

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS



DISCUSSION PAPER ON THE MUTUAL RECOGNITION OF REINSURANCE SUPERVISION

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This document was prepared by the Reinsurance Mutual Recognition Subgroup in consultation with IAIS Members and IAIS Observers.

The following members have contributed material or otherwise assisted with the drafting of this paper: Australia, Belgium, Bermuda, Canada, Europe, Germany, Guernsey, Hungary, International Monetary Fund (IMF), Ireland, Japan, Singapore, Spain, Switzerland, United Kingdom and The United States of America, in addition a number of observers provided helpful comments.

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Discussion Paper on the Mutual Recognition of Reinsurance Supervision

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1. Mission¹

1. The mission of the IAIS Reinsurance Mutual Recognition Subgroup of the Reinsurance and Other Form of Risk Transfer Subcommittee is to facilitate reinsurance by fostering the development of a framework for an efficient and effective international supervisory system. The framework should be sufficient to allow supervisors to mutually recognise the quality of the supervision exercised by one another in their respective jurisdictions and thus possibly remove or alleviate unnecessary regulatory and supervisory requirements for reinsurers in the host jurisdiction to the extent the home jurisdiction already applies and enforces equivalent regulation.

2. To this end the Subgroup should identify the minimum requirements or standards that supervisors might want to consider for the essential coordination of reinsurance regulation and supervision in a jurisdiction sufficient to allow mutual recognition and thereby further strengthen cooperation and trust between reinsurance supervisors.

2. Structure and nature of the reinsurance industry

3. Reinsurance is one of the most important risk mitigation tools for insurers. Through risk diversification and more efficient use of capital, the transfer of risk to reinsurers can provide significant economic benefits for primary insurers and their policyholders.

4. Natural catastrophes like severe storms and earthquakes are among the large risks for which reinsurance companies provide protection. Risk diversification is an important element of such business. A risk based supervisory approach should hence facilitate a spreading of reinsured risks which could result in increased diversification, even global diversification. It is therefore a logical aim for risk based (re-)insurance supervisors to remove unnecessary barriers which could hinder a cross-border global diversification of reinsured risks.

5. Currently reinsurance companies and markets in Bermuda, France, Germany, Ireland, Japan, Switzerland, the UK and the USA provide approximately 90% of worldwide reinsurance capacity. This concentration of supply is unsurprising, since the economics of reinsurance business rely on the law of large numbers, leading to a relatively small number of relatively large reinsurance enterprises. Therefore, one would expect what is actually observable on the reinsurance market: a relatively small number of well-diversified firms provide large amounts of capacity. Many of these large reinsurance groups operate a structure whereby they have local operating subsidiaries in a number of countries around the world, which in practice retain very little risk. In order to achieve sufficient levels of business and geographic diversification, the risk within the group is then pooled by means of internal retrocession to a central group entity.

¹ The basis for the text on the mission of the IAIS Reinsurance Mutual Recognition Subgroup is taken from the IAIS Website (www.iaisweb.org) - cf. folder for Members of the Subgroup.

6. A logical consequence of the above is that cross border risk transfer takes place, both within and between insurance groups. Geographic concentration of supply means that many insurers have to go outside their jurisdictions to place reinsurance cover, whilst reinsurers' business models often rely on internal retrocession to a central group company based in a jurisdiction other than that of the operating subsidiaries.

3. How the industry is currently supervised

7. Standards and practice in reinsurance supervision differ significantly between jurisdictions, with approaches varying from direct supervision of reinsurers, supervision through cedants, and, in some cases, little or no regulation of reinsurance activities. One should note that recently a convergence has occurred regarding reinsurance regulation and supervision among key jurisdictions.

8. Regulation can either be specific to reinsurers, or an adapted version of that which is applied to primary carriers, taking into account the fact that the business is conducted between market counterparties, and therefore there is relative equality of knowledge and expertise, although there remains information asymmetry between counterparties. Whilst precise modes of supervision vary, supervisory objectives are normally similar, revolving around ensuring that there is confidence in reinsurers' ability to meet their obligations, and achieving an appropriate degree of protection for customers of ceding companies.

