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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

PRINCIPLES ON MINIMUM REQUIREMENTS FOR SUPERVISION OF REINSURERS

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Principles on Minimum Requirements for Supervision of Reinsurers

This paper sets out principles on minimum requirements for supervision of pure reinsurers.[1] It identifies elements of the supervisory framework that should be common for primary insurers and reinsurers and those elements that need to be adapted to reflect the unique risks faced by reinsurers.

Captive insurers often operate as reinsurers. As a result, they are included in the scope of this paper. However, where captives only insure the risks of their owners and are part of the same organisation they may not pose the same risk to the financial system and separate regulations may be established recognising this reduced risk.

Contents

I. Introduction

1. Reinsurers contribute to the stability of insurance markets. They can improve the risk profile and the financial soundness of primary insurers by diversifying and limiting territorial accumulations of exposure, and consequently creating underwriting capacity. However, to have this stabilising effect these entities must be able and willing to meet their obligations as they fall due.

[1] While this paper addresses the minimum requirements for supervision of pure reinsurers the IAIS database of reinsurers include insurers who provide a significant amount of reinsurance business. The principles described in this paper will, with the necessary adaptations, also be applicable to insurers whose main activity includes the issuance of reinsurance coverage

2. Reinsurers offer cover through traditional means or through certain alternative risk transfer products (ART). They provide services across borders either directly or by establishing subsidiaries or branches. While reinsurers operate on a global basis, their business has to take account of the location of the risks, types of business or differences in regulation among jurisdictions.

3. Currently, reinsurers in some jurisdictions are fully or partly directly supervised; other jurisdictions rely on rating agencies in assessing the security of a reinsurer. Some supervisors maintain a register of those reinsurers authorised to underwrite reinsurance in their jurisdiction, while others evaluate reinsurers writing business in their jurisdiction. Some jurisdictions require reinsurers to post collateral, covering the likely liabilities (or liabilities plus a margin). In most jurisdictions, a reinsurer who also acts as a primary insurer is subject to direct supervision.

4. Internationally recognised principles for the supervision of reinsurers are needed because of the global nature of the business and the expectation that the business will continue to expand, for example into new regions. They are also needed to ensure that new entrants in the reinsurance markets or existing entities that expand their business rapidly offer acceptable security.

5. There is an on-going need for insurers to assess the security of the reinsurers with whom they deal.[2] Supervisors of primary insurers also need access to information on the reinsurers of their authorised insurers, including information on whether these reinsurers are subject to effective supervision elsewhere[3].

6. Recognising that there will always be some differences in the supervisory regimes, this principles paper identifies minimum requirements for supervision of reinsurers. These requirements should be supplemented by effective systems for exchanging information. It is assumed that the move towards global principles will be an evolutionary process especially because, in a number of jurisdictions, the supervisor presently lacks the powers or the resources to supervise pure reinsurers.

7. The minimum requirements 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 and is responsible and expected to communicate effectively with supervisors in other jurisdictions where the reinsurer writes business. In the interest of policyholders and by improving comparability, minimum requirements could help define a minimum level of acceptable security of reinsurers[4]. Within the framework of the global approach some form of accreditation of home supervisors will be necessary. In addition, the minimum requirements and standards for accreditation should be at such a sufficient level so that host supervisors can reasonably be expected to see no need for additional requirements.

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2 Cf. the *OECD Recommendation of the Council on Assessment of Reinsurance Companies*, C(98)40/FINAL.

3 Cf. *IAIS Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers*, January 2002.

4 Cf. *IAIS Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers*, January 2002.

8. The development of an efficient global approach to regulation of reinsurers may present advantages to reinsurers, primary insurers, and, therefore, to policyholders. These would include greater risk diversification, more effective use of available capital, minimalisation of duplicative regulation, and the reduction of alternative methods for assessing the recoverability of reinsurance claims.

9. The minimum requirements for the supervision of reinsurers naturally differ from those for primary insurers. Conduct-of-business rules do not apply, since the policyholders of reinsurers are not consumers and do not require the same protection. Jurisdictions supervising reinsurers should apply principles reflecting the characteristics of the reinsurance business and the types of risks entailed (particularly in relation to their financial strength). Regulation should take account of and reflect best practices in the industry. It should not stifle innovation that would improve the efficiency and stability of the reinsurance market.

