Guidelines on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

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Update: The Guidelines on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers have been rescinded for Solvency II firms with effect from 14 September 2020.

Guidelines on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

The following guideline is based on the 'Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers' (Supervisory Standard No.7) issued by the International Association of Insurance Supervisors and should be read in conjunction with that document.

The level of documentation required for compliance with the guideline will be reflective of the complexity of the underlying policies issued and the consequential reinsurance purchased. It is considered vital that all companies address the issues contained in this document, evaluate their compliance, and formalise policies and procedures.

If the self-evaluation reveals that the company is non-compliant with the requirements of this document then the company will need to develop a draft plan that will bring it into full compliance. This plan should be discussed with the Central Bank of Ireland prior to finalisation.

In recent years, reinsurance has evolved with the introduction of many new products. These are commonly known as alternative risk transfer (ART) products. Much of the guidance provided in this document also applies in the case of ART products.

The Central Bank expects all insurance companies to have a fully documented reinsurance strategy in place.

Context

The Central Bank is of the opinion that adherence to these guidelines is necessary for the compliance of insurance companies with Article 10(3) of the European Communities (Non-Life Insurance) Framework Regulations, 1994 (S.I. 359 of 1994) and Article 10(3) of the European Communities (Life Assurance) Framework Regulations, 1994 (S.I. 360 of 1994).

1. Introduction

Insurance companies assume risk on behalf of policyholders. They mitigate these risks by acquiring insurance with reinsurers. Through the use of reinsurance, an insurer can reduce risk, stabilise its solvency, use available capital more efficiently and expand underwriting capacity. Reinsurance helps an insurer obtain a desired, prudent risk profile (i.e. relationship between the risks a company runs and its financial strengths). An insurer may purchase reinsurance direct, or with the assistance of an intermediary. However, irrespective of the reinsurance obtained, the primary insurer remains contractually responsible for paying the full claim amounts to policyholders.

Accordingly, the quality of the reinsurers selected is pivotal to the financial stability of the ceding insurer.

The guideline is laid out in the following manner:

- Section 2 sets out to explore the general subject of managing reinsurance security (N.B. this is for background purposes only);
- Section 3 addresses the strict regulatory requirements, which represent the minimum acceptable legal standard;
- Section 4 outlines the Central Bank requirements for a ceding insurer's reinsurance strategy and related corporate governance; and,
- Section 5 describes how the Central Bank intends to administer this guideline.

2. Managing Reinsurance Security

Reinsurance purchased at the best terms and the lowest price means nothing if the reinsurance company is no longer in business when the claim payment for indemnification comes due.

Selection of Reinsurers

The four most important criteria used for selecting reinsurers are availability, price, security, (financial ability to meet its obligations), and service. These factors involve inverse relationships e.g. the weakest reinsurers in terms of security and service may be most attractive with regard to availability and price. As selecting reinsurers involves trade-offs among these four criteria, the insurer needs to evaluate which trade-offs are most suitable.

In practice, it is understood that insurers need to trade-off criteria and therefore some flexibility is required in the selection process. If the insurer sets the criteria for security too strictly, it may not be able to obtain adequate reinsurance, or the price may be too high. Similarly, if the insurer sets the criteria for price too strictly, adequate reinsurance may not be available; or the security may be imprudently weak. How these trade-offs are handled is a reflection of the expertise and experience of the ceding insurer's management. It is usually beneficial to make several successive attempts to determine an optimal trade-off. However, from a regulatory perspective security is of primary importance.

Role of Intermediaries

The role of the intermediary, if one is involved, is not to select reinsurers for the company, but merely to introduce them based on predefined quality criteria as set out by the company. The responsibility for selection of reinsurance remains with the ceding insurer. The company cannot delegate responsibility for the selection of the reinsurers to an intermediary or any other third party. The company remains responsible at all times for whatever reinsurers it accepts. Any abdication of this responsibility can potentially compromise the financial security of the company and would not be in compliance with the requirements of this guideline.

