Supervisory Standard No. 8

INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

STANDARD ON SUPERVISION OF REINSURERS

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[This document was prepared by the Reinsurance Subcommittee in consultation with members and observers.]

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 domiciled 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[1]. 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. However, as stated in the *Supervisory standard on the evaluation of the reinsurance cover of primary insurers,* 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 cedants in at least one jurisdiction outside their own. The standard also applies to domestic reinsurers to the extent that it is relevant. Supervisors may choose to apply the standard to insurers whose main activity is the issuance of insurance but who also provide a material amount of reinsurance coverage.

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 moving towards a system of accreditation of home supervisors. As this standard becomes more widely adopted and implemented, it may become one of the building blocks in the eventual development of such 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

[1] When the word supervisor is used in this standard it means the home supervisor of the reinsurer (i.e. the supervisor in the jurisdiction in which the reinsurer is incorporated) except where the context implies otherwise

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 and previous and subsequent standards and guidance papers. 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 e.g., International Financial Reporting Standards (IFRS)[2] or U.S. generally accepted accounting principles (GAAP), and should be publicly available.

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

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1. Technical provisions

Technical provisions for non-life reinsurers

1. Estimates of provisions, including loss provisions, are inherently uncertain as they attempt 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:

- Estimating adequate technical provisions – for example, when costs of claims, particularly for excess of loss contracts, are driven up by inflation, changes in life expectancy or more stringent liability laws
- Longer reporting lags – there is an inherent delay because claims are first reported to and evaluated by the cedant. This can sometimes be exacerbated by a periodic notification interval to the reinsurer and by the retrocession process.
- Differing interpretations of reinsurance terminology
- Scarcity of industry data and statistics – homogenous data is difficult to collect by account and by industry

[2] Issued by the International Accounting Standards Board, IASB (previously called IAS)

- Heterogeneity of data received – cedants may pay, establish provisions and code information differently
- Selective cedant information – cedants 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, cedant 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). Reinsurers should ensure that cedants provide them with cedant 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 cedant to report accumulated losses when they reach a certain level; this level should be set below the trigger level in the contract.

4. 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 provisions. The IAIS discussion paper, *Quantifying and assessing insurance liabilities*, provides useful background material.

General issues relating to life and non-life reinsurers

5. 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 to estimate the ultimate cost of claims as reliably as possible. These techniques, however, must be supplemented by professional and managerial judgment, using in-house or outside information as well as input from experts in both risk and claims assessment. Reinsurers should check data and other relevant information received from cedants and reinsurance brokers against historical data. They should be able to explain if a claim provision is not at least as high as the amount reported by the cedant or broker. Because of the issues mentioned above, there must be close cooperation at least between the reinsurer's underwriters, actuaries, claims managers and accountants.

6. Contracts between the cedants and the reinsurers lay down the terms and conditions to be followed by the parties, specifying for example, the length of the contract, premium payments, commissions, claims reporting time frames, and claims payment terms and time frame. Reinsurers should communicate with their cedants and their brokers regularly as this relationship is essential for reinsurers in order to be able to reliably establish technical provisions. In particular, the reinsurer should understand the risks assumed by each particular cedant and have a comprehension of the overall developments in the marketplace. Ongoing communication should be maintained throughout the life of the contracts so that reinsurers can react properly to changes in claims experience and development, and other relevant factors.

7. Reinsurers should have an in depth knowledge of the underwriting policy and the claims handling procedure of cedants and should be informed about any material changes. This may be obtained by collecting appropriate information from cedants on a regular basis in agreed formats and quality. The contract terms between the reinsurer and cedant also often provide that the reinsurer has the right and ability to conduct claims audits of the cedants.

8. In addition, reinsurers need to monitor market conditions and follow industry and societal trends. They should take note of 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.

9. Along with its annual audited financial statements and statements that include adequate disclosures concerning technical performance and risks, a reinsurer should provide detailed information for each reporting segment to the supervisor upon request. The supervisor may wish to require information on non-standard transactions such as the use of CAT bonds. The information should be supplemented by an opinion by a qualified actuary or other competent person on, at least, the adequacy of the technical provisions.

10. The supervisor should review the claims payment development, assessing it against past trends and where possible against similar information provided by reinsurers that accept similar type of risk, or are of a similar size or in a similar market. They should also review run off results and claims development statistics, as well as the reinsurer's risk management systems which may include internal risk models, scenario analyses and sensitivity and stress testing. These should include effects from each line of business on all relevant balance sheet items.

11. The supervisors should review 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 and conflict of interest safeguards apply.

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

2. Investments and liquidity

13. Internationally active reinsurers operate in more than one market, managing global portfolios of assets and liabilities. In addition to the risks run by primary insurers, reinsurers' mismatches between assets and liabilities may imply potentially significant exposure to currency risk. Reinsurers providing long-term coverage, such as life reinsurance, may face investment risk depending on the terms of the reinsurance contract.

14. Reinsurers should manage their assets and liabilities in a prudent manner. They should invest in assets that in terms of security, return, diversification and marketability cover their expected obligations as they fall due. Asset-liability matching policies should be subject to regular stress testing and scenario analysis. The scenarios tested should reflect the unique risk profile of the reinsurer. For example, reinsurers should test any unmatched assets and 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[3] and reinsurance recoverables. The supervisor should assess capital adequacy, liquidity and currency matching in light of the results of the stress testing. In addition, reinsurers should manage and monitor the counterparty credit risk inherent in the business.

