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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

STANDARD ON SUPERVISION OF REINSURERS

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Standard on Supervision of Reinsurers

With the adoption at the 2002 IAIS General Meeting of *Principles on Minimum Requirements for Supervision of Reinsurers,* insurance supervisors around the world are expected to supervise reinsurers headquartered in their jurisdictions.

Furthermore, the principles anticipate a global approach to the regulation of reinsurers. In such a system, the onus is placed on the home supervisor of the reinsurer. The home supervisor is responsible for effective supervision of the business worldwide and is responsible and expected to communicate effectively with supervisors in other jurisdictions where the reinsurer writes business. Minimum requirements help define a minimum level of acceptable security of reinsurers. These are needed to ensure that market stability and ultimately the interests of policyholders are protected. As stated in the Supervisory *Standard on the Evaluation of the Reinsurance Cover of Primary Insurers,* however, it is the responsibility of the ceding insurer to evaluate the security of proposed reinsurers and the duty of that ceding insurer's supervisor to ensure that the evaluation is adequate.

The principles state:

Principle 1: Regulation and supervision of reinsurers' technical provisions, investments and liquidity, capital requirements, and policies and procedures to ensure effective corporate governance should reflect the characteristics of reinsurance business and be supplemented by systems for exchanging information among supervisors.

Principle 2: Except as stated in Principle 1, regulation and supervision of the legal forms, licensing and the possibility of withdrawing the license, fit and proper testing, changes in control, group relations, supervision of the entire business, on-site inspections, sanctions, internal controls and audit, and accounting rules applicable to reinsurers should be the same as that of primary insurers.

This standard elaborates on Principle 1, focussing particularly on where reinsurers differ from primary insurers, hence requiring the supervisory framework to be adapted. The standard applies to internationally active reinsurers that are pure reinsurers or insurers, whose main activity includes the issuance of reinsurance coverage, having cedents in at least one jurisdiction outside their own. The standard also applies to domestic reinsurers to the extent that it is relevant.

Supervisory requirements include **financial strength**, **supervisory review** and **disclosure requirements**. These different aspects of the supervisory framework must be adapted according to the nature of the customers and the characteristics of the risks assumed. As stated in paragraph 7 of the *Principles on Minimum Requirements for the Supervision of Reinsurers* a global supervisory framework envisages a system of accreditation of home supervisors. This paper is the first step in the evolution towards an accreditation system.

This standard focuses on the supervisory review aspect of the framework. As stressed in the *Insurance Core Principles*, effective supervision can only be accomplished if home supervisors have adequate powers and resources. The role of the supervisory review process

is especially significant for home country supervision, particularly in the absence of international standards for financial strength requirements. In this regard the IAIS Solvency Subcommittee, with input from the International Actuarial Association, is developing the various components of a harmonised international approach to assessing solvency and capital adequacy.

Disclosure aspects will be addressed by the IAIS Subcommittee on Enhanced Disclosure in their [draft] standard, *Standard on Disclosures Concerning Technical Performance & Risks for Non-Life Insurers & Reinsurers* and subsequent standards. Due to the professional nature of the customers, disclosure should improve market discipline and thus provide an important adjunct to supervisory review. In order to facilitate market discipline financial statements of internationally active reinsurers should be prepared using internationally accepted accounting principles such as IFRS or US GAAP, and should be publicly available.

In supervising internationally active reinsurers, home supervisors should refer, where appropriate, to the *Insurance Core Principles* and related documents for guidance in areas not covered in this standard.

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I. Technical provisions

Technical provisions for non-life reinsurers

1. The estimation of provisions, including loss provisions, is an inherently uncertain process as it attempts to reliably give an insight into future claims emergence. This uncertainty may be more pronounced in reinsurance than in primary insurance, particularly for non-life business.

2. The challenges reinsurers may face when setting technical provisions include:

- Developing reserves – for example, when costs of claims, particularly for excess of loss contracts, are driven up by inflation or more stringent liability laws
- Longer reporting lags – there is an inherent delay because loss occurrences are first reported to and evaluated by the cedent. This can sometimes be exacerbated by a periodic notification interval to the reinsurer and by the retrocession process.
- Heterogeneity of reinsurance concepts between reinsurer and primary insurer and reinsurer and retrocessionaire

- Scarcity of industry data and statistics – homogenous data is difficult to collect by account and by industry
- Heterogeneity of data received – cedents may pay, provision and code information differently
- Selective cedent information – cedents may filter data provided to reinsurers, report on a different basis (e.g., by accident year instead of underwriting year), change their claims handling and reserving practices or make errors in data transmission
- Differing patterns in reporting information - patterns can differ depending on contract type, line of business, specific contract conditions, cedent and intermediary

3. Recognising that there may be delays in the claims reporting process and that information may often be incomplete, reinsurers establish provisions for claims incurred but not reported (IBNR) or incurred but not enough reported (IBNER). Administrative arrangements should be such that cedents provide reinsurers relevant and timely information on an ongoing basis so that the extent of possible claims can be anticipated and reliably estimated. For example, for an excess of loss contract a reinsurer should require the cedent to report accumulated losses when they reach a certain level; this level should be set below the trigger level in the contract.