Establishing Criteria for Evaluating Security of Reinsurers

The evaluation of a reinsurer's security can involve many complex considerations. To standardise this evaluation, the insurer should establish certain initial criteria. Special circumstances may suggest some modifications of the initial criteria, but the more structured the process, the sounder the evaluation. The most important and widely used initial criteria for security are size, rating, and ownership.

The influence of size on security is evidenced by the fact that insolvency occurs mostly amongst the smaller reinsurers, rather than the larger reinsurers whose business is more diversified both geographically and across class of business.

The rating of a reinsurer by an independent source is a second security criterion that may be used in conjunction with size. A rating is a relative benchmark, based on rigorous, objective and independent analysis and opinions developed using a consistent and predictable methodology by experts in the complex field of global financial markets. However, knowledge of how rating agencies rate reinsurers is useful in fully understanding the ratings and in evaluating the significance of changes in ratings. A significant limitation of ratings is the time lag in issuing reports

An insurer that selects only premier reinsurers is likely to have fewer problems with uncollectible reinsurance and needs to spend less time and resources evaluating its reinsurers. This does not mean that this insurer is a better evaluator of reinsurers than other insurers or the rating agencies. It means that *this* insurer places a higher priority on security relative to price and availability.

Insurers often modify security criteria under two circumstances: (1) for some kinds of reinsurance, especially long-tail lines; and, (2) for maintaining continuity of relationships with existing reinsurers.

Long-tail reinsurance, such as excess of loss liability, involves a longer time frame and requires more expertise than property catastrophe and pro-rata reinsurance. Accordingly, many insurers use stricter security criteria for long-tail reinsurance or restrict the amount of reinsurance placed with each reinsurer.

Many ceding insurers modify their security criteria, within reasonable limits, to include reinsurers that have served the ceding insurer well in the past. Continuity is an important element of good service. This is especially true for reinsurers that accommodated the ceding insurer during periods when availability of reinsurance coverage was a problem. Continuing such relationships helps to assure the insurer of adequate capacity during future periods of capacity contraction.

Limiting the Amount of Reinsurance Exposure with Selected Reinsurers

Many insurers limit the amount of their reinsurance exposure with any one reinsurer according to the size of the reinsurer's shareholders' surplus. They do so in order to reduce the chance the reinsurer will retrocede part of its business. The greater the participation in relation to the reinsurer's surplus, the greater the reliance on retrocessionaires. If a reinsurer uses a large amount of retrocessions, the financial security of the retrocessionaires becomes as important to the primary reinsurers as the reinsurer's financial security. Generally, a reinsurer is more likely to retrocede substantial portions of a block of business it has assumed when that block is more than 1 percent of its own shareholders' surplus. The existence of retrocessions may, potentially, lead to delays on claim payments, while the failure of a retrocessionaire may cause the reinsurer to become insolvent. It is therefore important that ceding insurer recognize that the quality of retrocessionaires is an essential component in the evaluation of the reinsurer.

Exceptions to the limit that insurers cede to a reinsurer in relation to the shareholders' surplus of the reinsurer may be merited when backup security is obtained.

Many insurers also limit the amount they cede to any one reinsurer on the basis of their own shareholders' surplus. This is especially true when ceding to other than premier reinsurers i.e. where the risk of insolvency is more significant. The amount of exposure to any one reinsurer, especially non-premier reinsurers, in terms of both the amount of one risk and the accumulation of balances recoverable, should not exceed the largest amount that the insurer is willing to retain on any one primary risk or catastrophe.

Another way to reduce the credit risk is to insert a right of offset clause in the reinsurance contract. Then, to the extent that uncollectible recoverables are due to the insurer, the insurer can reduce any payment that may be due the reinsurer.