9. Taking into consideration the fact that some major reinsurers operate on a world-wide basis, one of the principal barriers to fully effective supervision of the reinsurance market is that supervision tends to be restricted to legal entities in individual jurisdictions. Although this form of stand-alone regulation is valuable, it does not reflect fully the economic realities of the way in which many reinsurance businesses operate in practice (see above). In particular, stand-alone regulation does not fit well with the model where local risk-gathering subsidiaries are reliant by a variety of means, such as internal retrocession, parental guarantees, etc, on a 'head office' or central entity, normally based in a different country. Supervision of these local entities cannot be fully effective without taking into account the wider risks in the group, whilst supervision of the home entity cannot be fully effective without understanding properly the contagion risk posed by individual overseas subsidiaries or branches. Where a supervisor does attempt to take a global view in such a case, they often create significant additional work both for themselves and for the supervised entities, some of which could be avoided if they were able to recognise and place appropriate reliance upon the work of other supervisors. For the supervision of reinsurance markets (and reinsurers), therefore it is possible to supervise them on a group-wide basis, or to recognise and to place appropriate reliance upon the work of their supervisors.

10. Furthermore many functions - such as risk management, internal audit, etc. - may be performed at the group level rather than within individual entities. In this case, the home supervisor is better able to assess the quality of these functions than supervisors of local entities. This is another example of how supervisors could be more effective and efficient if they supervise reinsurers on a group-wide basis.

11. Some supervisory action currently takes place through cedants, for instance by restricting the circumstances in which they are able to take credit (for solvency or other purposes) for reinsurance cover they have purchased. This can arise where the supervisor of the ceding entity does not believe it is able to place reliance on the work of the (probably overseas) supervisors of the reinsurers, and therefore considers that the most appropriate way to discharge its supervisory obligations is to impose additional conditions (such as a requirement to post collateral) on their entities' reinsurance programmes. Recognition arrangements between countries could relieve administrative and capital allocation costs and better align supervisory methods with the global nature of the industry and the risks that it undertakes.

4. Benefits of mutual recognition

12. There are a number of readily identifiable benefits associated with an effective system of mutual recognition, which, if implemented properly, would serve the objectives of all of the various parties involved. A number of these are outlined below.

13. Reinsurers with cross border operations would be able to comply with relatively common requirements of regulation/supervision, thereby reaping economies of scale and capital savings by a significant reduction in the amount of administrative duplication necessary in order to be compliant with the framework of various host countries. In addition to the cost associated with inefficient capital allocation, compliance costs are a function of the differences in applicable regulations for reinsurers, and are something that might be considered a barrier to market entry. In this sense, a system of mutual recognition can be seen as a mechanism to facilitate market access and, in turn, increase market capacity.

14. As part of a system of mutual recognition, licensing systems could be developed that would more easily facilitate the entry and exit of reinsurers in individual markets, mitigating the administrative costs to supervisors. Regulators can reallocate the resources previously devoted to the redundant control of 'alien' companies and increase their capacity to supervise more effectively those entities domiciled in their jurisdictions, thereby increasing the quality of their work and the reliance which other supervisors can place upon it.

15. The absence of mutual recognition may preclude certain types of international transactions entirely in the sense of cross border operations, by necessitating a physical presence which would otherwise not be necessary. Mutual recognition for the supervision of reinsurance companies could potentially ease the minimum capital requirement for companies ceding business into those in member jurisdictions, thereby minimizing regulatory barriers to the flow of capital between companies in reinsurance groups regardless of jurisdiction.

16. Additionally, reinsurance groups may derive a benefit from mutual recognition as a result of diversification between companies within the group as regulatory barriers are removed and capital can be allocated more efficiently within the group. A further analysis on these circumstances shall be needed.

17. As capital market devices such as cat bonds or side cars continue to offer new mechanisms of risk transfer to the market, and 'new' areas of risk are identified (flu pandemic, terrorism, geopolitical unrest) the proper management or regulatory oversight of business models can be facilitated and enhanced by mutual recognition, in particular with regard to groups with operations in various jurisdictions. The direct benefit would be effective and robust risk management and measurement (valuation techniques, risk-based capital requirements and internal models) on a supervisory level.

18. Global harmonisation will increase transparency and facilitate comparisons across institutions thereby effectively reducing regulatory arbitrage.

19. Supervisors have a responsibility to monitor the solvency of, maintain the efficient, transparent and stable operation of insurance markets. As insurers become more complex and international in nature, the need for supervisors to have methodologies in place to facilitate the exchange of information pertinent to the prudential supervision and regulation of such entities increases.

