. Treaty reinsurance usually applies to a broad segment of the company's overall book of business (e.g., all Workers' Compensation business, all Commercial Property business, all Accident & Health business, all Aviation business, etc.) All sorts of segregations are possible, but the idea is to group together entire lines or classes of business. As long as the business to be reinsured is reasonably homogeneous in nature or exposed to loss arising from a common cause and written in sufficient volume it can be considered for treaty reinsurance. A sufficient volume of reinsurance is necessary in order to satisfy the reinsurers' need to collect reinsurance premiums that bear a reasonable relationship to the assumed liabilities. Treaty reinsurance is considered to be the most efficient and least expensive way of arranging for such transfers.

Non-life Facultative Reinsurance

63. Facultative transactions, by their nature, are not obligatory with respect to either the cedant or the reinsurer. Facultative reinsurance involves the reinsurance of the exposures covered by a single policy, or sometimes only specific portions of a policy. The nature of the underwriting process and the kind and amount of data which are usually required by the facultative underwriter make this approach far less efficient and much more expensive to handle than treaty reinsurance.

64. Nevertheless, facultative reinsurance often plays a significant role in a company's overall reinsurance program. It is commonly used to enable the company to write risks that may be excluded under its reinsurance treaties, to generate additional capacity needed that is not fully accommodated under its treaties, or to accept risks requiring technical underwriting expertise beyond that which may be available in–house.

65. It is also possible to arrange reinsurance protection on a "hybrid" basis that contains obligatory and non–obligatory elements.

Two commonly encountered facultative arrangements are:

a. Facultative obligatory insurance

66. Facultative obligatory reinsurance or “open cover” is an arrangement pursuant to which the cedant may, at its option, cede certain defined risks to the reinsurer, which the reinsurer must assume, subject to the cedant’s retention. This arrangement has both treaty and facultative elements. It is normally used to provide cover for risks that are irregular in incidence or to supplement a treaty that has limited capacity.

b. Semi-automatic Facultative Reinsurance

67. Semi-automatic facultative reinsurance requires the reinsurer to accept certain defined risks of the reinsured, subject to the right of the reinsurer to reject liability for any of such risks within a stated period after submission. Like facultative obligatory reinsurance, semi-automatic facultative reinsurance is also a hybrid of both treaty and facultative reinsurance.

Life & Health Automatic Reinsurance

68. Automatic life reinsurance is similar to non-life “treaty” reinsurance. In automatic reinsurance, the ceding company is able to bind the reinsurer on a risk without submitting an application for reinsurance provided certain conditions are met. These conditions vary by agreement, but typically obligate the ceding company to keep retention on the life, limit the amount of insurance on a life that may be ceded, and limit the overall amount of insurance that may be in force on the life in all companies. The ceding company may be required to notify the reinsurer of automatic reinsurance arrangements through specific cessions (i.e., “cession reporting”), otherwise it is called “bordereau reporting.” This type of reinsurance will be typically offered to broad segments of a company’s business, such as all issues of a specified policy form.

Life Facultative Reinsurance

69. Life facultative reinsurance is similar to non-life facultative reinsurance or to “special acceptances” reinsurance under treaty reinsurance. However, facultative obligatory” reinsurance and “semi-automatic” reinsurance will rarely be encountered in the life and health market.

Appendix II – Forms of reinsurance

70. Whether on a treaty basis or a facultative basis, there are two forms of reinsurance, Proportional (also often referred to as pro–rata reinsurance) and Non–proportional (often referred to as excess of loss reinsurance).

Proportional Reinsurance

71. Under proportional reinsurance the company and the reinsurer share in an agreed ratio all premiums, losses, and loss expenses arising out of the original business covered under the reinsurance agreement. There are two forms of proportional reinsurance: Quota Share and Surplus Share.

a. Quota Share Reinsurance

72. This type of reinsurance was the earliest form of proportional reinsurance and is still widely used wherever appropriate. Quote share reinsurance arrangements agreement represent a sharing of all business in a fixed ratio, or proportion. A 50% quota share agreement is one in which premiums, losses, and loss expenses are shared equally, half being retained by the company and half being ceded to the reinsurer. A 70% quota share would involve a 70% share ceded to the reinsurer, with the remaining 30% retained by the company.

73. In Practice – A $500,000 insurance policy remitting annual premiums of $1,000 under a 50% quota share agreement, would entitle the insurer and reinsurer to $500 of the annual premiums, and liability of up to $250,000 on a claim. The company's needs and objectives, and the amount of proportional capacity available in the reinsurance marketplace at the time of placement, will determine the percentage share it will retain for its own account. Quota share treaties are invariably obligatory contracts. The contract will contain a stipulated limit of liability with respect to any single original policy. There will ordinarily be certain forms of coverage or classes of business that are excluded under the terms of the contract. These may not be ceded to the reinsurer without prior review and approval (usually referred to as a special acceptance) by the reinsurer. The reinsurance premium is simply the reinsurer's proportional share of the company's original premium for all business ceded. The reinsurer's share of the company's acquisition costs and general operating expenses associated with the ceded business is recovered by the company via a ceding commission allowance, a deduction from the reinsurer's share of the gross original premium.

b. Surplus Share Reinsurance

74. This type of proportional reinsurance is a variation on the quota share concept. Instead of sharing every policy on the basis of a never-changing fixed ratio, a surplus agreement permits the company to cede varying amounts or percentage shares of each original policy to the reinsurer. The amounts ceded are still subject to a stipulated minimum retention and maximum cession.

75. In Practice – In a three-line surplus agreement, the insurer would transfer three times the amount of liability retained. On a $40,000 policy, the insurer would retain $10,000 (1/4) of the liability and the reinsurer would assume $30,000 (3/4). In the event of a total or partial liability claim, the insurer and reinsurer would maintain the same percentages for claim

resolution. (The percentages and amount assumed and ceded may differ among reinsurance contracts.)

76. Once a cession has been made to the surplus treaty, premiums, expenses and losses will be shared proportionally between the company and the reinsurer.

Non–Proportional Reinsurance

77. Non–proportional reinsurance occurs when the reinsurer indemnifies the ceding entity against the amount of loss in excess of the cedant company's specified retention. Non–proportional reinsurance, as the name implies, does not contemplate the sort of sharing of premium, losses, and loss expenses that occurs under proportional structures. Instead, the reinsurer assumes liability for only such loss as exceeds the company's stipulated net retention (or, in the case of a layered excess structure, loss which exceeds the combined limit of liability of all underlying layers of reinsurance plus the company's retention). The three types of non-proportional reinsurance include:

a. Excess per Risk

78. This reinsurance method provides indemnification to the ceding company for each covered risk up to a predetermined limit. The ceding company is required to meet the obligations of the claim up to a preset dollar amount before the reinsurer becomes liable.

79. In Practice – A company that utilises the excess per risk reinsurance method may cede amounts exceeding the first $100,000 of claim liability on a policy to a reinsurer. That reinsurer agrees to accept this risk, but limits their total liability for this policy to $900,000. In effect, a claim on this policy for $850,000 would be settled from $100,000 from the original insurer and $750,000 from the reinsurer.

b. Aggregate Excess of Loss Reinsurance (Stop-Loss)

80. This method provides reinsurer indemnification to the ceding company for the aggregate amount of losses during a specific time frame up to a predetermined limit or percentage.

81. In Practice – A company decides to cede all insurance losses that exceed 75% of the company's subject premiums for the calendar year ended 12/31/XX. The reinsurer agrees to assume this liability, but limits responsibility at $2,500,000. In effect, if the reinsurer incurred losses totalling 80% of the subject premiums, the reinsurer would be liable for 5% of the losses up to $2,500,000. (For these situations, the ceding company will be expected to provide documentation to the reinsurer of the premiums collected and the losses sustained.)

c. Per Occurrence (Catastrophe) Excess of Loss

82. This reinsurance method is identical to the 'Excess per Risk of Reinsurance' indicated above, except that the policies are designed to account for an accumulation of losses from a single catastrophic event.

83. In Practice – A company may decide to cede all insurance losses exceeding $4,000,000 that result from a natural catastrophic event. One reinsurer who accepts the risk may limit liability at $25,000,000. In the event of an earthquake that causes losses of $29,000,000, the original insurer would be responsible for the first $4,000,000 in losses and the reinsurer would be responsible for $25,000,000. As catastrophic events can result in

significant losses, the insurer may find it necessary to cede parts of the risk to different reinsurers, or the assuming reinsurer may cede some of the assumed risk to others (retrocession.)

84. In non-proportional reinsurance the reinsurer does not assume responsibility for a proportional share of all losses. Therefore the distribution of premium will not be on a proportional basis. Non–proportional reinsurance is commonly arranged in a series of layers, the first of which attaches immediately to the excess of the company's retention, followed by as many additional layers as are necessary to generate the required total amount of capacity (per risk), or to afford such catastrophe (per occurrence) or aggregate (net retained loss) protection as deemed prudent and sufficient, given the size, geographic distribution and nature of the company's portfolio of business.

Life & Health Reinsurance

There are two forms of life reinsurance: proportional and non-proportional.

Proportional Reinsurance

85. As a general rule life insurance companies establish limits of retention. These limits, which may vary by age at issue, plan, or substandard classification, are the amounts which the company has decided it can safely retain at its own risk for newly issued policies. A schedule of limits of retention also includes limits for supplemental benefits such as disability and accidental death. These limits may or may not be independent of the limits for life insurance benefits. With these limits of retention established for all the forms of coverage issued, a company makes reinsurance arrangements with one or more reinsurers to take care of those applications on which the amounts are in excess of the established retention.

Using the above methodology, proportional life reinsurance may be written on:

a. Yearly Renewable Term (YRT) or Risk Premium Reinsurance Basis

86. Reinsurance arrangements written on this basis transfer the mortality risk to the reinsurer. For every age, plan, and policy year, there is a certain reserve per $1,000 of insurance. In calculating the company's available surplus capital, this is the liability that is deducted from assets to arrive at the company's available surplus capital. Since this reserve amount is already in the company's liabilities, it is clear that if the company is called upon to pay more than this amount, only the excess over the reserve needs to be taken from the company's available surplus capital. In the event of a death claim, assets are reduced by the face amount paid, liabilities are reduced by the reserve amount, and the excess of the face amount over the reserve comes from its available surplus capital. This excess is called the "policy net amount at risk." In the reinsurance agreement the ceding company and the reinsurer agree upon how the policy net amount at risk will be apportioned between them.