When the insurer uses an unrated reinsurer from the same group of companies a concentration risk is created. Cut-through and insolvency clauses to retrocessionaires are only effective if the reinsurer accepting the insurer's risk is in turn retroceding a significant portion of the risk it is accepting to rated reinsurers. Another consideration is the volume of other reinsurance business the unrated group reinsurer is assuming, and the extent to which claims from these other sources will exhaust limits and aggregate retrocession cover provides.

Backup security or collateral is sometimes used to make acceptable a reinsurer that otherwise would not meet the security criteria of the ceding insurer or (2) to cede greater amounts to one reinsurer than the usual limitations of the insurer allow. Backup security can take several forms, including letters of credit, funds withheld, and trust funds.

Monitoring Reinsurers

A prudent insurer monitors its reinsurers during the life of the reinsurance agreements and for as long as any obligations remain outstanding. If a reinsurer's financial condition deteriorates during the term of the agreement, the insurer may consider a mid-term cancellation. If such trouble develops while balances remain outstanding, the insurer may wish to negotiate a commutation while the reinsurer is still trying to retain its status in the marketplace.

The insurer should follow a systematic program for monitoring changes in the ratings, surplus, assets, reserves, premium volume, ownership, and management, for monitoring news reports, the timeliness of claim payments, and other information from miscellaneous sources. This information helps prepare the insurer to take timely corrective action if unexpected financial problems arise with its reinsurers.

Documentation

In addition to substantive documentation of the reinsurance cover in the form of:

- copies of contracts and amendments;
- copies of slips and cover notes; and
- written contract descriptions and summaries;

the ceding company should be careful to document their compliance with those internal control procedures that it considers necessary and adequate to (a) evaluate the financial responsibility and stability of the assuming company, and (b) provide reasonable assurance of the accuracy and reliability of information reported to the reinsurer and amounts due to or from the reinsurer.

If an insurer increases its use of second and third-tier reinsurers (especially unrated, new and little-known reinsurers), it increases its need for information and analysis. This is particularly true if the insurer does not obtain available backup security and does not use prudent limitations. The insurer will be subject to a greater potential for loss from uncollectible reinsurance.

3. Regulations and Guidelines for their Interpretation

Article 12, Part II of the Insurance Act, 1989 provides for the Central Bank to make regulations for the proper exercise of its functions under the Insurance Acts in respect of authorised undertakings including information, which undertakings must supply in respect of their reinsurance arrangements.

Article 13 (4) of the European Communities (Non-Life Insurance) Framework Regulations, 1994 (S.I. No 359 of 1994) deals with the allowance of a reduction of technical reserves arising from reinsurance.

Technical reserves may, subject to sub-article (3) be established and maintained after the deduction of reinsurance cessions, ***provided such reinsurance arrangements are acceptable to the Central Bank***. However, any reduction in technical reserves arising from reinsurance shall be restricted to the extent of the insurance risk transferred under the reinsurance arrangements. Where the reinsurance arrangements are not acceptable, the Central Bank may require that, in respect of the insurance contracts covered

by such arrangements, reserves are maintained before the deduction of reinsurance cessions.

To provide context to the italicised phrase in the above paragraph, it is the undertakings themselves that are primarily responsible for the appropriateness and security of their reinsurance arrangements.

Sub-article (3) provides that, if more than 90% of the gross premiums written in any accounting class of insurance business adopted for the purpose of the annual returns is ceded by the insurer, then the insurance undertaking will be require to maintain technical reserves representing a minimum 10% of gross premium income or 10% of gross technical reserves relating to such business, whichever is the greater, in that class and to hold assets representing that amount accordingly.

Similarly, to the treatment of reinsurance on Non- Life insurers as noted above, the European Communities (Life Assurance) Framework Regulations, 1994 (S.I. No 360 of 1994), Article 12 (5) together with Annex VII discusses the suitability of reinsurance cessions and the acceptability of reducing technical reserves by reinsurance. Again, the responsibility for the appropriateness and security of the reinsurance arrangements rests with the insurer and must acceptable to the Central Bank. The reduction, in the case of Life reinsurance, is limited to 75% of the gross premiums written.