15. Often reinsurers and cedants work with current accounts (i.e., accounts in which premiums are credited and claims are debited). However, because of the types of coverage provided (e.g., catastrophe coverage) reinsurers are sometimes obliged to reimburse large-scale losses of cedants on demand. As a result, they should ensure that they maintain sufficient investments in liquid financial assets[4]. Alternatively, they should ensure that liquidity is easily and readily accessible through other means, for example secure lines of credit, in order to pay large and unexpected losses without having

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[3] In the US known as financial guarantee insurance
[4] Assets pledged as collateral can not be regarded as liquid

to sell a significant portion of their investments, particularly during periods of adverse market conditions or at short notice.

16. Along with the annual audited financial statements, the supervisor should receive reports concerning investment performance and risks from reinsurers. On a regular basis or 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 based on their notional amounts and fair value. Reinsurers should report what proportion of their asset portfolio has been pledged to primary insurers or other counterparties.

17. The supervisor should analyse this information over time and compare it to similar information on reinsurers that accept comparable type of risk or are of a comparable size or in comparable markets. The supervisor should then discuss the results with the reinsurer focusing specifically on key risks and how they are being managed and matched.

18. The 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.

3. Economic capital requirements

19. Regulators cannot prevent every failure. Prudential measures such as the establishment of regulatory capital requirements are put in place, however, to minimise the probability of such failures and their potential costs to the cedants and possible impact on policyholders.

20. Reinsurers need to hold capital to manage their overall risk against the possibility of insolvency, the risk undertaken through reinsurance contracts and assets, and other risks such as operational risk. On an individual contract basis reinsurers may assume more volatile risks than primary insurers - for example, by providing coverage for catastrophic events. However, this may be mitigated by better risk diversification on a global portfolio basis. Volatility may be caused by hardening or softening of markets through varying reinsurance prices, as well as volatility in the capital markets. Reinsurers should calculate their risk profile including the above risks as adequately as possible, and manage it against their risk appetite, as set by the board of directors, (e.g. using probability of ruin/default) by allocating sufficient capital reflecting the risk profile and the defined period of time.

21. Reinsurers should use models for internal management purposes to analyse their risk profile. 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, can be - but does not necessarily have to 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.

22. 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.

23. 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).

24. Reinsurers should provide information to the supervisor about their overall risk profile i.e. the relation between the risks run and their financial strength. The supervisor should review the risk profile and all other relevant information with the reinsurer. In the case of internationally active reinsurers, the supervisor should review information about the amount of risk (e.g. using the probability of ruin/default) the reinsurer considers to be the maximum acceptable. In such cases, the supervisor should monitor whether the current risk appetite is within the acceptable range taking into account the international nature of the business. The supervisor should monitor the capital held by reinsurers on a global basis.

25. The supervisor should have the capability either by using in-house staff or contracting with outside experts (who would be subject to confidentiality and conflict of interest 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 adequately diversified reinsurance book, that could mitigate the extent of overall losses. 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, if any, and/or its retroceded risks are with the same counterparty.

26. For reinsurers that are part of a group, models should take into account intra-group exposures and highlight the potential for double gearing[5] and contagion. Economic capital targets should be set for operations for the reinsurer as a whole and in specified areas as well.

27. Generally, internationally active reinsurers, or their holding companies, are evaluated by at least one reputable rating agency. Supervisors should seek to benefit from rating agency information to learn more about the companies they supervise. When a reinsurer has a declining rating or loses an investment grade rating, the supervisor should seek an explanation.

4. Corporate governance

28. Corporate governance refers to the manner in which boards of directors 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, internal controls, reporting, and auditing and ensuring that the reinsurer complies with the statutory and supervisory obligations imposed on it.

29. Given the specific nature of the reinsurance business 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 by location. Appropriate procedures for implementing and monitoring the policies

[5] The term double gearing is used to describe a situation where the same capital is used simultaneously as a buffer against risk in two or more legal entities of a conglomerate

should be established. They should include a review of the terms and conditions of the contracts to ensure that they are accurate and clearly understood. The underwriting guidelines should, where appropriate, require the reinsurer to obtain sufficient information on the cedants with whom it deals to assess their integrity, management and business policy.

- *Accumulations of exposures (e.g. catastrophe exposure such as 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 as a whole due to one and the same event. It should set limits on the whole portfolio and, where appropriate, per line of business to limit the effect of a situation where several lines are hit by the same event or the same underlying cause. 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 may be subject to confidentiality and conflicts of interest 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 adequately address the specific challenges faced by reinsurers, particularly with respect to establishing IBNR 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
  – any limits on retrocession to any one retrocessionaire
  – 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).
  In their strategy for retrocession management, reinsurers 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.

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

- *Contracts*
  Reinsurers should establish a process whereby contracts are reviewed and approved on a timely basis

- *Investments*
  A reinsurer's investment policy should reflect the global nature of the business and specifically deal with asset/liability management, 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 the long tail and the short tail 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 board of directors and within regulatory constraints, if any.

30. The 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.

5. Exchange of information

31. The home supervisor of an internationally active reinsurer has the duty to communicate with supervisors in the jurisdictions in which the reinsurer underwrites reinsurance 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, including factual information on individuals holding positions of senior responsibility in the reinsurer to the extent that such information is relevant to the host supervisor's supervisory responsibilities.

32. A formal agreement is not a prerequisite for sharing information, but it is desirable in order to clearly set out the conditions of the information exchange. In any case, supervisors in host jurisdictions who receive confidential information from the home supervisor must agree to keep the information confidential. 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.

33. 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.

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

35. 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.

36. 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.