87. In Practice - The ceding company would prepare a schedule of the net amounts at risk for each policy year. The reinsurer would develop a schedule of yearly renewable term premium rates for reinsurance on the ceding company's schedule. The ceding insurer would pay the reinsurer the established premiums for the appropriate net amounts at risk each year. In the occurrence of a claim, the reinsurer would remit payment for the assumed potion of the policy's net amount at risk.

88. Although the policy net amount at risk will decline over time as the policy reserves increase, it is common for the parties to agree to make adjustments only at agreed intervals

to ease administration and lower processing costs. This reinsurance method is widely used because it reduces reinsurance to its fundamentals and provides a very flexible mechanism for satisfying the company's reinsurance needs.

b. Coinsurance Basis

89. This type of reinsurance is considered to the most comprehensive basis since it usually involves transfer of a portion of all the risks inherent in the original business on a quota share or excess of retention basis from the ceding company to the reinsurer.

90. In this type of reinsurance, the insurer and the reinsurer share a portion of the risks under the original insurance policy. The reinsurer receives a portion of the gross paid policy premiums based on the amount of risk assumed and establishes a correlating reserve. In addition to fulfilling the assumed portion of the claim, the reinsurer is also required to reimburse the insurer for any other benefits provided under the policy (i.e., policy dividends, commissions, premium taxes, etc.) The reinsurer also provides the ceding company with a commission to cover the marketing, underwriting and distribution aspects of the policy.

91. In Practice - If the insurer desired to cede 50% of a $500,000 life insurance policy with annual premiums of $1,000, the reinsurer would receive $500 (50%) of the premiums collected. The reinsurer would establish an adequate reserve on their books and pay the insurer for the share of commission costs and benefits provided. In the event of the death of the policyholder, the reinsurer would be required to remit $250,000.

c. Coinsurance with funds transferred

92. A slight variation of this reinsurance method may occur if assets are transferred between the insurer and reinsurer. Under this method, assets supporting the reserves on the ceded portion of the business are transferred to the reinsurer. Typically, unless otherwise stated, any investment gains and losses arising on these assets belong to the reinsurer.

93. In some circumstances the ceding company may wish to retain control of the funds arising from its own policies either to maximise its own investment returns, or as security against the event that the reinsurer's ability to discharge its obligations to the ceding insurer becomes impaired. (The latter may also be a concern to regulators in the ceding company's state of domicile.) In response to such considerations, the modified coinsurance (a variation of the coinsurance reinsurance method) method to account for reinsurance was developed.

d. Modified Coinsurance Basis

94. Modified coinsurance, or 'modco', differs from coinsurance agreements in that the portion of policy assets normally entitled to the reinsurer are actually retained by the ceding company. In addition to the transactions required in a coinsurance arrangement, a "reserve adjustment" must be calculated. For each accounting period, the change in reserves is first determined. If these have increased, the amount of the increase, less interest on the reserve for the period, will be payable to the ceding company. If reserves have decreased, the amount of the decrease, plus interest on the reserve, will be payable to the reinsurer.

95. In Practice – (Using the same example for the coinsurance method) If the insurer desired to cede 50% of a $500,000 life insurance policy with annual premiums of $1,000, the insurer and reinsurer would each receive $500 (50%) of the premiums collected. The insurer would establish the full portion of the reserve for this policy and retain all funds held to support the reserve. Each year, the reserve basis would be determined, and after

considering the impact of interest on the funds held by the insurer, the reinsurer would remit or receive payment to cover the increase/decrease in reserve. In the event of the death of the policyholder, the reinsurer would be required to remit $250,000.

96. The rationale for this procedure is that the ceding company holds the policy reserves and the corresponding assets on the reinsured business and, therefore, is responsible for the portion of the reserve increase derived from interest on the policy assets. Any other fluctuations in the reserve would be the responsibility of the reinsurer. Establishing the reserve adjustment interest rate is a complex part of the treaty negotiations. The formula for calculating the interest rate is typically set forth in the reinsurance agreement.

Non-proportional Reinsurance

97. Non-proportional reinsurance provide for aggregate losses rather than indemnification on individual policies. Typically, these reinsurance policies are written annually to protect from excessive losses.

Non-proportional Life & Health Reinsurance may be written as:

a. Catastrophe Reinsurance

98. This provides for payment by the reinsurer when the ceding company's aggregate net retained claims resulting from a single accidental event exceed the company's retention under the reinsurance agreement. Commonly the reinsurer pays something less than 100% of such excess, the balance being retained by the company, and a limit is placed on the amount the reinsurer will pay on any one catastrophe. An annual limit may also be placed on the total amount to be paid by the reinsurer. The coverage may be purchased on the ceding company's entire portfolio of retained risks or on any readily definable category, such as all retained individual risks, a particular group case, a category of group cases, etc. Normally, both the regular life insurance risk and the accidental death risk will be included.

99. In Practice - The insurer cedes to a reinsurer 100% of aggregate, entire portfolio claims caused by a natural catastrophic event that exceed $5,000,000. The reinsurer agrees to accept the risk with a limit of 2 claims per year and an annual dollar limit of $10,000,000. In the event of an earthquake that resulted in life claims totalling $7,500,000, the insurer would be responsible for $5,000,000 and the reinsurer would be responsible for $2,500,000. If a second natural catastrophe occurred throughout the same calendar year, the reinsurer liability would be limited to $7,500,000.

b. Stop-Loss Reinsurance

100. The term stop–loss reinsurance is commonly used to describe coverage for a collection of insurance risks under which, once the ceding company pays the total amount of all claims in a specified period, usually a calendar year, up to a total aggregate limit determined in advance for the period, the reinsurer will reimburse a specified proportion (e.g., 90%) of the amount in excess of the aggregate retention for the period, subject to a maximum reinsurance limit. In practice, the maximum amount of claim on any one life is usually "warranted" by the ceding company. Any policy amounts issued in excess of the warranted maximum are reinsured conventionally.

101. In Practice - The insurer wishes to cede the risk that life insurance claims for the calendar year will not exceed $2,000,000. The reinsurer agrees to accept the risk, and agrees to pay 90% of all claims that exceed the $2,000,000 threshold. At the end of the

calendar year, the reinsurer would receive documentation of the current-year paid claims from the ceding company, and remit any required amounts based on the stated liability.

c. Managed Care Reinsurance

102. Managed Care reinsurance contracts have generally operated on a per risk excess of loss basis with an aggregate limit per year on each risk and aggregate limit on the life of the member covered. Reinsurance premiums paid are based upon the number of members reinsured and are generally paid on a per member per month basis with options by the reinsurer to adjust the premium with notice based upon certain agreed upon terms. There is normally a minimum reinsurance premium owed by the reinsured independent of the number of members covered.

103. Generally, the reinsurer will reimburse an agreed upon percentage (i.e. 90%) of claims once the reinsured has satisfied its retention on network claims. A lesser percentage (i.e. 70%) is normally reimbursed by the reinsurer for out-of-network claims. A different retention level for hospital claims (i.e. $100,000) vs. physician claims (i.e. $15,000) is common in a Managed Care reinsurance contract.

Appendix III - Glossary definitions

104. Throughout this paper a number of definitions and key words will be used in describing the concepts of reinsurance and its supervision. Some are described here; for more general insurance terminology, refer to the *IAIS Glossary of Terms*.

105. Insurance can be defined as an economic activity for contractually reducing risk for the policyholder against premium. In effect, insurance spreads risk through pooling, in that loss by an individual policyholder is compensated for at the expense of all the other policyholders insured for the risk in question. Insurance can be offered on a sound basis when the pooled risks are sufficiently stable for the determination of a proper premium rate, such as when the law of large number works for the independent risks.

Cedant

An insurer who cedes (transfers) a risk to reinsurers or retrocessionaires.

Co-insurance

Co-insurance is a form of insurance whereby two or more primary insurers enter into a single insurance contract to cover a risk in agreed proportions of the total premium. Each primary insurer is directly liable to the policyholder for its own portion.

Financial reinsurance

A specialised form of limited liability reinsurance whereby the financial and strategic motivations of the reinsured to effect the transaction take precedence over the risk transfer motivation.

Funds Withheld

Assets that would normally be paid over to a reinsurer but are withheld by the cedant to permit statutory credit for non-admitted reinsurance, to reduce a potential credit risk, to retain control over investments or to assist in realising the time value of money in jurisdictions that do not allow discounting or equalisation reserves.

Insurance contract

Legally binding bi-/multilateral agreement between the risk-transferring entity (buyer of the contract or policyholder) and the risk-assuming company (seller of the contract) to indemnify the buyer under specified circumstances.

Insurer

An insurer is a company that offers protection through the sale of an insurance contract to a risk-transferring policyholder. If the risk-transferring policyholder is not an insurer itself, the risk-assuming insurer is called the primary insurer.

Names (Lloyds)

An individual Member of the Society of Lloyd's.

Reinsurance

Reinsurance is a form of insurance where the primary insurer reduces the risk by sharing individual risks or portfolios of risks with a reinsurer against a premium. The sharing may be proportional or cover losses in excess of a fixed amount or percentage (per case or per portfolio). Reinsurance also spreads risk through pooling, in that the loss by a single primary insurer is compensated for at the expense of all other (primary) insurers reinsured for the risk in question.

Reinsurer

A reinsurer is an insurer that offers protection through the sale of a reinsurance contract to a risk-transferring policyholder who is an insurer. If the risk-transferring policyholder a (re)insurer itself, the risk-assuming insurer is called the reinsurer, and the risk transfer is known as (retro)cession.

Side Agreements

Formal or informal agreements that essentially unwind a reinsurance arrangement or alter the risk transfer inherent in the contract, which results in a financing transaction instead of an insurance transaction.

