Guernsey Financial Services Commission

GUIDANCE NOTE FOR LICENSED INSURERS ON REINSURANCE AND OTHER FORMS OF RISK TRANSFER

1. Introduction

The Finance Sector Code of Corporate Governance requires the board of a licensed insurer to set and oversee the insurer's risk strategy and risk appetite. An insurer is required to establish, and operate within, effective systems of risk management.

The Insurance Business (Solvency) Rules 2015 further requires that licensed insurers must establish and maintain a risk management framework that is appropriate to the nature, scale and complexity of its business. The risk management framework is the totality of the systems, structures, policies, processes and people that identify, assess, mitigate and monitor all internal and external sources of risk that could have a material impact on the licensed insurer.

This guidance note sets out the Commission's expectation that licensed insurers' will effectively manage their use of reinsurance and other forms of risk transfer as part of the risk management framework.

The principle of proportionality applies to this guidance. Application should be commensurate with the nature, scale and complexity of the insurer's business.

This guidance applies to both long-term and general insurance business and to insurers and reinsurers.

For the purposes of this Guidance, the term "reinsurance" shall refer to both mainstream reinsurance and other forms of risk transfer including alternative reinsurance arrangements, such as risk transfer to the capital markets.

2. Guidance

a) Ceding licensed insurers should have a reinsurance programme that is appropriate to their business, and that is part of their wider underwriting, risk and capital management strategies.

A ceding insurer's underwriting, risk and capital management strategy should clearly articulate the part played by reinsurance, in particular:

- the objectives that are pursued by using reinsurance;
- the risk concentration and ceding limits; and
- the mechanisms to manage and control reinsurance risks.

The reinsurance strategy should take into account the ceding insurer's business objectives, levels of capital and business mix, with particular reference to:

- insurance risk appetite (both gross limit and net retention);
- peak exposures and seasonality in the insurance book;
- levels of diversification in the insurance book; and
- appetite for credit risk posed by reinsurers.

The reinsurance programme comprises the detailed implementation of the reinsurance strategy in terms of coverage, limits, deductibles, layers, signed lines and markets used. It should reflect the ceding insurer's overall risk appetite, comparative costs of capital and liquidity positions determined in the reinsurance strategy. Therefore, reinsurance programmes can vary significantly in complexity, levels of exposure and number of participants.

In some instances, an insurer may have a business strategy and risk appetite to retain all risk and therefore a reinsurance programme would not be necessary.

Senior Management develops the reinsurance strategy and programme, and is also responsible for establishing appropriate systems and controls to ensure that these are complied with. The Board is responsible for approving the reinsurance strategy and programme.

Large and/or complex ceding insurers, or those with a complex reinsurance strategy, may wish to appoint a committee of the Board to oversee the implementation of the reinsurance strategy.

The Board and Senior Management of the ceding insurer should regularly review the performance of its reinsurance programme, to ensure that it functions as intended and continues to meet its strategic objectives. It is likely that such a review would take place as part of the feedback loop that is part of the risk management framework.

b) Licensed insurers should establish effective internal controls over the implementation of their reinsurance programme.

Control of the reinsurance programme should be part of the ceding insurer's overall system of risk management and internal controls. Controls and oversight in place must be suitable in the context of the ceding insurer's business and the appropriateness of the reinsurance programme in addressing the ceding insurer's reinsurance needs.

Link to capital assessment

The ceding insurer should ensure that the characteristics of its reinsurance programme, including the credit risk posed by the reinsurer, are adequately reflected in its capital assessment, including its Own Risk and Solvency Assessment[1].

Credit risk posed by the reinsurer

When developing the reinsurance programme the ceding insurer should consider its appetite for reinsurer credit risk. Reinsurers may face solvency issues, leading to delayed payment or default, and this can have significant consequences for the solvency and liquidity of the ceding insurer.

There are various ways for the ceding insurer to mitigate reinsurer credit risk, for example:

- establishing criteria on the financial strength and claims payment record of eligible reinsurers;
- setting limits on risks ceded to a single reinsurer;
- ensuring a spread of risk amongst a number of reinsurers;
- incorporating rating downgrade or other special termination clauses into the reinsurance contract;
- requiring the reinsurer to post collateral (the ability to require this will depend upon the relative commercial strengths of the ceding insurer and reinsurer); and
- withholding reinsurer's funds.