20. The mutual recognition framework will enable both host and home supervisors to recognise the quality of regulation and supervision in the other's jurisdiction and consequently to remove or reduce unnecessary regulatory / supervisory requirements to reinsurers in those same jurisdictions.

21. To summarise: for reinsurers, the benefits of mutual recognition and the standardisation of regulation and supervision may include:

- reduced compliance costs
- less work in seeking market access (if, for example, licensing systems could be developed that would more easily facilitate the entry and removal of reinsurers to and from the market)
- greater certainty of the regulatory process (i.e. becoming less vulnerable to arbitrary decisions by host countries)
- fewer barriers to entry in new locations (as the benefit of operating in a new location would no longer have to be weighed against the regulatory costs)
- more efficient allocation of capital with the removal of regulatory barriers to the flow of capital between companies in reinsurance groups. A further analysis of these circumstances shall be needed.

22. For insurers the benefits of mutual recognition may include:

- increased access to reinsurance markets (thus potentially increasing their ability to do business and allowing better risk diversification)
- reduces the costs (for primary insurers ceding business in other jurisdictions).

23. For supervisors the benefits of mutual recognition may include:

- lower administrative costs by taking advantage of the comparable supervisory regimes in the countries where reinsurance entities or groups are registered
- more resources available to devote to domestic supervision
- improved collaboration with their counterparts in other jurisdictions
- less regulatory arbitrage.

24. For the insured the benefits of mutual recognition may include:

- facilitated insurance and reinsurance market stability
- increased insurance policy holder protection

5. Possible risks or barriers to mutual recognition

25. Mutual recognition implies both privileges and obligations for jurisdictions. The term mutual recognition can be broken down into its two components so that regulation in one jurisdiction can be relied upon by another jurisdiction. The “recognition” component entails recognition of the “equivalence”, “compatibility” or (at least) “acceptability” of a counterparty’s regulatory system. The “mutuality” component indicates that the recognition is reciprocal.

26. Supervisors contemplating entering into a mutual recognition agreement should consider the risks associated with entering such an agreement, which arise from uncertainties relating to:

- non-existence of complete harmonisation in detailed regulatory requirements between jurisdictions
- specification and limitation of both the purposes of exchange of information and use of information exchanged to insurance supervision
- the observance of principles of materiality
- determination of how the supervisory practices are assessed and how they should be treated by the various jurisdictions.

27. Regulatory compatibility is a function of the degree of convergence across regulatory culture, policies, and standards which affect perceptions of regulatory effectiveness. Differences in risk assessment, scientific evidence, and the goals of regulations, of course, all hinder mutual recognition; although a system based on assessments of broad comparability means that some of these issues can be significantly alleviated.

28. Having sufficient supervisory resources is also a key issue for mutual recognition. Information and regulatory exchange are not free. Where supervisors are already overburdened, they may not take the time, *ex ante*, to engage with their foreign counterparts or, *ex post*, to review information. Supervisors must also hold the resources necessary to make mutual recognition work over time. The extent to which these additional resources are necessary should be offset over time by a reduction in duplication of effort, but that does not mean that this is not an important issue for some supervisors.

29. Of equal importance is the extent to which supervisors are held to account for their conduct (or lack thereof) and therefore the extent to which they feel they can have confidence in the work of counterparties over whom they have no control.

30. Supervisors should start by asking the question: On what common basis can legal, regulatory and political systems interact without merging into one; in other words, how do they decide what are legitimate differences between them? In order to give effect to this general principle, supervisors adopt mutual recognition as a contractual form whereby they may agree to “swap” jurisdictional authority among themselves, or may simply choose to place a greater degree of reliance on each other’s work than they otherwise would.

31. There are a number of specific technical issues which need to be considered when designing a system of mutual recognition for the reinsurance industry. For example, the potential impact of different internationally recognised accounting standards might be significant in relation to comparability of technical provisions, and jurisdictions have different approaches to the treatment of equalisation reserves. Issues such as these would need to be considered by supervisors as part of the establishment of any mutual recognition agreement, bearing in mind once again the need to ensure broad comparability while maintaining minimum standards rather than exact equivalence in all circumstances. At the same time it should be considered that such broad comparability is a sufficient criterion to rely on other supervisors.