Admissibility of Reinsurance Recoverables as support for Technical Reserves

Annex III, Article 5, 1 & 4 (Non-Life), provides that the value of any debt due the insurance undertaking under any contract of reinsurance to which the insurance undertaking is a party shall be the amount which can reasonably be expected to be recovered in respect of that debt (valued net of all amounts owed to the same third party) provided that no account shall be taken of any debts arising out of reinsurance operations which are owed by intermediaries and which have been outstanding for more than three months.

Schedule 2, Part 1 (Non-Life) limits the admissibility of reinsurance recoverable, on paid claims, to 50% of net technical reserves, based on the reasonable expectation that the debt will be recovered.

Annex V, Article 5, 1 & 5 (Life), contain the same provisions for the valuation of debt due the insurance undertaking under contracts of reinsurance as in the Non-Life Regulations. Schedule 7 Part 1 (Life) limits the admissibility of reinsurance recoverable, on paid claims, to 1% of net technical reserves for each reinsurer, and 2.5% in aggregate, again, based on the reasonable expectation that the debt will be recovered.

Impact of Reinsurance on Minimum Solvency

Annex II, Part A, (Non-Life), reduces the required solvency margins calculations based on the reinsurance recoverable in the last financial year, capped at a maximum of 50%. Similarly, Annex II, Part A, (Life), limits the reinsurance reduction factor to a maximum of 15% for the solvency margin calculation based on mathematical reserves, and to a maximum of 50% for the solvency margin calculation based on the capital at risk.

4. Reinsurance strategy and Corporate Governance

Board of Directors

It is expected that every insurer should have a reinsurance strategy, approved by the company's Board of Directors, appropriate to the company's overall risk profile. The reinsurance strategy will be part of the company's overall underwriting strategy. The Board should review the reinsurance strategy annually. In addition, the reinsurance strategy should be reviewed when there have been changes in the company's circumstances, its underwriting strategy, or the status of its reinsurers.

The reinsurance strategy should define and document the insurer's strategy for reinsurance management, identifying the procedures for:

- the reinsurance to be purchased;
- how reinsurers will be selected, including how to assess their security;
- what collateral, if any, is required at any given time; and
- how the reinsurance programme will be monitored (i.e. the reporting and internal control systems).

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

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

Senior management

Senior management should document clear policies and procedures for implementing the reinsurance strategy set by the Board of Directors. This includes:

- setting underwriting guidelines that specify the types of insurance to be underwritten, policy terms and conditions, and aggregate exposure by type of business;
- establishing limits on the amount and type of insurance that will be

automatically covered by reinsurance (e.g. treaty reinsurance); and

- establishing criteria for acquiring facultative reinsurance cover.

In order to avoid uncovered risks, the terms and conditions of the reinsurance cover should be compatible with those of the underlying business.

Limits on the net risk to be retained should be set either per line of business or for the whole account. The insurer may also set limits per risk or per event (or a combination thereof). The limits must be based upon an evaluation of its risk profile and the cost of the reinsurance. In particular, the insurer should have adequate capital to support the risk retained. Some insurers may use the results of dynamic financial analysis techniques (using the reinsurance cover as one of the variables) as input into these operating decisions.

The ceding insurer should ascertain whether the proposed reinsurer intends to retrocede any of the assumed business. If this is the situation it is then essential that the ceding insurer be equally satisfied as to the quality of the retrocessionaires used.

The insurer should maintain an up-to-date list of reinsurers that it has approved. For each approved reinsurer the appropriate level of exposure should be specified. To do this, the insurer should evaluate the ability and willingness of the reinsurer to fulfill its contractual obligations as they fall due (i.e. its security). Such assessment is required whether collateral is posted or not. The assessment should take into account the effects of any collateral the reinsurer has posted in favour of other insurers. The insurer's credit guidelines should describe the system for controlling exposures to each reinsurer.