Unbundling (Bifurcation, US)

Unbundling is the separation of a contract into financing and risk transfer components for accounting purposes.

Appendix IV - Sample agreements of finite reinsurance

106. The following are examples of the problems raised by the so-called “financial” - or rather “unconventional” – reinsurance.

Time and Distance Policy

107. This treaty represents the most elementary form of a first-generation financial treaty and is characterised by payments of claims at agreed dates and for agreed sums, independently from the actual technical performance of the treaty.

108. In particular, under a “time & distance” contract, on 1st January of the year X the ceding company C transfers undiscounted provisions for claims outstanding for an amount of 100 to the reinsurer R. The reinsurer undertakes to make five deferred payments of 20 each to the ceding company as a reimbursement of claims paid.

109. If we assume a 5% discount rate, the advance single premium that C will pay to R at the date when the contract becomes effective will be 86.6, calculated according to the following table:

Pattern of payments

Years		Advance single premium	Claims paid	Interests	Balance of claims outstanding
X	1 January	86.6			
	31 December		20	4.3	70.9
X1	31 December		20	3.6	54.5
X2	31 December		20	2.7	37.2
X3	31 December		20	1.8	19.0
X4	31 December		20	1.0	0
Total		**86.6**	**100**	**13.4**	**0**

110. It comes out from the above that in the year X the ceding company transfers 100 of claims outstanding to the reinsurer against payment of a premium of 86.6, with a net profit of 13.4 and an increase of the net capital for an equal amount and a consequent improvement of the solvency margin as well as of the representation of technical provisions.

111. It is worth underlining that the reinsurer does not bear any underwriting or timing risk, since all the payments have been agreed in advance. R will only have to invest the premium collected in advance in assets yielding at least an amount equal to the above-mentioned discount rate. The rate risk, arising out of the difference between the cost of money and the return on investments, is one of the risks typical of banking and financial operators and therefore is not an insurance risk.

112. These treaties cannot be taken into account for technical purposes, since there is neither a transfer of the insurance risk nor the consequent possibility of economic losses for the reinsurer.

Current Examples of Agreements:

Retrospective Covers

Adverse Development Cover

113. These contracts address old year liabilities and permit management to focus on ongoing business. They can include transfer of claims management.

114. This example of an adverse loss development cover is similar to the Time and Distance example, but with some changes in contract terms which substantially modify its result.

Under this contract, on 1st January of the year X, the ceding company transfers undiscounted provisions for claims outstanding for an amount of 100 to the reinsurer.

The maximum amount of aggregated claim is 110, therefore covering the potential negative result of provisions for claims outstanding of 10. No limitations have been envisaged to the amount of claims that can be paid in each year.

If we assume a 5% discount rate, the premium will be 86.6 euro.

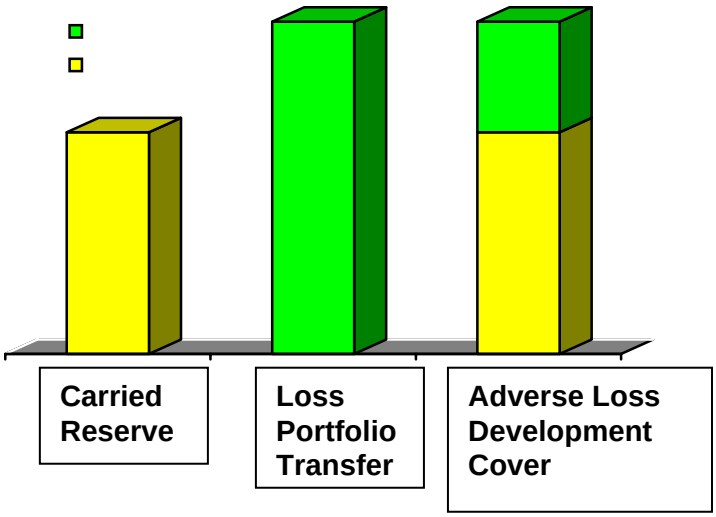
However if the amount of claims paid during each year were 10% higher and the ceiling of aggregate claim were overcome (110 euro), the reinsurer would obtain a negative result of 11,2 euro, as shown below in detail:

Pattern of payments

Years		Advance single premium	Claims paid	Interests	Balance of claims outstanding
X	1 January	86.6			
	31 December		22	4.3	68.9
X_1	31 December		22	3.4	50.3
X_2	31 December		22	2.5	30.8
X_3	31 December		22	1.5	10.3
X_4	31 December		22	0.5	(11.2)
	Total	**86.6**	**110**	**12.2**	**---**

Differently from the contract mentioned in the first example, in this case the reinsurer assumes both the underwriting risk and the timing risk. In fact the above negative result is made up of 1.2 (13.4-12.2) due to the loss of interests resulting from the faster pattern of payment (timing) and 10 (110-100) due to the adverse development of claims (underwriting).

115. However, given that from some aspects this contract is not in line with the correct accounting principles (i.e. the reinsurer immediately pays the ceding undertaking future investment income, with the consequent increase of operating results and the possible distribution of profits to shareholders), US trade associations have issued specific regulations in this regard for the purpose of neutralising the distortions noticed.



116. Can include transfer of claims management, which requires that the reinsurer knows the projected payout pattern of the claims as the reinsurer runs the risk of payments that are more rapid than expected.

Loss Portfolio Transfer (LPT) Example

117. Primary (ceding) insurer increases its technical provisions for liability business by 600 monetary units. Of those 600, it cedes 300 to a reinsurer, which receives a premium of 200. The cedant deducts this amount from its premium income in its income statement.[2]

Income Statement	Without Loss Portfolio Transfer	With Loss Portfolio Transfer
Earned Premiums	1000	800
Paid Losses	(100)	(100)
Increase in Loss Reserves	(600)	(300)
Underwriting Expenses	(350)	(350)
Technical Result	(50)	50
Investment Income	50	50
Overall Result	**0**	**100**

[2] Swiss Re, sigma no. 5/1997

Balance Sheet			
Assets	**Liabilities**	**Assets**	**Liabilities**
2000		1800	
Loss Reserves	600		300
Other Debt	1100		1100
Equity	300		400

Key Financial Ratios		
Loss Ratio	70%	50%
Expense Ratio	35%	43.75%
Combined Ratio	105%	93.75%
Solvency Margin	30%	50%

An empirical system for verifying the transfer of the underwriting risk and the timing risk

118. Within the wider framework of alternative instruments for the transfer of risks the last few years have seen the spread of so-called “finite” treaties, structured on an individual basis by the reinsurer in order to answer to the specific requirements of the ceding company.

119. The main characteristic of these contracts is that, when determining the premium, they take mainly or exclusively into account the financial aspect, that is the value of money over time, with a predetermined or reduced transfer (or no transfer at all) of the portfolio insurance risk to the reinsurer.

120. Generally speaking, from the point of view of a correct technical approach, it would certainly be correct to establish that if the treaty does not actually reduce the ceding company’s risk of portfolio, i.e. if there is no possibility of an economic loss for the reinsurer, a reduction of the solvency margin cannot be allowed if the ceding company’s risks, and therefore its probability of ruin, remain unchanged.

121. From an accounting point of view it follows that the treaty should bear no effects on the balance on the technical account, on the solvency margin and on the representation of technical reserves.

122. In light of the above and of the fact that any type of reinsurance treaty (either proportional or not) can or cannot transfer the insurance risk by means of adequate provisions in contract terms, as it is self-evident from the simple examples quoted, it is necessary to examine each contract on an individual basis and in the totality of risk transfer between the parties.

123. In this regard US trade associations have adopted an empirical system (the so-called “risk transfer test”) capable of verifying the possible results of each treaty for the purpose of establishing whether it is “reasonably possible” that the reinsurer may realise a “significant loss” resulting from the transfer of the insurance risk, that is to say of both the underwriting and the timing risk.

Prospective

Structured Quota Share

124. These arrangements allow access to traditional pro rata protection while allowing the customer to retain a share of the positive economics.

Reinsured	ABC Ceding Company (the "Reinsured")
Reinsurer	XYZ Reinsurance Company (the "Reinsurer")
Type	Quota Share Reinsurance Agreement
Business Covered	Losses on policies in force as of December 1, 2002 and classified as workers compensation or employers liability
Term	December 1, 2002 to November 30, 2003
Quota Share Percentage	50%
Limit and Retention	The Reinsured shall cede and the Reinsurer shall accept the Quota Share Percentage of the net retained liability for Ultimate Net Loss as respects the business covered hereunder. The Reinsurer shall not be liable for any Ultimate Net Loss in excess of a loss ratio of 65% until such loss ratio exceeds 70%, whereby the Reinsurer is liable for its quota share percentage of losses excess of 70% loss ratio, not to exceed 100% loss ratio. The Reinsured is liable for net loss in excess of the loss ratio of 100%.
Premium	The Reinsured shall pay the Reinsurer the quota share percentage (50%) of the subject gross net premium the Reinsured charges on the policies reinsured by this Agreement.
Reinsurer's Margin	4% of Premium; minimum of $1 million.
Ceding Commission	A Ceding Commission will be paid which will vary according to the Ultimate Net Loss. The provisional ceding commission will be 30% of Ceded Premium for Direct Loss Ratios of 65% through 75%, inclusive. As the Loss Ratio decreases from 64% to 55%, the ceded commission rate will increase on percentage-by-percentage basis from 30% to 40%, with 40% being the maximum Ceding Commission percentage. As the Loss Ratio increases from 76% to 80%, the ceded commission rate will decrease on percentage-by-percentage basis from 30% to 25%, with 25% being the minimum Ceding Commission percentage.

Experience Account

The Reinsurer will establish a notional Experience Account for the benefit of the Reinsured. The Experience Account shall be maintained by the Reinsurer and adjusted quarterly as follows:

a Beginning balance, plus
b Premium, less
c Ceding Commission, less
d Reinsurer's Margin, less
e Ceded Ultimate Net Losses Paid, plus
f Interest Credit

The beginning balance at inception will be the unearned premium on in force business at inception less Minimum Ceding Commission and less Reinsurer's Margin.

Interest Credit

Interest credit will be 3% per annum.

