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INVISIBLES: INSURANCE

Reinsurance security */

Study by the UNCTAD secretariat

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PREFACE

1. At its eleventh session, the Committee on Invisibles and Financing related to Trade adopted resolution 28 (XI) requesting the UNCTAD secretariat to prepare, "in the interests of avoiding the adverse effects on insurance markets of the use by their markets of unreliable reinsurers, a study on all the criteria for assessing the security and credibility of reinsurers". The Committee also requested the UNCTAD secretariat to "seek the opinion of representatives of the various interests involved and other experts". The present report has been prepared in response to the Committee's requests.

2. Pursuant to the Committee's instructions, the secretariat submitted the draft of the present report to a group of experts who met to discuss it in Geneva from 13 to 17 October 1986. (For list of experts, see annex). The expert group reviewed the draft study prepared by the UNCTAD secretariat, and very valuable comments and suggestions were made, after which the secretariat prepared the study in its present form. The secretariat is grateful to all who assisted in the preparation and revision of the study through their ideas, opinions and factual information, but it alone is responsible for the text of this document.

3. The introduction to the report describes briefly the international reinsurance scene and its latest developments, characterized by failures and undesirable practices and the importance of selecting technically and financially sound reinsurers. Chapter I deals with the ways and means for ceding companies to select their reinsurers, since the reinsurers' security is their prime responsibility. It also describes the limits of the means at their disposal. Chapter II deals with the ways and means of assessing reinsurance security through the supervision of ceded reinsurance. Chapter III deals with the possibilities of State supervision of reinsurance sellers. Finally, chapter IV deals with possible international co-operation in the field of supervision of reinsurance companies.

INTRODUCTION

4. Reinsurance is a machinery for the distribution and sharing of risks. 1/ Its main purpose is to allow primary insurers to respond to the needs of their insured when large values or new types of risks require cover which they cannot afford by themselves alone. Reinsurance also provides a protection to primary insurers so that their underwriting and financial performances may not be unduly affected by negative experience or by unexpected occurrences. The reinsurer, from his side, gains an insurance portfolio and investible funds.

5. Initially, reinsurance was exchanged amongst primary insurers in the same market. However, in the middle of the nineteenth century, the first specialized reinsurance company was created in Germany and was followed by several other specialized reinsurers in Europe and North America. The emergence of specialized reinsurance institutions signalled the internationalization of this type of activity. With the ever-increasing number, size and complexity of risks insured and the emergence of risks of an international character, this trend of internationalization has been enhanced further because of the greater need for risk distribution and sharing. 2/ For their part, reinsurers attempt to operate in as many countries as possible, not only to increase their premium receipts but also to achieve profit maximization through better risk distribution.

6. Reinsurance premium receipts have been growing steadily since before the First World War. However, the fastest growth has been recorded in the last 20 years. Such growth has exceeded the growth of direct insurance premiums written during the same period, as shown in table 1. The table indicates that while world direct non-life insurance premiums increased almost sevenfold during the period 1965-1983, world reinsurance premiums increased almost

Table 1

World non-life premiums a/
(In billions of US dollars)

Year	Direct insurance (1)	Reinsurance (2)	Reinsurance/direct insurance (2)/(1) in %
1965	39.6	5.6	14.1
1970	68.3	9.4	13.8
1975	131.3	19.3	14.7
1980	250.9	40.5	16.1
1983	263.3	40.0	15.2

Source: Sigma, Swiss Reinsurance Co., No. 10, October 1985.

a/ Excluding the USSR, the socialist countries of Eastern Europe and China.

eightfold. The background to such quick growth is obviously the unprecedented economic upswing which industrial countries have experienced since the end of the Second World War. Technological progress and sociological developments have engendered larger and new needs for cover. World-wide reinsurance was the only way to raise sufficient capacity to cope with such needs.