To improve the security of the overall reinsurance cover, insurers may choose to use a number of different reinsurers. Diversification by the insurer reduces the impact of counterparty credit risk or withdrawal of capacity on reinsurance renewal in periods of capacity contraction.

Generally speaking, the fewer the number of reinsurers used, the more important the security of the reinsurers. If a company takes advice on the strength and security of a reinsurer, then it should be satisfied that the advice received is sound. Similarly, if reinsurance cover is acquired through

an intermediary, the company should evaluate the operational risk associated with the transaction.

Senior management should ensure that the management information system in place meets all Board requirements with respect to reporting frequency and level of detail. In addition, there should be adequate systems of internal control to ensure that all underwriting is carried out in accordance with company policy and that the planned reinsurance cover is in place. The underwriting control systems should be able to identify and report on a timely basis where underwriters infringe authorised limits, breach company guidelines or otherwise assume risks exceeding the ability of the company's capital base and reinsurance cover to service.

If an insurer in Ireland is part of a global insurance group, the reinsurance strategy should include information on the global reinsurance strategy. The information should identify the control mechanisms and detail the reporting arrangements for monitoring the reinsurance arrangements of the group, including where the responsibility resides for the monitoring of the arrangements. The strategy should also include the reporting arrangements between Irish and foreign operations, the monitoring of Irish insurer's operations by the foreign parent and the home regulator's supervisory arrangements regarding reinsurance. Any elements of the strategy that are controlled by the parent company or group should be identified and detailed.

The following mandatory contract terms should appear in all reinsurance policies:

- Insolvency Clause requiring the reinsurer to perform its contract obligations without diminution in the event of the ceding insurer becoming insolvent.
- A policy provision stating that the reinsurance agreement constitutes the entire contract between the parties.
- A policy provision requiring reinsurance recoveries to be paid to a cedent without delay and in a manner consistent with the orderly payment of claims by the ceding insurer.
- A policy provision providing for reports, at least quarterly for proportional policies and at least annually for non- proportional policies,

regarding premiums, and paid and incurred losses.

While the Solvency II Directive is not in effect yet it will bring in some requirements which may be useful for insurers to consider at this point. Under Article 44 of the Solvency II Directive, an insurer must have a written risk management policy in relation to reinsurance and other risk mitigation techniques. The current Level 2 Text (which is subject to change) specifies that the insurer's policy on reinsurance must include:

(i) actions to be taken by the insurer to ensure the selection of suitable reinsurance and other risk mitigation techniques;

(ii) actions to be taken by the insurer to assess which types of risk mitigation techniques are appropriate according to the nature of the risks assumed and the capabilities of the undertaking to manage and control the risks associated with those risks;

(iii) the insurer's own assessment of the credit risk of the risk mitigation techniques of the counterparties.

There is also a provision in the current Level 2 Text, which prohibits, for risk management purposes, sole reliance by (re)insurers on the credit assessments of counterparties by external ratings agencies.

Internal control

There should be internal control systems in place to ensure that claims are reported to the appropriate reinsurer and that reinsurance claims payments are being promptly collected. The underwriting control may include an actuarial assessment of the risk and whether it has been transferred as presumed. This assessment may also include a review of the reinsurance contracts. The Board of Directors should receive regular and comprehensive reports on the effectiveness and performance of the claims system and the reinsurance protection. Companies' internal control systems should be subject to regular audit examination.

5. Supervisory monitoring of compliance with the guideline

The Central Bank may seek to verify that the Board of Directors has established an overall strategy framework – addressing, *inter alia*, underwriting and reinsurance. This will include evaluation of reinsurance cover, reinsurer security and collateral that may be posted. The Central Bank will take a risk-based approach (based on the Impact rating of companies under PRISM) – ensuring that the company has appropriate policies, systems and procedures in place and focusing more detailed examination work on areas posing specific and significant concern.