32. Aside from these relatively technical issues, there are broader questions about, for instance, expected standards of risk management and corporate governance, which will also vary significantly from jurisdiction to jurisdiction, and again supervisors will need to form a view as to the broad comparability of their regimes.

6. Possible reinsurance mutual recognition approaches

33. There are a number of different approaches which could be adopted in order to achieve mutual recognition. Mutual recognition is neither restricted to a certain form nor to certain prescriptive contents. Issues which need to be taken into account include the scope of recognition and the evaluation process. This could take place using a variety of *multilateral*, *bilateral* and *unilateral* approaches both before and after entering into a potential agreement. Naturally, a unilateral recognition is not by definition “mutual”, but it can be an option if a host supervisor unilaterally chooses to place reliance on the work of another. This could lead to subsequent negotiations towards a genuine “mutual” recognition if the parties wish to do so.

34. The objectives of mutual recognition can, it would appear, most readily be achieved by fully recognising the jurisdiction of a reinsurer’s home supervisor. This is not, however, always possible for both legal and practical purposes.

35. Nonetheless, both supervisors and internationally active reinsurers can also take profit from some form of partial recognition of supervisory regimes. For example, recognition could be restricted to reporting requirements or to financial supervision, thus alleviating both supervisory work and - from the reinsurer’s perspective - administrative burdens to some extent. Furthermore a gradual extension of the scope of recognition may allow parties to intensify and deepen cooperation and mutual trust on a step-by-step basis.

36. Whatever the intended scope of recognition may be, communication between supervisors and the exchange of information, typically based on a Memorandum of Understanding, prior to or as part of a mutual recognition agreement is the inevitable starting point for efforts towards mutual recognition.

37. Supervisors should start by asking the question: On what common basis can legal, regulatory and political systems interact without merging into one; in other words, how do they decide what are legitimate differences between them? In order to give effect to this general principle, supervisors adopt mutual recognition as a

contractual form whereby they may agree to “swap” jurisdictional authority among themselves, or may simply choose to place a greater degree of reliance on each other’s work than they otherwise would.

38. In order to achieve an effective system of mutual recognition supervisors will need to determine a means by which they can continually evaluate each other’s work, and the extent to which they comply with a set of minimum standards. Supervisors should seek to establish that their counterparties’ work is *broadly comparable* with their own, rather than seeking exact equivalence in all aspects.

39. The first and most obvious way to evaluate whether a foreign jurisdiction can be deemed reliable is the own judgement by parties on a multilateral, bilateral or unilateral basis. Such judgements would be easier to make between jurisdictions where regulatory regimes are relatively similar, but the same principle applies more globally. Further advantages of this option are a potentially fast, efficient and unbureaucratic judgement process, an intensified communication prior to signing a mutual recognition agreement and the opportunity for a detailed identification of areas where duplication of efforts can be avoided or where additional effort is needed to place reliance on the home supervisor.

40. This approach may require a degree of cultural change in certain jurisdictions, in order to ensure that there is recognition of the broad approach of other supervisors, notwithstanding the absence of exact equivalence in all areas.

41. If supervisors wish to utilise an objective judgment by international organisations, such as the periodic country assessments by the International Monetary Fund (IMF) or the World Bank, they are free to do so.

42. This may not prove to be effective on a standalone basis because of the necessarily limited scope under which the IMF and the World Bank typically assesses supervisory regimes. A full reliance on the IMF as trusted third party or on any other third party places some restraints on the intensity and on the level of detail parties of a mutual recognition agreement may wish to apply to the envisaged recognition process. Therefore it is likely that the judgements and opinions of the IMF and others could be most effectively considered in the course of a mutual recognition process as a supplement or double check to a supervisor’s own opinion.

43. The viability of a mutual recognition process would likely depend on an assessment of the supervisory regime in different jurisdictions. It also may depend heavily on ‘infrastructure’ issues such as the political, legal and operational characteristics of the home regime. Parties of a mutual recognition agreement are therefore free to decide which benchmark they choose to verify a level of prudential supervision appropriate to allow reliance on the home supervisor. This paper includes a proposal for supervisory issues and standards supervisors should evaluate in the course of a mutual recognition requirement. These proposals are based on the existing international work on standards regarding supervision of reinsurers. However, the proposed standards are not seen as necessarily binding for all mutual recognition processes. They are rather to be seen as proposed minimum requirements subject to adjustment or to additional issues or to a higher level of prudence.