7. A second reason for the dramatic growth of international reinsurance activities is the change in the structure of insurance markets in many parts of the world and in particular developing countries. An increasing number of these countries have limited or excluded altogether the operation of direct foreign insurance companies in their territory, and domestic insurance companies have assumed the responsibility of covering local risks. Given the restricted size of some of the emerging markets involved and the lack of past experience, young domestic insurers could not produce enough capacity to cover their local risks, and they were compelled to rely heavily upon international reinsurance facilities to make good such deficiencies. Even in countries where the insurance sector has come totally under State control, dependence on international reinsurance has continued and in many cases increased.

8. Traditionally, there were few major markets which were in a position to offer reinsurance facilities on an international scale. Reinsurers from five countries dominated the international reinsurance scene, namely the Federal Republic of Germany, Switzerland, the United Kingdom, the United States and France. However, the increased demand for reinsurance all over the world has spurred a tremendous expansion in the number of reinsurers, not only in these five countries but also in many other parts of the world. New markets have sprung up, particularly in free zones and in countries that offer off-shore facilities. Captives 3/ which were initially created to cover the risks of their principals enlarged the scope of their activity to englobe reinsurance of open market business. Also a number of reinsurance companies were set up in several developing countries on a national and regional basis. These companies, while concentrating their activities on their respective countries or region, endeavoured to extend their activities to international business in an attempt to acquire a wider base.

9. This growth in the number of reinsurers can be explained by several factors. The most obvious of these is the ever-growing demand for reinsurance cover for the reasons stated above.

10. The second of these factors is the increase of the regulatory climate in respect of direct business, which prevented international companies from carrying out their activities as primary insurers in foreign markets. To continue having access to some markets, these companies had to switch to reinsurance, a field characterized by ease in transcending national frontiers due to the inexistence of strict regulation in this respect.

11. Also, the relatively slow growth and stagnation of direct insurance premium receipts compared with reinsurance have induced many insurers and other financial institutions to invest in reinsurance, particularly taking into consideration the modest capitalization and reduced management expenses required by this type of activity and the growth and profitability which the reinsurance business has achieved.

12. To illustrate the strong rise in the number of reinsurance companies in the second half of this century, it is sufficient to mention that today there are about 376 professional reinsurance companies operating in the world;

Table 2

World's insurance and reinsurance premiums - Non-life
(In billions of US dollars)

Insurance premiums						Reinsurance Premiums					
	1965	1983	Percentage increase	Percentage of aggregate world premiums 1965	Percentage of aggregate world premiums 1983		1965	1983	Percentage increase	Percentage of aggregate world premiums 1965	Percentage of aggregate world premiums 1983
United States	25.3	147.2	482	64	56	United States	1.8	10.3	472	25	26
Western Europe	10.8	72.4	570	27	27	Western Europe	4.8	23.2	383	66	58
Rest of world	3.5	43.7	1 149	9	17	Rest of World	0.6	6.5	983	9	16
Total	39.6	263.3		100	100	Total	7.2	40		100	100

Source: *Sigma*, Swiss Reinsurance Co., No. 10, October 1985.

3 per cent of these have existed for 100 years or more, 2 per cent between 75 and 100 years, 8 per cent between 50 and 75 years and 12 per cent between 25 and 50 years, thus leaving a balance of nearly 75 per cent which have existed for less than 25 years. 4/

13. At first glance, the increase in the number of reinsurers and the expansion of the market appears to be a favourable development, since one of the objectives of reinsurers is to protect the ceding companies and to achieve the widest international distribution and coverage of risks. The new capacity thus created, when properly used, could help to ease and to improve the cover of risks on a world-wide basis. Unfortunately, the proliferation of reinsurers in recent times has brought with it many serious problems. The reason for this is that a large percentage of this new capacity has been both unknowledgeable and inexperienced. It has viewed reinsurance underwriting merely as a vehicle for developing investment funds at a time characterized by extraordinary high interest rates. Reinsurers in this category are blamed for much of the deterioration in the quality of underwriting and the depressed market situation. They have accepted substandard risks and exposures at rebate rates to attract premiums, counting upon high yields from investments to make good losses in technical results. In the face of such tough competition, traditional reinsurance markets felt obliged to hold on to their business at all costs, which inevitably meant undercutting rates.