4. Along with its annual audited financial statements that should include adequate disclosures concerning technical performance and risks, a reinsurer should provide detailed information for each line of business to the home supervisor upon request. For internationally active reinsurers this information should be supplemented by an actuarial opinion on the adequacy of the technical provisions.

5. Supervisors should understand the techniques used by reinsurers and their actuaries in setting technical provisions with specific focus on those used to arrive at IBNR and IBNER. The IAIS discussion paper, *Quantifying and Assessing Insurance Liabilities*, provides useful background material.

General issues

6. Reinsurers have developed a number of techniques to deal with the general challenges of estimating technical provisions. For example, they use a variety of quantitative techniques, including models, to estimate the ultimate cost of claims. These techniques, however, must be supplemented by professional and managerial judgment, using in-house or outside experts in both risk and claims assessment. Figures and information received from cedents and reinsurance brokers should be checked against empirical data. Reinsurers should provide an explanation if a claim provision is not at least as high as the amount communicated by the cedent or broker. There must be close cooperation between at least the reinsurer's underwriters, actuaries, claims managers and accountants.

7. The contract between the cedent and reinsurer lays down the terms and conditions to be followed by both parties, specifying for example, the length of the contract, premium payments, commissions, claims reporting time frames and claims payment terms and time frame. Nonetheless reinsurers should communicate with their cedents and their brokers frequently. Relationships are essential for reinsurers understanding the risks undertaken by particular cedents and overall developments in the marketplace. Ongoing communication

should be maintained throughout the contracts so that reinsurers can react properly to changes in claims development patterns and other factors.

8. Reinsurers should have an in depth knowledge of the underwriting policy and the claims handling procedure of cedents. This can be obtained by collecting detailed information from cedents on a regular basis in pre-arranged formats. The contract terms between the reinsurer and cedent therefore often provide that the reinsurer has the right and ability to conduct claims audits of the cedents.

9. In addition reinsurers need to monitor market conditions and follow industry and societal trends. They should be particularly concerned about counterparty credit risk. They should develop indicators based on past experience and expectations of inflation and more stringent liability laws. Reinsurers should follow claims payments developments to be able to identify changes or anomalies early.

10. The home supervisor should review this information, assessing it against past trends and where possible against similar information provided by reinsurers of a similar size or in a similar market. They should also review run off results and claims development triangles, as well as the reinsurer's scenario analyses and sensitivity and stress testing, which should include effects from each line of business on all relevant balance sheet items.

11. The home supervisors should have the ability to review and challenge information provided by reinsurers, particularly when they suspect problems. This capability can either be provided by in-house staff or by contracting out as long as confidentiality requirements are respected.

12. In addition to understanding the techniques, the home supervisor should review the procedures used by the reinsurers to verify the results and to compensate for information delays and weaknesses in the data.

II. Investments and liquidity

13. Internationally active reinsurers operate in more than one market, managing global portfolios of assets and liabilities. Mismatches between assets and liabilities imply potentially significant exposure to market, interest rate or currency risk. For example, life reinsurers, as well as liability reinsurers, may face investment risk depending on the terms of the reinsurance contract.

14. Reinsurers should manage their assets and liabilities in a prudent manner taking into account their capital and overall financial situation. Reinsurers should invest in assets that in terms of security, return, diversification and marketability are sufficient to cover their obligations as they fall due. Assets pledged, or may potentially be pledged, to counterparties are to be taken into account in this respect and to be periodically matched to liabilities.

15. Often reinsurers and cedents work with current accounts where premiums are deposited into an account and funds to pay claims come from that account. However, because of the types of coverage provided (e.g., catastrophe coverage) reinsurers are sometimes obliged to reimburse large-scale losses of cedents on demand.

16. As a result they should ensure that they maintain sufficient investments in liquid financial assets. Alternatively, they should ensure that liquidity is easily and readily accessible through other means, such as secure lines of credit, in order to pay large and unexpected losses without having to sell investments during a period of adverse market conditions or at short notice.

17. Reinsurers should apply well thought out asset-liability matching policies that are subject to stress testing and scenario analysis at regular intervals. The scenarios tested should adequately reflect the unique risk profile of the reinsurer. For example, internationally active reinsurers should test the part of their investment portfolio, which is not matching liabilities, against changes in interest and exchange rates. Stress testing and scenario analysis should also be used in relation to market and credit risk in general, including credit insurance and reinsurance recoverables. The supervisor should assess capital adequacy, liquidity and currency matching in light of the results of the stress testing.