Commutation

If the experience account is positive the Reinsured may commute ant any time after December 1, 2005. The Reinsured will be entitled to 100% if any positive balance in the experience account.

If the Experience Account is negative, commutation must be mutual agreement between the Reinsured and the Reinsurer.

Example:

Pre contract observations:

1. Aggressive Growth
   a. Written Premium in 2003 is fives times the Written Premium in 2000.
   b. Average annual increase in last 3 years is 73%.

2. Company's historical data is no longer valid for projecting future expected losses.
   a. Even so, mean historical loss ratio is about 77% with standard deviation of 9%.

Contract Provisions:

1. Type:	Finite Quota Share for 2004 policy year
2. QS Percentage:	60% Capped at 92.5% of Ultimate Loss Ratio
3. Reinsurer's Margin:	8% of subject premium
4. Funds withheld account:	Interest Credited at 2.5%
5. Commission:	Sliding Scale with provisional = 39% (min = 29% at 68% LR and max = 49% at 47% LR)
6. Subject Premium:	Approximately $170 million.
7. Commutation:	Company can commute only with the consent of the Reinsurer, all ceded ultimate net loss outstanding.

Results of Risk Transfer Analysis:

1. There is just a little over 10% (10.2% to be exact) chance that the reinsurer's loss is 10% or more, but never more than 13.5%.
2. The reinsurer's maximum loss is about 13.5% when the loss ratio is 92.5% or more and the probability of which is approximately 6%.
3. On average, the PV of the reinsurer's profit is 4,149, which is about 7% of ceded premium less provisional commission.
Also on average, the PV of the reinsurer's profit is 4,149, which is 5% of PV of the funds withheld balance of 75,653.
4. Expected Reinsurer Deficit (ERD) (defined as the average reinsurer deficit over all values where a deficit exits) is -7%

Comments:

1. If the ultimate loss ratio is over 92.5%, the cedant pays all the losses 100% above 92.5%.
2. In general, when a company is growing at an annual rate of about 73%, the loss ratios deteriorate, all else being equal.
Which means, one can reasonably expect the loss experience to deteriorate but cannot be quantified.
3. Since, company is ceding 60%, they get immediate surplus aid or increase in capacity, which in turn enables the company to write even more!
4. Although the company passed the so-called 10-10 rule, the maximum the reinsurer loses is 13.5% in the worst-case scenario.
Incidentally, SSAP 62 DOES NOT mention the 10-10 rule. It is a completely made up number.
5. Note how close the average reinsurer's profit percentage of 7% of ceded premium less margin is to reinsurer's margin percentage of 8% of subject premium.

Example:

Pre contract observations:

1. Unauthorised Offshore Reinsurer
2. Reinsurer surplus: $6 million as of 12/31/2003.

Note: Company did not provide Financial Statement of Reinsurer as of 12/31/2002, although the effective date of coverage is 1/1/2003.

3. Company's mean historical loss ratio is about 84% with standard deviation of 5%.

Contract Provisions:

1. Type:	Excess Layer for Losses incurred in 2003.	
2. Subject Premium:	Approximately $800 million.	
3. Ceded Premium:	$35 million.	
4. Attachment Point	65% of Ultimate Loss Ratio.	
5. Max Ceded Layer %	12% but not in excess of $110 million.	
6. Funds withheld account:	Interest Credited at 6%	
7. Agreement Date:	9/28/2003	but policy is effective 1

Results of Risk Transfer Analysis:

1. There is 99.5% chance (virtually guaranteed) that the reinsurer's loss is 10% or more.
2. The probability that the reinsurer profits is remote.

Comments:

1. The offshore reinsurer's surplus is only $6 million, while the maximum ceded amount is $115 million.
2. The reinsurer is guaranteed of loss, so why would the reinsurer write this contract? Are there side agreements?
3. Paragraph 8(c) of SSAP 62 states the requirements for reinsurance arrangements, one of which is that there should be no guarantee of profit from ceding entity to reinsurer or vice versa. This contact does not even comply with the requirements of reinsurance contract.
4. This contract does pass the so-called 10-10 rule, which in this case is meaningless.
5. The company does not have any documentation including underwriting files, correspondence, etc.

Catastrophe Excess

- uses multiple years of coverage to reduce reinsurers' risk charge

125. Traditional catastrophe reinsurance is purchased annually and the pricing for such covers can vary dramatically depending on the pricing cycle and the loss history from one year to another. Insurers may wish to smooth their high-level catastrophe costs over a multiple year time period utilising finite reinsurance.

Example # 1

126. Funded catastrophe cover – the ceding company purchased a low catastrophe attachment cover to smooth its earnings. Depending on how big a catastrophe loss is relative to the fund balance, the shortfall is made up by the insurer in subsequent years

through increased premiums, cancellation penalties or settlement adjustments. In the event of a profit accumulating in the experience account, the adjustments are made based on (1) an experience refund account, which reimburses the ceding company x% of the profit; or (2) annual increases in the level of limit of liability.

Aggregate Stop Loss

- provides whole account protection against both frequency and severity of loss, also referred to as the "Ultimate Catastrophe Cover" for management.

Example # 1

127. Reinsurer: Company X

Scope: All direct lines of business

Retention: 10% of the Ultimate Net Loss each Accident Year Excess of the Accident Year Target Loss Ratio Retention each Accident Year.

Coverage: 90% of the amount of the Ultimate Net Loss each Accident Year Excess of the Accident Year Target Loss Ratio Retention each Accident Year. Annual Recoverable limited to the greater of $2,750,000 or 200% of annual premium. Term recoverable limited to 165% of term premium.

Premium: 6% of subject premium for first Accident Year.
5% remaining years of contract term.

Effective date: June 1, 1998

Termination: December 31, 2000, however, the reinsurer may cancel at any December 31st upon 90 days' prior written notice to the company or the company may cancel at any December 31st upon 90 days' written notice to the reinsurer if the Experience Account is positive.

Example # 2

128. During 1998, Company X executed an aggregate stop loss reinsurance agreement, which covers the period June 1, 1998 through December 31, 2000. This agreement was put in place to provide stability to X's loss ratio, additional catastrophe coverage, and additional Year 2000 protection. More detail of this agreement is outlined in the section of this report captioned "Reinsurance." This agreement was reviewed extensively by the examiners and was determined to adequately transfer risk to the reinsurer. However, other issues arose from the review of the agreement and its accounting.

129. Under this agreement, premium ceded equalled 6% of earned premium for 1998, and will equal 5% of earned premium for 1999 and 2000. The attachment point under this agreement is a 56% loss ratio for 1998 and 66.25% in 1999. The attachment point for 2000 will be determined at year-end 1999. The reinsurer's annual limit on the agreement is $2.75 million or 200% of the accident year premium whichever is greater. The reinsurer's aggregate limit is 165% of the premium paid. This agreement also contains an experience account, which does not allow the company to terminate the agreement if the experience account is negative.

130. Due to the significant number of catastrophic events during 1998, X exhausted the limits of the aggregate stop loss agreement for the first year and placed the experience account into a negative position. The experience account was sufficiently negative so that the company cannot terminate the agreement for 1999 nor 2000, and so is obligated to pay the $3.0 million additional premium for the entire agreement. The company should have recorded a liability at year-end 1998 regarding this agreement.

131. Examiners and company personnel reviewed the contract's premium payments and expected recoveries over the three-year life of the contract, to determine the appropriate portion of the total three-year premiums that should be attributed to the first year. Examiners and company personnel determined that an additional $700,000 of reinsurance premiums should have been attributed to the first year of the contract. Therefore, an adjustment to surplus of $700,000 is reflected in the section of this report captioned "Reconciliation of Surplus per Examination." It is recommended that when the company has a multi-year aggregate excess of loss reinsurance agreement with an experience account, under which it is obligated to pay one or more future years of reinsurance premium because the experience account is negative, the company should establish an appropriate liability for the future reinsurance premium payments.

Example # 3

132. Company AAA and Company BBB have each entered into reinsurance arrangements which are written as 50% coinsurance on a funds-withheld basis, and cede approximately 50% of the companies' accident and health premiums and associated life coverages to reinsurers indicated in the table below. As funds-withheld agreements, all of the assets and liabilities remain with the ceding insurers.

2003 Business	**AAA**		**BBB**	
	Reins %	Premium Ceded	Reins %	Premium Ceded
Reinsurer X	10	$111,988,713	6	$ 38,624,019
Reinsurer Y	20	223,977,425	17	173,808,085
Reinsurer Z	20	223,977,425	27	109,434,721
Total	50	$559,943,563	50	$321,866,825
Expense and Profit Charge		$ 3,231,434		$ 1,953,571

133. The contracts establish a target combined ratio of 94%. In the event that the combined ratio is 98% for any three-month period, or 96% for any six-month period, or 94% for any twelve-month period, revised premiums would be implemented by the company as soon as practical to achieve the targeted combined ratio.

134. The following table lists the combined ratios reported on the reinsurance arrangements for the past five years. The amount reported for 2004 is a rolling twelve-month ratio through September.

	AAA	**BBB**

2000	89.3%	96.7%
2001	85.1	87.6
2002	79.3	83.1
2003	78.2	83.9
2004	71.2	78.2

135. The reinsurance arrangements have an experience refund which returns all of the profits less an expense and profit charge based on premiums ceded of .58% for AAA and .61% for BBB as long as the combined ratio on the business ceded is less than 98%. For combined ratios between 98% and 100% the profit commission is reduced so that the ceding company and the reinsurers share the profits equally. The reinsurers provide coverage under the arrangements when the combined ratio is between 100% and 110% where the reinsurers would pay their participating share (50%) of the losses and expenses. The reinsurers pay a separate stop-loss premium of .5% of premium ceded to AAA and BBB as compensation for the 110% cap on coverage. AAA and BBB report this stop-loss premium as reinsurance assumed on their annual statements, even though the subject premium being assumed is on policies directly written by AAA and BBB and separate assumption reinsurance arrangements were not established.

136. The companies each reported the experience refund as miscellaneous income in the Summary of Operations. The following table represents the experience refunds reported in the companies' financial statements on business reinsured. The amounts reported for 2004 was through September 30.