Before granting authorisation, the Central Bank must be satisfied with the company's planned risk management and reinsurance strategies, and accompanying policies. When examining the business plan of an insurance company, the Central Bank will evaluate if the proposed reinsurance covers maximum foreseeable loss. In the business plan, the company must describe how, and to what extent, future policies will be reinsured.

Companies should maintain adequate reinsurance cover at all times based on their risk profile. While many reinsurance treaties operate on an annual basis, some treaties especially for life business and some ART contracts can operate for many years. In such cases, assurance that the reinsurer offers sufficient security to act as a long-term counterparty will be required. The Central Bank should be made aware of the security and adequacy of the reinsurance or ART coverage for long-tail business (where claims development is slow) and the top layers of catastrophe programmes (where amounts involved can be large).

Sufficient and relevant information should be available on the reinsurers used and the reinsurance cover arranged. Relevant information may include:

- reports prepared by the ceding insurer describing the reinsurance cover, reinsurance programmes or treaties; and,
- the ceding insurer's financial statements, detailing the result of reinsurance, any amounts outstanding from reinsurers and the effect of the ART techniques, including financial reinsurance.

  The company should have available on a timely basis:

- copies of contracts and amendments;
- copies of slips and cover notes;
- financial statements of reinsurers used; or
- written contract descriptions and summaries.

Using this information and other relevant information received during a Prism Full Risk Review or similar engagement, the Central Bank will evaluate:

- the prudence of the company risk profile including an evaluation of any risk concentration, i.e. an aggregate exposure with the potential to produce losses large enough to threaten the insurer's financial health or its ability to maintain core operations;
- compliance with the company's reinsurance strategy and its Risk Appetite Statement;
- the sufficiency of the reinsurance cover and the insurance company's financial strength, in particular under extreme, but plausible loss scenarios;
- the sufficiency of the reinsurance security, taking into consideration a wide range of factors including financial strength, whether reinsurers are properly supervised and whether or not collateral is posted; and,
- the appropriateness of any ART techniques (such as securitization) used.
- the frequency and appropriateness of internal monitoring and reporting of reinsurance exposures, credit ratings, etc.

The choice of reinsurance cover is a business decision made by management within the overall reinsurance strategy of the insurer. However, where insufficient or inappropriate reinsurance cover affects the company's ability to pay policyholders' claims, the Central Bank will enter into discussions with the management of the company.

The Central Bank may disallow credit in whole or in part for reinsurance when calculating solvency requirements or technical provisions on a net basis or when determining the coverage of gross technical provisions by reinsurance recoverables i.e. the amount of an insurer's incurred losses that

its reinsurers will pay calculated in accordance with the legislation.. As well, the Central Bank may require the insurer to:

- obtain additional reinsurance cover;
- provide additional capital;
- establish additional technical provisions; and,
- have additional collateral posted, if applicable.

Under Solvency II, a reinsurance recoverable could generate a capital charge i.e. a higher Solvency Capital Requirement, depending on the credit rating of the reinsurer.

Reinsurance recoveries in excess of 90 days overdue will generally not be admissible as assets. Where reinsurers have balances that fall into this category, only 80% of the reinsurance recovery reserve from these reinsurers will be admissible. However, the Central Bank is cognisant of the fact that disputes/differences in interpretation do occur; as such it will extend the

90 days to 180 in the case of disputes on specifically referenced claims. The Central Bank will permit offsetting provided that the offsetting is with the same counterparty, there is provision in the reinsurance contract for offsetting, and that the offsetting actually occurs within a prescribed period of time. This is an important but necessary tightening of the position as laid out in the regulations.

Within a reasonable period after their finalisation, significant changes in reinsurance arrangements (including the panel) must be notified to the supervisor, who may request sight of all relevant documentation in assessing the appropriateness and adequacy of the changes.

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