18. Along with the annual audited financial statements, the home supervisor should receive reports concerning investment performance and risks from reinsurers. Upon request a breakdown of the investment portfolio by asset and rating class and currency should be provided. Reinsurance recoverables are considered as an asset class in this respect. Derivatives are to be reported according to their underlying assets and be supplemented by information on their notional amounts and fair value. Reinsurers should indicate what proportion of its asset portfolio has been pledged to primary insurers or other counterparties.

19. The home supervisor should analyse this information over time and compare it to similar information provided by reinsurers of a similar size or in similar markets. The supervisor should then discuss the results with the reinsurer focusing specifically on key risks and how they are being managed and matched.

20. The home supervisor should be aware that because reinsurers' premiums are collected in advance, a negative cash flow could be an indication of problems in the reinsurance portfolio. Accordingly they should monitor this aspect requesting explanations where necessary. Sometimes there are legitimate reasons for a negative cash flow, e.g., when a reinsurer is reducing its business volume in a softening market. There may also be instances where other positive cash flow is available to compensate the negative cash flow.

21. The home supervisors should refer to the *Supervisory Standard on Derivatives* and the *Supervisory Standard on Asset Management by Insurance Companies* for guidance when assessing a reinsurer's investment portfolio, as well as its investment policies, reporting and internal control procedures.

III. Economic capital requirements

22. Even in an efficient market, regulators cannot prevent every failure. Prudential measures such as the establishment of regulatory capital requirements are put in place, however, to minimise the occurrence of such failures and their potential costs to the cedents and possible impact on policyholders.

23. Reinsurers need to hold capital to reflect their volume of business, risk appetite and the volatility of the market. On an individual policy basis reinsurers may assume more volatile risks than primary insurers - for example, by providing coverage for catastrophic events. However, this may be counter balanced by the potential for better diversification on a global portfolio basis. Volatility may be caused by hardening or softening of markets that result in prices varying.

24. Reinsurers should use models for internal management purposes to analyse their risk assumption. Some risks faced by reinsurers are similar to those of primary insurers. Whereas a primary insurer faces the credit risk that its reinsurers may not fulfil their obligations, for example, a reinsurer faces the same risk with its retrocessionaires. Both face underwriting risk, although particular aspects of underwriting risk - such as the risk of cumulations - may be more acute for a reinsurer. Similarly, as noted above, both face investment risks, the significance of which can differ depending on the global reach and lines of business underwritten.

25. In addition, like primary insurers, reinsurers are exposed to a variety of operational risks the sources of which could be employees (e.g., inadequate 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).

26. The reinsurer's risk assumption model should provide estimated loss distribution tables. The board of directors should determine what are acceptable probabilities of default over defined periods and ensure that sufficient capital is in place.

27. Reinsurers should provide information to the home supervisor about their risk profile and agreed upon acceptable probabilities of default. The supervisor should review the risk profile with the reinsurer and, in the case of internationally active reinsurers, monitor whether the probabilities of default level are within the acceptable range for host supervisors, which are relying on his work. The supervisor should monitor the own funds held by reinsurers on a global basis and require that the capital adequacy models be subject to periodic stress tests and scenario analysis.

28. The supervisor should have the capability either by using in-house staff or contracting with outside experts (who would be subject to confidentiality requirements) to review reinsurers' models, seeking to ensure that the models adequately reflect the unique risk profile of the business, including whether the business is long-tail or short-tail, as well as the potential for large claims and volatility. Frameworks for establishing economic capital should take into account countervailing factors, such as a prudently diversified reinsurance

book, that could mitigate the extent of overall loses. They should not only consider risks individually but also in total, bearing in mind the effects of dependencies, such as when a reinsurer's investments, its issued financial guarantees and its retroceded risks are with the same counterparty.

29. For reinsurers that are part of a group, models should be designed to prevent double gearing by taking into account intra-group exposures. Economic capital targets should be set for operations in specified areas as well as for the reinsurer as a whole.

30. Market discipline is facilitated when internationally active reinsurers, or their holding companies, are rated. The supervisor may wish to discuss the basis for the rating with the rating agency and should have access to the information disclosed to the rating agency by the reinsurer. If a reinsurer loses its investment grade rating, it should be subject to immediate focused supervisory attention.

IV. Risk management and corporate governance

31. Corporate governance refers to the manner in which boards of director and senior management oversee the business and affairs of the reinsurer. In particular, their responsibilities include establishing and maintaining policies and procedures regarding risk management and internal controls and ensuring that the reinsurer complies with the statutory and supervisory obligations imposed on it.