	AAA	**BBB**
2000	$ 46,021,055	$18,467,117
2001	61,952,355	41,628,576
2002	100,659,099	51,808,739
2003	125,685,558	53,662,335
2004	129,999,563	44,972,018

In the event that the experience refund for any period is negative, it is carried forward at interest until it is paid back through future profits. It appears, depending on the method of termination, that payment for a negative profit commission would be due from AAA and BBB to the reinsurers.

137. Risk transfer under the agreements occurs at a 98% combined ratio. Coverage is limited to when the combined ratio is between 100% and 110%. Considering that the combined ratio of the block of business is significantly less than the point at which the reinsurers would participate and that there are provisions in the agreements, which address higher loss ratios with rate increases, it is questionable whether the contracts transfer any significant amount of risk. In addition, the contracts cede 50% of the premium to provide coverage for 5% (half of the range between 100% and 110%) of the losses. The agreements in practice work more like a stop-loss agreement than coinsurance. The benefit of the agreements being structured as coinsurance agreements rather than a stop-loss agreement is that AAA and BBB significantly reduce their reported net premium which results in lower required capital for Risk Based Capital and Compulsory and Security Surplus. The reinsurance arrangements do not misstate total liabilities or surplus since the reserve credit taken for the 50% coinsurance is offset by the additional liability "Funds held under coinsurance."

138. SSAP 61 Life Deposit Type and Accident and Health Reinsurance and FASB Statement 113 Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts address reinsurance arrangements. SSAP 61 indicates that FASB Section 113 is adopted with modification. None of the seven modifications listed in SSAP 61 include differences between GAAP and statutory accounting with regard to the standards for evaluating reinsurance transfer of risk, and the guidance in FASB Statement 113 is applicable to evaluating the 50% coinsurance agreements.

139. FASB Section 113 requires that 1) the reinsurer assume significant insurance risk under the assumed portions of the underlying contracts, and 2) it must be reasonably possible that the assuming entity may realise a significant loss. The company provided an analysis performed by their auditors at the time of entering into the agreements.

140. For the first test, it was indicated that the requirements do not require an exact correlation of results, but some correlation is expected. The analysis determined if the treaties were treated as a stop-loss treaty, once the combined ratio exceeded 100%, the reinsurer would share in the losses, thus meeting the requirement. For the second test, it was indicated that the reinsurer could incur a significant loss at a combined ratio of 110%, their maximum exposure. (This is becoming increasingly unlikely as the table above has shown combined ratio has significantly decreased in the past four years.)

141. The possible scenario identified is that the combined ratio would spike in the last quarter of the year and there would be not enough time to take remedial action on the premium rates to address the increased loss history. (This does not address the fact that the negative result is used as a carry-forward amount in determining future experience refunds.) It was also indicated that the reinsurers would likely cancel the contracts if the combined ratio got closer to 100%. The ultimate conclusion is that for GAAP purposes, the agreements would qualify for reinsurance accounting under FASB Statement 113 only as stop-loss and that only the expense and profit charge should be recognised as the ceded premium. Analysis indicated that the only impact to surplus is the expense and profit charge. The company has reported the reinsurance as stop-loss on its GAAP statements but as proportional coinsurance on its statutory statements.

142. The examiners' review as well the company auditor's GAAP basis analysis document that the economic substance of the 50% coinsurance agreement is much more closely aligned with that of an excess of loss reinsurance agreement. Therefore, the examination does not consider agreements to be 50% coinsurance.

143. As a result of the disallowance of the company's accounting treatment for the 50% coinsurance agreements, the examination found that the company misclassified $126,322,798 "Aggregate reserve for accident and health contracts" as the liability for "Funds held under coinsurance." The misclassification did not change total liabilities or capital and surplus.

144. As noted above, the agreements provide significant premium leverage, which affects capital requirements, as shown in the following table. The pro-forma Risk Based Capital amount is an estimation of the actual amount as it may not have considered all of the changes that retaining the ceded premium would have affected. In neither case would it result in AAA or BBB failing Compulsory Surplus or being at a Risk Based Capital action level.

Risk Based Capital as a Percentage of Authorised Control Level

	AAA	BBB
Risk Based Capital as Filed	800%	1,013%
Pro-Forma Risk Based Capital	486	769
Excess Compulsory Surplus as Filed	$67,604,228	$98,250,398
Pro-Forma Excess Compulsory Surplus	41,714,980	65,337,482

145. In December 2004, AAA and BBB terminated their 50% coinsurance agreements effective December 31, 2004. Due to the termination of the agreements subsequent to examination fieldwork, the examination did not make a recommendation regarding the agreements.

Example # 4

146. One jurisdiction cited a large multi year stop loss contract that was designed to spread losses over a 5 year period with a fund that would attract interest and pay back any surplus at the end of the period. It looked to contain significant risk transfer - $200 million in fact. The expectation was that it would provide a smoothing effect; however two large losses (one in 1999 and the other in 2001) blew the limit and proved embarrassing for the reinsurer. There was a clause that allowed for the cancellation of the contract should the CEOs of the parties change during the contractual period. This could be an example where a “hand shake” replaced a side letter. The business relationship result has just reached break-even in 2005 after at least 2 very profitable years.

Example # 5 (Life Reinsurance)

147. A ceding company seeking financial relief from what it perceives to be onerous reserving requirements based on the 1980 CSO mortality table, which is well above the best-estimated mortality experience. Thus, even allowing for a generous MfAD (“Margin for Adverse Deviation”), there is no loss anticipated, hence no provision required for future claims.

Example # 6 (Life Reinsurance)

148. A combination of co-insurance with funds withheld and modified co-insurance arrangement, whereby an arbitrary funds withheld amount is used to protect the reinsurer against any cash calls that could occur due to a temporary loss. If such a loss occurs due to either a fluctuation in mortality or to asset defaults, the funds withheld account is used first to pay the loss. The relief is provided on a quota share basis with the remainder of the reserves left on a modified coinsurance basis. All excess profit over the scheduled repayment is returned to the ceding company through an experience refund account.

Example # 7 (Life Reinsurance)

149. In late 1998 and early 1999 a life insurer (Company A) agreed to offset a proportion of statutory reserves by a reassurance agreement valued at approximately 800 million. That reassurance eventually took the form of a stop loss treaty with a reinsurer (Reinsurer B). However, Company A gave Reinsurer B a side letter which provided that, should the withheld reinsurance claims balance exceed 100 million at the end of any year, and if no acceptable restructuring of the treaty could be achieved, the parties would cancel the treaty. In its

annual return for 1998, Company A attributed a value of 793 million to this treaty, although it could not be relied upon for more than 100 million.

As a result of this, one individual was banned by a jurisdiction.

Example # 8

150. An insurer (Company A) had a wholly owned subsidiary (Subsidiary B), based in another jurisdiction. In late 1999 it became apparent that Subsidiary B's results for the year were likely to be worse than expected. The directors sought ways to improve them. They entered into a stop loss agreement (SLA) with a reinsurer (Reinsurer C). In parallel, however, Company A gave Reinsurer C a letter of guarantee undertaking to repay, with interest, any net loss which Reinsurer C sustained under the SLA. Ultimately, Subsidiary B claimed 22.9 million under this contract.

151. Company A did not want to have to reflect the letter of guarantee in its own financial statements and, before the close of its own financial year, it replaced this with retrocession agreements and a profit commission waiver, to the benefit of Reinsurer C. It also issued a letter of confirmation that these agreements and the SLA should be viewed as components of a single transaction, and that Company A would compensate Reinsurer C for all the monies advanced to Subsidiary B, plus interest and a 1.5% management fee. The arrangements therefore were in effect a loan from Reinsurer C to Subsidiary B, though they were accounted for as reinsurance.

152. In March 2000, Company A announced a proposed merger with Company D, and it was agreed that full repayment of Reinsurer C should be made before the merger date. To achieve this, further deceptive arrangements involving other companies were used.

153. There was also in early 2000 a cash injection into Subsidiary B from Company A disguised as reinsurance, and falsely dated, in order to avoid taxes.

154. As a result of these arrangements, six directors of Subsidiary B were banned by one jurisdiction.

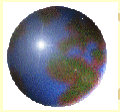
Example # 9

155. An insurance company ("Company X") wanted to improve its apparent financial position. Over a period of time it reinsured certain business into a group company in another country, and from that company into an unrelated company ("Company R"). Company X also concluded, however, an inwards reinsurance agreement with Company R's sister company ("Company S") in a third country, under which Company X agreed to repay Company S for any losses that it, or its associated companies (which of course included Company R) might suffer on a list of the outwards treaties into which Company X had entered. The arrangements were therefore completely circular, but accounted for as reinsurance.

Appendix V - Accounting and risk transfer testing

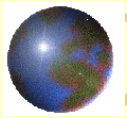
156. This appendix explains the difference between treating a reinsurance contract as effective reinsurance, and treating it as a deposit. The example uses US regulatory accounting conventions. Although the details would be different under other existing accounting conventions, the broad effect would be similar. The appendix then goes on to examine the effect of IFRS.

157. Traditional reinsurance can provide "financing" or "available surplus capital relief" when an adequate amount of risk is transferred between the parties. The following is an example of how the financial ratios can be ameliorated using a simple quota share contract that fully transfers risk.