10. Principle 1 describes where supervisory requirements and practices for reinsurers differ from those applied to primary insurers because of the characteristics of the business undertaken. Principle 2 identifies where the same methods can be applied.

II.

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**

Technical provisions

11. Supervisors should have the ability to assess the adequacy of procedures used by reinsurers to establish their liabilities.

12. Supervisors should take into consideration limitations that reinsurers face. For example, they largely depend on information from primary insurers in establishing technical provisions. As a result there may be significant delays in receiving claims information. Thus, it is particularly important that the reinsurers have adequate systems for establishing provisions for claims incurred but not reported or incurred but not enough reported (known as IBNER)[5]. Generally, reinsurers and primary insurers use similar actuarial methods to establish and review their IBNR and IBNER provisions. However, the exercise can be more complicated for reinsurers because of non-homogenous portfolios, long tail classes, or information delays. Often, it is necessary to review individual treaties.

[5] Some jurisdictions refer to these provisions collectively as IBNR; in other jurisdictions they are referred to separately IBNR and IBNER.

Investments and liquidity

13. Reinsurers, as well as primary insurers, must invest in assets that in terms of security, return, diversification and marketability are sufficient to cover their obligations as they fall due. Reinsurers' investment strategies are further complicated because often they need to manage and match assets and liabilities in a number of currencies and different markets. In addition, they may have to reimburse the large-scale losses of primary insurers on demand. Reinsurers need to have effective tools in place to manage their investments and liquidity risks and monitor their cash flows.

Capital requirements

14. In setting capital requirements supervisors should take into account risk profiles, including the volume of business and degree of diversification. The higher a company's sensitivity to risk, the greater the need for it to have strong risk management practices and capital to shore up its financial strength. Significant risks faced by reinsurers include **underwriting** (including cumulations and geographical diversification), **retrocession**, **investments** (liquidity and currency matching), **taxation**, and, for reinsurers in a group, **group risk**. In addition, like primary insurers, reinsurers are exposed to a variety of operational risks the sources of which could be employees (e.g., human error and internal fraud), technology (e.g., technological failure and deteriorating systems), customer relationship (e.g., contractual disputes), and external (e.g., external fraud). Also since reinsurers' operating results are potentially more volatile than those of primary insurers, they must hold capital reflecting the risks inherent in this type of business and sufficient to be able to withstand extreme but plausible loss scenarios.

15. Reinsurers may use dynamic financial analysis tools or other risk models to determine the required economic capital[6]. Supervisors should be knowledgeable about these tools and have access to expertise as necessary. Provided the models in the future are sufficiently reliable, and provided they meet supervisory standards and are properly controlled, they may be used to facilitate mutual recognition of capital requirements of reinsurers.

Corporate governance

16. Standards should be present to ensure effective corporate governance of reinsurers. For example, there should be standards with respect to the roles and responsibilities of the board of directors.

17. In many respects reinsurers and primary insurers face the same problems. However, in the case of reinsurers some of the problems may be different and sometimes more acute and of greater magnitude. With this in mind, reinsurers should be required to have appropriate policies and procedures covering:

- underwriting (including counterparties' integrity, management and business policy);
- provisioning;

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[6] This term is normally used to describe the capital needed to support a given risk profile of the company

- identification, handling and control of aggregates;
- cumulations (storm, quake, flood and hail);
- business line and geographical diversification;
- retrocession (cover and security);
- investments (including asset/liability matching and asset diversification);
- liquidity and cash flow; and
- currency matching.

18. In addition, the following IAIS Standards should be referred to: *Supervisory Standard on Asset Management,* December 1999; *Supervisory Standard on Derivatives*, October 1998; and *Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers,* January 2002.

Exchange of information on supervision of reinsurers

19. By exchanging information, supervisors can learn from each other's experiences. This is especially true given the international and the dynamic nature of reinsurance and ART business. In particular, supervisors should exchange information on supervisory methods and experience, including information and experience on catastrophes. Such exchanges will be subject to normal confidentiality provisions.

III.