7. Next steps and open questions

44. The above quoted mission of the Subgroup is intended to guide the work within the IAIS towards reinsurance mutual recognition. It is hence reasonable to recall that this mission includes the following statements: “facilitate reinsurance by developing an efficient and effective international supervisory framework”, “possibly remove or alleviate additional regulatory and supervisory requirements for reinsurers in that host jurisdiction” and “identify the minimum principles for the essential coordination of reinsurance regulation and supervision in a jurisdiction”.

45. Moreover, it seems to be appropriate at this point to specify the idea of “identifying minimum principles for the essential coordination” among supervisors. First of all such minimum principles should be regarded as a starting position for jurisdictions which aim at recognising each other mutually. Without this option jurisdictions would be forced to develop a framework for their cooperation from scratch individually. The latter is a rather uneconomic procedure. Secondly, however, the IAIS recognises the fact that there could be different appropriate ways for individual jurisdictions towards the aim of reinsurance mutual recognition.

46. On the way towards a global system of mutual recognition the recognition of equivalence between supervisors is a necessary step. Recognition of equivalence would need to reach a position where supervisors were satisfied as to broad comparability of a counterparty’s approach, as opposed to an exact replication of regimes between one jurisdiction and another. In order to facilitate the recognition of equivalence the IAIS could develop a procedural canon. Further steps may include but are not restricted to becoming a signatory of the existing IAIS Multilateral Memorandum of Understanding (MMoU). However, information sharing is only a piece of mutual recognition and reliance.

47. In its further considerations the Reinsurance Mutual Recognition Subgroup will have appropriate regard for other work streams within the IAIS, including but not restricted to the relevant work concerning the MMoU, group and conglomerate issues and also the work on solvency requirements.

48. Mutual recognition arrangements will be more sustainable when all parties are confident that the others abide by the letter and spirit of the agreement. Such confidence will be based on the initial familiarisation and continued involvement with the foreign system, including through:

- obligations of **transparency** of regulatory systems and decision making processes, including any changes in them, through the continued exchange of information between supervisors²
- mutual monitoring or **dialogue** that allows for the continued assessment of technical competence, capabilities and efficiency of the home jurisdiction; and

² While mutual recognition is negotiated at a given moment in time, home regulations and enforcement practices are bound to change as a function of participating actors, prevailing beliefs, and technological developments. Home and host jurisdictions can, to start, notify regulatory changes to each other to ensure greater transparency, a process that has been institutionalised.

- **trust** that the other supervisors will continue to have adequate regard for prudential standards in circumstances where there is necessarily information asymmetry
- **familiarisation and confidence** are likely to be supported by structured staff exchanges.

49. There is a number of remaining open questions on the way forward. Among those questions are the following:

- To what extent can mutual recognition agreements be enforced in court? In whose court – that of the host or the home supervisor, and would this in fact be necessary?
- Can a supervisor be accountable to a government or policyholders in a different jurisdiction, or does accountability continue to rest with entity supervisors, making their decision to rely on the work of others a matter of more genuine judgement?
- To what extent are supervisors required to inform foreign actors as thoroughly as domestic ones?

50. In any case a system of mutual recognition ultimately requires at some point a supervisor's own judgement of his counterpart. Thereby involved parties could in some cases, if an additional source of reference is needed, rely on existing international work on standards, such as that of the IMF.

51. This Discussion Paper proposes the following next steps on the way towards reinsurance mutual recognition.

- 2007 and beyond: IAIS offers a platform where the consultation among supervisory authorities is taking place when they are assessing the equivalence of each others supervisory regimes;
- 2008 October: presentation of a Guidance Paper on Mutual Recognition.

52. To summarise: reinsurance mutual recognition is a worthwhile aim. A core aim of the IAIS is to support the shaping of an efficient and effective international supervisory framework which could facilitate reinsurance mutual recognition. IAIS Members and Observers are invited to provide comments, for example comments which could assist handling and disposing possible risks or barriers. Furthermore, the IAIS would also welcome comments which facilitate answering the remaining open questions on the way towards reinsurance mutual recognition.

53. The Subgroup aims to provide criteria for an envisaged guidance paper that might serve as potential minimum requirements for mutual recognition and will consult with other relevant IAIS Committees in the drafting due process.