Impact of Quota Share

Quota Share 80%			
Commisson Rate 30%	6/30/04	80%	6/30/05
Override Commission 5%	Before	Q/S	After
	Reinsurance	Reinsurance	Reinsurance
INCOME STATEMENT			
PREMIUMS WRITTEN	10,000,000	**(8,000,000)**	2,000,000
CHANGE IN UPR	4,000,000	**(3,200,000)**	800,000
PREMIUMS EARNED	6,000,000	**(4,800,000)**	1,200,000
LOSSES INCURRED	3,000,000	**(2,400,000)**	600,000
LOSS EXP.INCURRED	550,000	**(440,000)**	110,000
OTHER UND. EXPENSES	3,000,000	**(2,800,000)**	200,000
UNDERWRITING DEDUCTIONS	6,550,000	**(5,640,000)**	910,000
UNDERWRITING INCOME	(550,000)	**840,000**	290,000
INVESTMENT INCOME	250,000		250,000
OTHER INCOME/LOSS			
TAXES	0		365,000
NET INCOME	(300,000)	**840,000**	175,000
LOSS RATIO	**59.17%**		**59.17%**
PW/Surplus	**285.71%**		**57.14%**
Commission Ratio	**30%**		**10%**



80% Quota Share

Balance Sheet	6/30/04	0.8	6/30/05
ASSETS	Before	Q/S	After Reinsurance
----------	Reinsurance	Reinsurance	----------
INVESTMENTS & CASH	20,980,000	**-5,200,000**	15,780,000
AGENTS' BALANCES	1,650,000		1,650,000
REINSURANCE RECOV.	150,000		150,000
MISC. ASSETS	135,000		135,000
	----------	-	----------
TOTAL ASSETS	22,915,000	**-5,200,000**	17,715,000
=======	==========	=	==========
LIABILITIES			

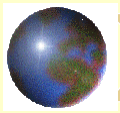
LOSSES & LAE	15,250,000	**-2,840,000**	12,410,000
REINSURANCE PAYABLE	450,000		450,000
UNEARNED PREMIUMS	3,500,000	**-3,200,000**	300,000
OTHER EXP. & TAXES	150,000		150,000
MISC. LIABILITIES	65,000		65,000
	----------	-	----------
TOTAL LIABILITIES	19,415,000	**-6,040,000**	13,375,000
	----------	-	----------
CAPITAL AND SURPLUS			
CAPITAL	2,750,000		2,750,000
UNASSIGNED SURPLUS	750,000		750,000
REINS.BEN.		**840,000**	840,000
	----------	-	----------
POLICYHOLDERS' SURPLUS	3,500,000	**840,000**	4,340,000
	----------	-	----------
TOTAL LIAB. AND SURPLUS	22,915,000	**-5,200,000**	17,715,000
	==========	=	==========
Ratio of liab. to surplus	**554.71%**		**308.18%**

158. Since acquisition expenses must be expensed immediately, but premiums must be earned over the life of the contract, there is a timing disconnect between income and expense recognition. In the example, the reinsurer reimburses the ceding insurer for those acquisition expenses via a ceding commission. This will help the cedant offset its cost for production of business (agent commissions, underwriting expenses, etc.) In addition, there may be an override or a contingent commission that may be paid due to the volume of business written or also can compensate the ceding insurer for the profitability of the business ceded to the reinsurer. Since the losses are shared between the insurer and reinsurer in a 1:1 proportional relationship, the loss ratio does not change after the effects of reinsurance. However, since the reinsurer has compensated the expenses of writing new business, the available surplus capital relief is evident in the premiums written/available surplus capital ratio. Before reinsurance, the cedant has a leverage ratio of 285% premiums written to available surplus capital while that ratio has been reduced to 57% after the reinsurance transaction. In addition, the expense ratio has been reduced from 30% to 10% since the “Other Underwriting Expenses” were shifted to the reinsurer ($ 2,800,000 = 35% commission [30% commission + 5% override commission] * $ 8,000,000 in ceded premiums to the reinsurer). Also, the ratio of liabilities/available surplus capital improved from 554% to 308%.

159. If any contract does not meet the risk transfer requirements, then it receives “deposit accounting treatment.”

- No reduction in loss reserves or liabilities

- Gains are not recognised until the termination of the contract
- All cash flows processed through a deposit account.



Deposit Accounting

Balance Sheet			
ASSETS			
INVESTMENTS & CASH	20,980,000	**-3,250,000**	17,730,000
AGENTS' BALANCES	1,650,000		1,650,000
REINSURANCE RECOV.	150,000		150,000
MISC. ASSETS	135,000	**3,250,000**	3,385,000
TOTAL ASSETS	22,915,000	**0**	22,915,000
LIABILITIES			
LOSSES & LAE	15,250,000	**0**	15,250,000
REINSURANCE PAYABLE	450,000		450,000
UNEARNED PREMIUMS	3,500,000	**0**	3,500,000
OTHER EXP. & TAXES	150,000		150,000
MISC. LIABILITIES	65,000		65,000
TOTAL LIABILITIES	19,415,000		19,415,000
CAPITAL AND SURPLUS			
CAPITAL	2,750,000		2,750,000
UNASSIGNED SURPLUS	750,000		750,000
REINS.BEN.			0
POLICYHOLDERS' SURPLUS	3,500,000		3,500,000
TOTAL LIAB. AND SURPLUS	22,915,000	**0**	22,915,000

160. U.S. GAAP deposit accounting for reinsurance contracts that do not transfer insurance risk differs somewhat from U.S. SAP deposit accounting. Among other things, GAAP allows contracts that transfer underwriting risk but not timing risk to be accounted for in the income statement of the insured as an offset against incurred losses. SAP does not allow deposits to affect the underwriting accounts, which means that those contracts won't affect the combined ratio.

161. Under US GAAP, embedded derivatives are not subject to exemptions from the general principle of separation and fair value measurement when they are not closely related to the host contract. FAS 133 (accounting for derivatives) requires to bifurcate derivative components from insurance components (if not insurance related)

162. US GAAP has no single definition of an insurance contract. The classification of contracts under US GAAP is performed by reference to the combined requirements of several different standards (FAS 60, FAS 97, FAS 113 and FAS 120).

163. Unbundling (i.e. separating contract elements) is required if liabilities are not recognised under existing GAAP and if cash flows are independent, unbundling if an embedded derivative exists (unless embedded derivatives are considered insurance contracts) Embedded derivatives need to be accounted for under IAS 39 at fair value (movements recorded in P&L)

164. In addition, if an entity elects to adopt the fair value option under IFRS, the accounting for liabilities associated with investment contracts can be different from US GAAP, where these liabilities are typically reflected at their account value. In the context of fair value, the IFRS requirement to keep the liability at no less than the amount payable on demand (also known as the 'deposit floor') adds another difference to the accounting for investment contracts.

165. Reinsurance is one area where contracts are not accounted for as insurance under US GAAP but may be defined as insurance contracts under IFRS. Another area where differences in definition arise is the concept of the insured event.

166. In the early-90's, U.S. GAAP (FASB 113) accounting as well as U.S. statutory accounting (SSAP No. 62) rules were amended in order to require that, in order to receive proper accounting treatment for reinsurance transactions, real risk transfer must take place which placed an emphasis on underwriting risk being transferred as well. It should be emphasised, that traditional reinsurance transactions have similar effects of improving financial ratios, stabilising income and boosting available surplus capital. Effective 1 January 2005, International Financial Reporting Standard (IFRS) 4 is the first guidance from the IASB on accounting for insurance contracts. However, a second phase of the IASB's Insurance Project is under way

Risk Transfer

167. The supervisor should review the procedures followed by the company in accordance with the selection of reinsurers and the ongoing monitoring of their financial condition. It is important to review all reinsurance documentation (placement slips, cover notes, reinsurance arrangements and any addenda thereto) for completeness, accuracy and timeliness.

168. For a fee that can total several million dollars, a reinsurer might create a financing vehicle that allows the insurer to move real or expected losses off its balance sheet. On its face, the finite reinsurance deal has transferred the risk to the reinsurer. However, through side agreements premiums are ceded back to the insurer, which then takes the charges or losses over multiple periods.

169. Supervisors should require that adequate risk transfer take place prior to giving companies reinsurance accounting treatment. For US statutory accounting purposes "risk" is defined in SSAP No. 62, Property and Casualty Reinsurance, of the NAIC Accounting Practices and Procedures Manual as consisting of two distinct elements: underwriting risk and timing risk.

- Underwriting risk is the possibility that losses and expenses recoverable by the cedant from the reinsurer will exceed the consideration received by the reinsurer, thus resulting in an underwriting loss to the reinsurer
- Timing risk exists when anticipated loss payment patterns are not considered during the development of recoverable losses under the reinsurance agreement, and result in a reduction in investment income to the reinsurer as an effect of the accelerated loss payments.

170. The NAIC Casualty Actuarial Task Force, along with the American Academy of Actuaries, has also been asked to re-evaluate risk transfer requirements for reinsurance contracts.

171. Regulators are considering whether the so-called "10-10 rule" (where the reinsurer has at least a 10% probability of incurring a loss of 10% or greater on the contract) should be

eliminated. Although the 10-10 rule is not codified under current statutory or GAAP pronouncements, the insurance industry, accounting profession and the actuarial community routinely follow it.

Application of the Risk Transfer Test

172. The contract is an excess of loss treaty for general liability insurance. All the losses occurred in the year in which the contract is in force will be reimbursed within the seven following financial years.

Contract terms

1 000 000 per loss and per occurrence in excess of 1 000 000

Lump-sum annual premium: 2 000 000

Commissions: 15%

Remarks

Loss ratio: it is reasonably possible that the ultimate loss ratio on the contract could range from 75% to 120% of premiums ceded.

Payment pattern: the payment pattern could vary; the majority of claims may be paid within the 2nd or 3rd year or later. It is reasonably possible that payments may be made in three payment speeds (slow, medium, fast) under each possible ultimate loss ratio.

To determine whether there is a “significant risk transfer” the three following steps of the test should be performed:

1st step: Is there any uncertainty on the ultimate amount of payments due under the contract (has the underwriting risk been transferred)?

Yes. The contract has reasonable potential variability in the amount of losses. In fact, these could vary from a minimum of 1 500 000 (annual premium multiplied by a 75% loss ratio) up to a maximum of 2 400 000 (annual premium multiplied by a 120% loss ratio). The contract does not envisage any other clause limiting the variability of the maximum amount of the loss to be borne under the treaty.

2nd step: Is there any uncertainty on the timing of payments to the ceding undertaking? (has the timing risk been transferred?)

Yes. The contract envisages a payment pattern of seven years. The majority of losses could be paid in the first few years as well as in the last ones. No provisions in the contract limit the timing of payments.

3rd step: Does the reinsurer have a reasonable possibility of a significant loss resulting from the treaty?