Approved security criteria

The ceding insurer should have in place procedures for identifying reinsurers that provide security that it finds acceptable and should keep these procedures periodically under review. There should also be processes for dealing with situations where there is a need to assess reinsurers outside any pre-approved list. Ceding insurers may have their own credit committees to make their own assessment of the risk.

[1] The Insurance Business (Solvency) Rules 2015 require a licensed insurer to conduct an Own Risk and Solvency Assessment, an assessment and calculation of its solvency requirement, assessment of risk management and future capital needs.

In line with other approaches to identifying appropriate reinsurers, any approved security criteria should be derived from a high level statement of what reinsurance security will be acceptable to the ceding insurer, which may be based on:

- external opinions;
- the ceding insurer's own view of the reinsurer;
- minimum levels of capital;
- duration and quality of relationship;
- expertise of the reinsurer;
- levels of retrocession;
- reinsurance brokers' security criteria; or
- a mixture of these and other factors.

Aggregate exposure limits or guidelines

A ceding insurer should set prudent limits or guidelines reflecting security and size of the reinsurer, in relation to its maximum aggregate exposure to any one reinsurer or to a group of related reinsurers, which would be complementary to any supervisory limits or guidelines.

The ceding insurer should have in place procedures for monitoring this aggregate exposure to ensure that these limits or guidelines are not breached, including procedures to bring excess concentrations back within limits or guidelines, or otherwise managed, going forward.

Matching of underlying underwriting criteria

The ceding insurer should give due consideration to the risk posed by a mismatch in terms and conditions between reinsurance contracts and the underlying policies. The ceding insurer may bear a greater net exposure than it initially intended because of this gap.

Criteria and procedures for purchasing facultative cover

The ceding insurer should have appropriate criteria in place for the purchase of facultative coverage. Any facultative reinsurance coverage bought should be linked to the procedures for aggregations and recovery management. The ceding insurer should have a specific process in place to approve, monitor and confirm the placement of each facultative risk. If facultative reinsurance is necessary to ensure that acceptance of a risk would not exceed maximum net capacity and/or risk limits set by the Board, such reinsurance should be secured before the ceding insurer accepts the risk.

Operational risk related to contract documentation

In order to reduce the risk and scope of future disputes, the ceding insurer and the reinsurer should have in place processes and adequate controls to document the principal economic and coverage terms and conditions of reinsurance contracts clearly and promptly.

Ceding insurers and reinsurers should finalise the formal reinsurance contract without undue delay, ideally prior to the inception date of the reinsurance contract.

All material reporting due to and from reinsurers should be timely and complete, and settlements should be made as required by the reinsurance contract.

The ceding insurer should consider how its reinsurance contracts will operate in the event of an insolvency of itself or its reinsurer.

c) A licensed insurer should consider the impact of its reinsurance programme in its liquidity management.

Given the nature and direction of cash flows within a ceding insurer, liquidity risk historically has not been considered to be a major issue in the insurance sector. However, there can be liquidity issues within an individual ceding insurer which could arise specifically from the ceding insurer's reinsurance programme.

Reinsurance contracts do not remove the ceding insurer's underlying legal liability to its policyholders. The ceding insurer remains liable to fund all valid claims under contracts of insurance it has written, regardless of whether they are reinsured or not. For this reason, a large claim or series of claims (e.g., resulting from a major catastrophe) could give rise to cash flow difficulties, especially if there are delays in settlement by reinsurers or in the ceding insurer providing proof of loss to reinsurers.

As with all risks, the insurer should develop its own response to the level of risk it faces and the Commission should assess these responses. There are a number of ways in which liquidity risk may be mitigated. For example, some insurers choose to arrange a line of credit from a bank in order to deal with short-term liquidity issues.

Ceding insurers may make arrangements with their reinsurers in order to mitigate their liquidity risk. These arrangements may include clauses that trigger accelerated payment of amounts due from reinsurers in the event of a large claim and/or the use of collateral or deposit accounts, giving ceding insurers access to funds as needed. Use of such arrangements is a commercial matter between the ceding insurer and reinsurer.

External triggers can give rise to liquidity issues, especially where reinsurers have retroceded significant amounts of business. If a reinsurance contract contains a downgrade clause that gives the ceding insurer the right to alter the contract provisions, or obliges the reinsurer to post collateral with a ceding insurer to cover some or all of its obligations to that ceding insurer, such action may cause liquidity issues among reinsurers and may be pro-cyclical. Ceding insurers are required to take appropriate measures to manage their liquidity risk including funding requirements in reasonably adverse circumstances.