Principle 2: Except as stated in Principle 1, regulation and supervision of the legal forms, licensing[7]and the possibility of withdrawing the licence, 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

Legal forms

20. The law of the home jurisdiction should define the legal forms of reinsurance entities.

Licensing and the possibility of withdrawing the licence

21. Reinsurers must be licensed or authorised in their home jurisdiction before undertaking reinsurance activities. The supervisor has the right to revoke the licence if the company no

[7] Some entities are given permission to underwrite reinsurance through "authorisation"; in this paper the term licensing will include authorisation

longer fulfils the conditions for obtaining a licence, or is able, but not willing to fulfil its obligations. If the licence is revoked, the reinsurance company must stop writing new business.[8]

Fit and proper testing

22. Supervised reinsurers should be run by persons of good repute, with appropriate professional qualifications and experience. Thus, substantial owners, the board of directors and management should be subject to fit and proper tests. These tests should be made in accordance with the *IAIS Guidance Paper for Fit and Proper Principles and their Application*, October 2000.

Changes in control

23. The home jurisdiction supervisor should have the authority to approve or object to shareholders with material interests in reinsurers.

Group relations

24. Reinsurers in a group should be supervised on a consolidated or solo-plus basis[9], incorporating all activities that could have an impact on the financial position of the individual licensed entities. In particular, supervisors should assess capital adequacy, underwriting and other risk concentrations, and intra-group transactions including intra-group exposures on a group-wide basis. The following IAIS Standard may be referred to: *Supervisory Standard on Group Co-ordination,* October 2000. Reference is also made to the Joint Forum papers: *Capital Adequacy Principles,* February 1999, *Risk Concentration Principles,* December 1999 and *Intra-Group Transactions and Exposures Principles*, December 1999, and *Framework for Supervisory Information Sharing*, February 1999.

Supervision of the entire business

25. The home jurisdiction supervisor must make sure that all parts of the business of a reinsurer are subject to effective supervision. The supervisor should be able and willing to share relevant information with other insurance and reinsurance supervisors, subject to confidentiality rules.

On-site inspections

26. The supervisor should have the authority to carry out on-site inspections to review the business and affairs of the reinsurer, including the inspection of books, records and other

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[8] Licensing should follow similar principles to those described in the *IAIS Supervisory Standard on Licensing, October 1998.8.* This Standard, however, refers to licensing of primary insurers only.

[9] The concept of solo-plus supervision implies that in addition to the solo or stand-alone supervision of regulated entities supplementary supervision should also be applied on a group wide basis. The supplementary supervision would normally include a review of the group's capital (ensuring that there is no double gearing or double leveraging), intra-group transactions or risk transfers (ensuring that they are conducted as if they were on an arm's length basis), risk concentrations, and co-operation among supervisors.

documents. The following IAIS Standard may be referred to: *Supervisory Standard on On-Site Inspections,* October 1998.

Sanctions

27. Supervisors must have the authority to take remedial action where problems involving licensed reinsurers are identified. The supervisor must have a range of actions available in order to apply appropriate sanctions to problems encountered, recognising reinsurers and primary insurers may face different problems. The powers available to the supervisor should be set out in legislation and/or statute. Where there are serious doubts about the ability of a company to continue operations, the supervisor would be expected to notify other relevant insurance and reinsurance supervisors, on the condition that these other supervisors would maintain the confidentiality of the information according to the rules of the home jurisdiction.

Internal controls and audit

28. The supervisor should be able to review the internal controls that the board of directors and management approve and apply, and request strengthening of the controls where necessary.

29. The supervisor should require accounts to be audited by external auditors. In addition, the supervisor may require auditors to certify compliance with certain requirements.

Accounting rules

30. Accounting rules should be in line with those applicable to primary insurers and should include valuation principles. Since reinsurance is a global business and most entities operate in several jurisdictions, all reinsurers should use similar accounting principles.

Access to non-public information

31. It is important that reinsurance supervisors have access to and receive information necessary to form a proper opinion on the risk profile of each reinsurance company domiciled in their jurisdiction. The information needed to carry out this review and analysis should be obtained from the financial and statistical reports, including accounts that are filed on a regular basis and supported by information obtained through special information requests, on-site inspections and communication with actuaries and external auditors. All reinsurance supervisors should be subject to confidentiality constraints in respect of information obtained in the course of their activities, including the conduct of on-site inspections.[10]

[10] Cf. IAIS Supervisory Standard on the Exchange of Information, January 2002.