This can be verified by determining the present value of the expected cash flows at the date when the contract becomes effective and by applying a number of different assumptions on the loss ratio and the pattern of payments. There is no strict bright line number to determine

what constitutes a “reasonable possibility”. However, in some accounting guidance, it is defined as more than “remote”. To explain more clearly we quote a concrete example based on the assumption of a loss ratio of 120% and a medium speed of reimbursement of losses.

Assessment of the possible loss borne by the reinsurer
The premium has been paid in advance at the first day of contract period; loss payments have been made on 31st December of each financial year.

Insurance Component Assumptions - loss ratio: 120%;

- payment pattern (medium speed of payment):

Year 1	10%
Year 2	20%
Year 3	30%
Year 4	20%
Year 5	10%
Year 6	6%
Year 7	4%
	100%

Financial ComponentAssumptions - The interest rates applied are those established by public bodies.

CASH FLOWS

Years	1/1/X1	31/12/X1	X2	X3	X4	X5	X6	X7	Total
	2 000 000								2 000 000
Premiums									
Commissions	(300 000)								(300 000)
Loss payments		(240 000)	(480 000)	(720 000)	(480 000)	(240 000)	(144 000)	(96 000)	(2 400 000)
TOTAL	**1 700 000**	**(240 000)**	**(480 000)**	**(720 000)**	**(480 000)**	**(240 000)**	**(144 000)**	**(96 000)**	**(700 000)**
PRESENT VALUE OF CASH FLOWS									
Assumed rates	0	3.5%	4.4%	4.9%	5.4%	5.9%	6.0%	6.4%	---
Present Value	**1 700 000**	**(231 884)**	**(440 393)**	**(623 744)**	**(388 937)**	**(180 190)**	**(101 514)**	**(62 184)**	**(328 846)**

Potential loss borne by the reinsurer

Total present value of payments by the reinsurer (328 846) = (16.4%)

Total present value of payments by the ceding company

(gross of commissions) 2 000 000

The example shows that the sum of the present value of all future payments amounts to a loss to the reinsurer of 328 846. This sum, compared to the value of the advance premium of 2 000 000 (gross of commissions), determines the potential loss to which the reinsurer is exposed, which in this example is 16.4%. This percentage has been judged significant by US authorities.

Given that it is reasonably probable that the reinsurer may realise a significant loss arising out of the treaty, we may say that the contract has got through the 3rd step of the test.

Finally, since all the three steps of the test have been passed, the contract can be recorded in the accounts as a reinsurance treaty.

It should be noted that in case B described in Annex 1, the treaty does not pass any of the three steps of the test.

However, in practice it is very difficult to apply this test because its application rests upon valuations and assumptions that might strongly influence the results.

173. Moreover there is the need to establish a minimum threshold to assess when the potential loss to be borne by the reinsurer becomes significant. US trade associations have not established this threshold, yet in normal practice they deem it acceptable, for insurance purposes, that a contract, at the end of its multi-year term, may realise a total loss of at least 10% of premiums ceded.

174. When a company tries to circumvent the method by adding a reinsurance cover to the cosmetic cover, the two covers should be examined separately.

175. It is also necessary to issue specific guidelines on the accounting treatment of items relating to treaties that do not meet the requirements of the above-mentioned test. In the US these items must be recorded as deposits with reinsurers.

176. Finally it is important to underline that before applying the said test or making any valuation on a treaty it is always necessary to gather exhaustive documents on the contract. The experience of supervisors has shown that the ceding company itself and the auditors sometimes have difficulties in obtaining such documents.

177. The other elements of risk, including credit risk or yield risk, are inherent in most reinsurance arrangements, and result in a reduction in investment income to the reinsurer as an effect of the accelerated loss payments. There is no defined quantitative level of risk transfer that must be met before the transaction can be accounted for as reinsurance. The language in SSAP No. 62 requires only that the reinsurer assume significant insurance risk (i.e., underwriting and timing risk) and that a reasonable possibility exists that the reinsurer, in so doing, may sustain a significant loss from the transaction. The determination of what amount of risk is “significant” is to be made on a case-by-case basis by the regulator. The term “reasonably possible” is defined as any probability that is “more than remote.”

178. One jurisdiction has specific guidance concerning low frequency and high severity risks: “In order to assess a contract for sufficient risk transfer, combination of greater than 120% loss ratio possibility on a discounted basis and a reasonable man approach to assessing probability. Are the events giving rise to a maximum loss so remote that a reasonable man would not expect them to possibly occur and therefore not purchase?”

179. In the simplified illustration that follows, if the probability of a loss ratio of 100% or higher on the business reinsured does not illustrate a greater than "remote" possibility one would have to conclude that the transaction does not transfer sufficient risk to the reinsurer to warrant reinsurance accounting treatment.

Simplified Illustration of Cash Flow Analysis
Assumptions:

• Ultimate loss ratio will be no lower than 75% and no greater than 125%

• $5,000,000 premium less 20% ceding commission will be paid at inception

• Interest rate = 5%, compounding annually

• Paid losses will be recovered from the reinsurer at the end of each year as follows:

Year 1	20%
Year 2	35%
Year 3	20%
Year 4	15%
Year 5	10%
	100%

Cash flows @ 75% loss ratio

	Paid Losses					
Net Premium:	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
$4,000,000	($750,000)	($1,312,500)	($750,000)	($562,500)	($375,000)	($3,750,000)
Present Value						
$4,000,000	($714,286)	($1,190,476)	($647,878)	($462,770)	($293,822)	($3,309,232)

Gain/(Loss) to Reinsurer: $4,000,000 – $3,309,232 = $690,768 = 17% gain

Cash flows @ 100% loss ratio

	Paid Losses					
Net Premium:	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
$4,000,000	($1,000,000)	($1,750,000)	($1,000,000)	($750,000)	($500,000)	($5,000,000)
Present Value						
$4,000,000	($952,381)	($1,587,302)	($863,838)	($617,027)	($391,763)	($4,412,311)

Gain/(Loss) to Reinsurer: $4,000,000 – $4,412,311 = ($412,311) = 10% loss

Cash flows @ 125% loss ratio

	Paid Losses					
Net Premium:	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Total**
$4,000,000	**($1,250,000)**	**($2,187,500)**	**($1,250,000)**	**($937,500)**	**($625,000)**	**($6,250,000)**
Present Value						
$4,000,000	**($1,190,476)**	**($1,984,127)**	**($1,079,797)**	**($771,284)**	**($489,704)**	**($5,515,388)**

Gain/(Loss) to Reinsurer: $4,000,000 – $5,515,388 = ($1,515,388) = 38% loss

180. In determining whether reinsurance accounting is allowable, it should be noted that in certain instances the business covered by the reinsurance agreement might be inherently profitable. As long as the provisions of the reinsurance agreement place no limitations on the obligations of the reinsurer, (i.e., the reinsurer's underwriting result can be expected to mirror that of the ceding company) commission impact aside, it would be appropriate to allow reinsurance accounting.

Risk Transfer – Life & Health Reinsurance

181. For life and health reinsurance, the evaluation of risk transfer is quite different from that for property/casualty reinsurance. SSAP No. 61 in the NAIC Accounting Practices and Procedures Manual, Deposit-Type and Accident and Health Reinsurance, requires a transfer of significant risks inherent to the business reinsured. The regulation does not address the probability of loss to the reinsurer at all in defining transfer of risk. "Significant risks" are defined with reference to a table of risks and contract types. The examiner should consult SSAP No. 61 for details concerning the evaluation of risk transfer for life and health reinsurance arrangements. The SSAP specifically prohibits the use of side agreements, which differs from the property/casualty treatment of side agreements.

182. Some jurisdictions have indicated that there are issues concerning finite life reinsurance contracts. If there is no transfer of risk, life reinsurance contracts should be

accounted for as financing contracts. But since the type of risk and amount of risk transferred is not defined in all jurisdictions, in practise life reinsurance contracts are accounted for within reserve calculations regardless of type or amount of risk transferred.

183. In some jurisdictions, there are no specific requirements for disclosure of finite risk contracts. The balance sheet may also be presented net of reinsurance for life business and gross of reinsurance (i.e. receivable from reinsurer is reported as an asset as opposed to negative liability) for non-life business.

184. For life reinsurance, the public financial reporting disclosure requirements in some jurisdictions are as follows:

- the extent to which actuarial liabilities have been reduced by reinsurance ceded
- amounts of significant concentration of reinsurance coverage
- a statement that reinsurance does not relieve the insurer of primary obligation to insured.

Appendix VI - Examples of supervisory approaches to finite reinsurance

185. A number of responses were received from various jurisdictions to an IAIS questionnaire sent to members of the Reinsurance and Other Forms of Risk Transfer Subcommittee concerning the supervisory approaches to finite reinsurance, which are summarised in this appendix.

One jurisdiction gave the following response:

186. In accordance with FRS 5, the economic substance of a reinsurance transaction should be reflected in the result for the year and the balance sheet.

187. A key characteristic of reinsurance is the transfer and assumption of significant insurance risk. There will be no transfer of insurance risk where the contract provides for the reinsurer to receive no more than a lender's rate of return under all reasonably possible scenarios. The assessment as to whether there has been a significant transfer of risk should be made having regard to the timing of all cash flows anticipated under the contract and any related contract.

188. The insurance risks relating to a long-term reassurance contract include mortality, morbidity, investment, persistency and expenses risks.

189. The insurance risks relating to a general reinsurance contract may consist of either or both of underwriting risk and timing risk.

190. In considering whether or not a significant transfer of insurance risk has taken place, the entity should consider first whether it is reasonably possible that the reinsurer may realise a significant loss from the contract and secondly whether there is reasonable possibility of a significant range of outcomes from the contract. Insurance risk will not have transferred unless both of these conditions exist. 'Significant' should be assessed in the context of the commercial substance of the contract or contracts being evaluated as a whole, and should be judged with reference to the range of outcomes that would reasonably be expected to occur in practice.

191. The assessment as to whether significant insurance risk is transferred should be made prospectively at the time the contract is entered into. The method of accounting should be followed consistently over the whole period of the contract. If there has been a material change in contract terms during the period of the contract, the entity should perform a new assessment of whether or not a significant transfer of insurance risk has occurred.