32. Reinsurers should have appropriate policies and procedures covering:

- *Underwriting*
  Policies should be in place identifying the lines of business and types of risks to be assumed by the reinsurer in each location. Appropriate procedures for implementing and monitoring the policy should be established. The underwriting guidelines should, where appropriate, require the reinsurer to obtain sufficient information on the cedents with whom it deals to assess their integrity, management and business policy.

- *Accumulations (storm, quake, flood, hail and man made disasters)*
  The reinsurer should identify, monitor, and measure any concentration of risk on the underlying lines of business and on the portfolio due to one and the same event. It should set limits on the whole portfolio and, where appropriate, per line of business to cap the effect of a situation where several lines are hit by the same event.

- *Catastrophes*
  Where necessary, there should be risk assessment models for catastrophes and supervisors should have the capability, either with in-house staff or by engaging external experts (who are subject to confidentiality requirements), to assess the controls over a reinsurer's catastrophe exposures.

- *Provisioning*

Reinsurers should have policies and procedures in place for establishing technical provisions. They should address the specific challenges faced by reinsurers, particularly with respect to establishing IBNR and IBNER provisions.

- *Retrocession (cover and security)*
  Like primary insurers, reinsurers should define and document their strategy for retrocession management, identifying the procedures for:
  - the retrocession to be purchased
  - how retrocessionaires will be selected, including how to assess their security
  - what collateral, if any, is required at any given time
  - how the retrocession programme will be monitored (i.e. the reporting and internal control systems).

  The retrocession policy should take into account that there may be situations where the reinsurer finds itself unable to place retrocession with a retrocessionaire with an acceptable level of security.

- *Policy conditions*
  The reinsurer should identify, monitor and control any special policy conditions, such as aggregates, that will affect the amount recoverable from a retrocessionaire.

- *Investments*
  A reinsurer's investment policy should reflect the global nature of the business and specifically deal with asset/liability matching, asset diversification, liquidity, and cash flow, considering the group structure. It should identify approved investments, set limits by asset class, describe what assets are considered to be suitable matches for different lines of business and how various risks will be managed - for example, what the reinsurer does to manage currency risk when it insures risks in several countries. The investment policy should have concentration limits, such as limits for investments in companies or groups and limits on investments in particular industry sectors. The reinsurer should have procedures in place to monitor and control its investment policy against the limits approved by the management board and within regulatory constraints, if any.

33. Corporate governance includes the setting of clear objectives, establishment of strong guidelines, regular reporting, control and auditing. Like primary insurers, reinsurers need to have, or have access to, qualified staff, including experienced underwriters, claims specialists, accountants and actuaries.

34. The home supervisor should review the reinsurer's corporate governance policies and procedures, including its system of internal controls, to ensure that they address the nature of the risk undertaken.

V. Exchange of information

35. The home supervisor of an internationally active reinsurer has the duty to communicate with supervisors in the jurisdictions in which the reinsurer is active and who are relying on the work of the home supervisor. At the request of the supervisor in the host jurisdiction, the

home supervisor should provide relevant financial and other supervisory information, as well as objective information on individuals holding positions of senior responsibility in the reinsurer.

36. A formal agreement, while desirable, is not always a prerequisite for sharing information. However, supervisors in host jurisdictions who receive confidential information from the home supervisor must agree to keep the information confidential.

37. The home supervisor should inform supervisors in host jurisdictions of any material changes in supervising a reinsurer that have a significant bearing on the operations of the reinsurer. In particular the home supervisor should inform the supervisor in the relevant host jurisdiction when withdrawing a license or taking action that will affect the operations of the reinsurer in that jurisdiction.

38. Equally, supervisors in the host jurisdiction should inform the home supervisor of any material circumstances or concerns that could affect the reinsurer.

39. The *Supervisory Standard on the Exchange of Information* sets out the conditions that should apply when insurance supervisors exchange information. In addition, supervisors may wish to refer to the *OECD: Decision on the Exchange of Information on Reinsurers, C(2002)134.* Where memorandums of understanding or multilateral agreements exist, these should be extended to cover reinsurers.

40. The IAIS database on reinsurers supports the exchange of information by providing data on reinsurers in different jurisdictions. Members can obtain information on whether a reinsurer is licensed and supervised in another country or review its annual accounts over a number of years. When using the database, members should be aware that the completeness and accuracy of the information is dependent on members' efforts, and when in doubt should contact the relevant supervisor directly for validation.

41. Exchange of information should not be limited to company specific information. Through discussions supervisors learn from each other's experiences. For example, a supervisor may learn about new approaches to estimating technical provisions for catastrophes from another supervisor facing similar risks.