192. Ireland is proposing to use two contractual provisions similar to that used in the U.S. in addition to those listed. The similar provisions are:

i. The agreement shall constitute the entire agreement between the parties with respect to the business being reinsured there under and that there are no understandings between the parties other than as expressed in the agreement; and

ii. Any change or modification to the agreement shall be null and void unless made by amendment to the agreement and signed by both parties.

193. Ireland is also proposing other mandatory policy conditions such as:

i. Certification that the cedant has discussed the transaction with the company's Auditor who is satisfied the purposed accounting treatment reflects the substance of the transaction; and,

ii. Certification that the cedant has discussed the transaction with relevant authority that supervises the company, and that the Supervisor is satisfied with the appropriateness of the transaction and the purposed accounting treatment of such. They will also be drafting conditions that attempt to tackle the following situations:

- where a subsequent policy is issued to the cedant the purpose of which is to mitigate or in any way offset the financial effects of the first policy
- where there is a multiplicity of contracts to various parties which if accounted for together to reflect the true substance, but different when accounted for individually in their legal form. Some jurisdictions do not require such certification
- a "fronted" contract, where the cedant and the retrocessionaire could potentially enter into side agreements unbeknownst to the reinsurer.

U.S. approach

194. Under current U.S. SAP and GAAP accounting and disclosure standards no distinction is made between traditional reinsurance and so-called finite or financial reinsurance arrangements. Despite being characterised by the parties as traditional or finite, a reinsurance transaction either meets the risk transfer and other requirements of SSAP 62 and FAS 113, or it does not. If it does, then the transaction is accounted for as reinsurance. If it does not, it does not receive reinsurance accounting and is accounted for as a deposit. For those finite reinsurance transactions where reinsurance accounting treatment is sought the parties generally take great care to assure that the applicable accounting rules are followed. A common method established by auditors and actuaries that there must exist at least a 10% probability that the reinsurer could sustain a loss of at least 10% of the premium on the transaction (or the so-called "10/10" rule). Transactions that cannot satisfy statutory risk transfer requirements must be accounted for as deposits rather than reinsurance.

195. The US has specific accounting guidance for non-life reinsurance and a model regulation for life reinsurance that are enacted in all jurisdictions:

Current guidance in SSAP No. 62 – Property and Casualty Reinsurance (non-life):

196. In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed by the ceding entity for reinsurance recoverable where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

- The agreement must contain an acceptable insolvency clause
- Recoveries due the ceding entity must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding entity
- The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding entity or from the ceding entity to the reinsurer
- The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis, unless there is no activity during the period. The report of premiums and losses shall set forth the ceding entity's total

loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding entity and reinsurer will be recorded and reported on a basis consistent with this statement.

NAIC Life and Health Reinsurance Agreement Model Regulation requirements:

Section 5. Written Agreements

A. No reinsurance agreement or amendment to any agreement may be used to reduce any liability or to establish any asset in any financial statement filed with the Department, unless the agreement, amendment or a binding letter of intent has been duly executed by both parties no later than the "as of date" of the financial statement.

B. In the case of a letter of intent, a reinsurance agreement or an amendment to a reinsurance agreement must be executed within a reasonable period of time, not exceeding ninety (90) days from the execution date of the letter of intent, in order for credit to be granted for the reinsurance ceded.

C. The reinsurance agreement shall contain provisions, which provide that:

(1) The agreement shall constitute the entire agreement between the parties with respect to the business being reinsured there under and that there are no understandings between the parties other than as expressed in the agreement; and

(2) Any change or modification to the agreement shall be null and void unless made by amendment to the agreement and signed by both parties.

197. Regarding the CEO attestation, supervisors should require that the ceding company and the reinsurer maintain the underwriting files that contain the actuarial analysis supporting the proper risk transfer and accounting procedures. In some instances, the outside auditor or the reinsurance intermediary may be the only place where that information is stored, which makes the analysis of risk transfer more difficult. Simply reviewing the contract terms of an agreement may not be sufficient to determine whether risk transfer has actually occurred. Two reinsurance contracts that have the identical terms and structure might differ in terms of transfer of risk depending on the underlying types of business being reinsured and the assumptions that go into the risk transfer analysis.

198. In the US, which has received the majority of the focus on these transactions, the following regulatory items are being addressed:

Enhanced Disclosure

199. Regulators have indicated that current disclosure requirements are inadequate and should be ameliorated (perhaps even requiring reinsurance intermediaries to provide information concerning the contracting parties). Here is a draft proposal from insurance supervisors concerning additional financial statement disclosure of these agreements:
NAIC Annual Statement - General Interrogatories

Part 2 – Property & Casualty Interrogatories

Current Guidance

Question 7.1

200. Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract which includes a provision which would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions)?

Based on the 2004 filing, 350 out of approximately 2,700 U.S. property and casualty insurers answered, “Yes”. However, some possible misreporting has been noted.
Proposed Additional Guidance

7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes__ No__

Current Guidance: Question 8.1

Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured?

Based on the 2004 filing, 143 U.S. property and casualty insurers answered affirmatively to this interrogatory. Again, possible misreporting has been noted.

Proposed Additional Guidance

9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of current year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of current year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years when the contract is non-cancellable by the reporting entity during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop loss reinsurance coverage;

(d) An unconditional or unilateral right by either party to commute the reinsurance contract;

(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

(f) Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions under approved pooling agreements or to captive insurance companies owned directly or indirectly by the policyholders of the reporting entity that are unaffiliated with,

and/or not controlled by the reporting entity, where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty–five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.

9.3 If yes to 9.1 or 9.2, please provide the following information in a supplemental filing:

(a) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2;

(b) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved; and

(c) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

9.4 Has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

- accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles ("SAP") and as a deposit under generally accepted accounting principles ("GAAP"); or
- accounted for that contract as reinsurance under GAAP as a deposit under SAP?

9.5 If yes to 9.4, explain in a supplemental filing why the contract(s) is treated differently for GAAP and SAP.

REINSURANCE SUMMARY TO GENERAL INTERROGATORY 9 (Part 2 P&C)

SUMMARY OF REINSURANCE CONTRACT TERMS	MANAGEMENT'S OBJECTIVES

FINANCIAL IMPACT

	As Reported	Restated Adjustments	Restated
Assets			
Liabilities			
Surplus as Regards to Policyholders			
Net Income			

If the response to General Interrogatory 9.4 (Part 2 Property & Casualty Interrogatories) is yes, explain below why the contract is treated differently for GAAP and SAP.

REINSURANCE ATTESTATION SUPPLEMENT (IN ADDITION TO THE ABOVE ENHANCED DISCLOSURE REQUIREMENTS)

ATTESTATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER REGARDING REINSURANCE AGREEMENTS SUPPLEMENT

Insurers are required to file a supplement to the annual statement titled "Reinsurance Attestation Supplement" by March 1 each year. The following provides a list of what is required within this filing.

201. The Chief Executive Officer and Chief Financial Officer shall attest, under penalties of perjury, with respect to all reinsurance contracts which the reporting entity is taking credit on its financial statement, that to the best of their knowledge and belief after diligent inquiry:
(I) Consistent with SSAP No. 62—Property and Casualty Reinsurance, there are no separate written or oral agreements between the reporting entity (or its affiliates or companies it controls) and the assuming reinsurer that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract, other than inuring contracts that are explicitly defined in the reinsurance contract except as disclosed herein;

(II) For each such reinsurance contract entered into, renewed, or amended on or after January 1, 1994, for which risk transfer is not reasonably considered to be self-evident, documentation concerning the economic intent of the transaction and the risk transfer analysis evidencing the proper accounting treatment, as required by SSAP No. 62—Property and Casualty Reinsurance, is available for review;

(III) The reporting entity complies with all the requirements set forth in SSAP No. 62—Property and Casualty Reinsurance; and

(IV) The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of SSAP No. 62—Property and Casualty Reinsurance.

202. Any exceptions to the aforementioned shall be disclosed in the attestation and an explanation of the exceptions shall be attached to the attestation.

203. FOR PURPOSE OF FILING U.S. GAAP FINANCIAL STATEMENTS
The Sarbanes-Oxley Act of 2002 requires the following:

"SEC. 302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED.—The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers— (A) are responsible for establishing and maintaining internal controls; (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarise, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and (6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses."

Appendix VII - Reinsurance corporate governance

204. This appendix contains excerpts regarding reinsurance corporate governance which have been taken from the IAIS *Supervisory Standard No. 7: Supervisory Standard on Evaluation of Reinsurance Cover of Primary Insurers and the Security of their Reinsurers* (January 2002).

205. Many global reinsurers have branch or affiliate offices in many countries around the world. It has been noted that the CEO may not be aware of all reinsurance transactions and that some of the questionable transactions have been completed by middle management operating a branch in a particular jurisdiction and may want to enhance the legal entity financial results before divulging those results to the parent company. If the branch manager has the authority to bind reinsurance coverage, then these transactions may not be brought to the attention of executive management without the proper internal controls in place to disclose these transactions.

206. 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.

207. 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 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.

208. Where the risk profile has life insurance attributes, reinsurers' economic capital must allow for the specific risks arising from the reinsurance contract structure. Life reinsurance can include long-term premium guarantees and exposure to selective options, either in the contract with the cedant or in the contract between the cedant and the policyholder. Long-term premium guarantees expose the business to adverse trends. Changes in investment conditions can expose embedded options. These need to be identified, understood and adequately priced, and subsequently monitored and mitigated. Supervisors should expect reinsurers to adopt best market practice to control such risks.

209. In addition, like primary insurers, reinsurers are exposed to a variety of operational risks such as those arising from employees (e.g., mis-management, human error and internal fraud), technology (e.g., technological failure and deteriorating systems), customer relationships (e.g., contractual disputes) and external sources (e.g., external fraud or changes in legal interpretations).

Board of Directors

210. 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.

211. 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
- how the reinsurance programme will be monitored (i.e. the reporting and internal control systems).

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

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

Senior management

213. 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)
- establishing criteria for acquiring facultative reinsurance cover.