Table 3

Number of reinsurers in the world

Region	1968	1975	1985	World share in 1985
North American	31	55	117	31.1%
Western Europe	129	121	175	46.5%
Rest of the world	37	53	84	22.4%
World total	197	229	376	100%

Source: Sigma, Swiss Reinsurance Co., No. 10, October 1985.

14. Obviously, high interest rates earned on investment have been essential to the stability of the performance of reinsurers. However, as interest rates have dropped recently, the investment earnings of many of these reinsurers have shrunk accordingly. None the less, the price of items upon which indemnities were based did not drop in parallel. This has resulted in cases of financial difficulties. Some reinsurers have not been able to meet their obligations towards their ceding companies due to the depletion of their financial resources. Several other reinsurers have had to go out of business or disappear, leaving their ceding companies without cover and without payment of balances due to them.

15. It is true that financial collapse among reinsurers has so far been rare, and on some occasions markets have acted to provide short-term support, recognizing that the collapse of a reinsurer may have much wider implications

for the market as a whole. There is no guarantee, however, that this could happen again in this way. There could also be an international domino effect which would pull sound reinsurers down with the unsound ones.

16. Another disturbing phenomenon that has been observed in the last few years is that reinsurance payments of several billion dollars have suffered considerable delays. Obviously, such delays in the settlement of reinsurance recoverables may indicate, among other things, serious deficiencies in the financial situation of some reinsurers. Moreover, millions of uncollected reinsurance recoverables have been written off or are in dispute.

17. Reinsurers facing financial difficulties because of insolvency or because of the non-flow of cash are not the only concern for buyers of reinsurance. There have been several cases of fraudulent dealings and notorious scandals involving certain unscrupulous reinsurers and intermediaries. The disclosure of such affairs involving Pritchard & Baird, Posa, Kenilworth and Peter Cameron Webb (PCW) and others has diminished the credibility of the reinsurance profession and wrecked confidence in reinsurance security. Furthermore, a number of Lloyds syndicates have been involved in a series of scandals in recent years, though the international insurance community has continued to accept the institution of Lloyds as reasonably secure. Before such problems occurred, there was little question of closely vetting the list of one's reinsurers. Now the risks involved in unsafe reinsurance have caused many insurance companies to worry over security. The need for proper security analysis was finally recognized, and various companies, brokers and specialized organizations began simultaneously to analyse the performance of reinsurers operating in the international market. 5/

18. How do the problems of reinsurance security affect the insurance markets in developing countries? It is known that the insurance markets in most of these countries, reflecting the early stages of economic development, have not yet reached the level of growth and sophistication which characterize their counterparts in developed countries. Structural, financial and technical constraints such as under-capitalization, the small size of markets, the imbalanced nature of insurance portfolios, and lack of sufficient experience and know-how make the technical and financial dependence of these markets on international reinsurance very extensive. 6/ Besides, there is nothing to indicate that the degree of such reliance will diminish in the near future, because developmental efforts which are being or have to be carried out in these countries are likely to require more and more capacity which cannot be obtained but from international reinsurance markets.

19. The implication of such heavy technical and financial dependence on international reinsurance is that the insurance markets in developing countries become particularly vulnerable to any upheavals which may involve the international reinsurance field and its financial ability. The failure or disappearance of a reinsurer would have dire consequences and may cause a very serious chain reaction starting with the ceding companies themselves and then their policyholders and ending with the national economy at large. In the face of such a danger, it is desirable that certain measures be taken to create a situation where ceded reinsurance be offered only to credible and solvent reinsurers.

20. It would be fair to say that reinsurer security assessment is primarily the responsibility of the ceding company, and this is in application of the principle of "caveat emptor". The ceding company can assume the task of selecting reinsurers who meet the conditions of solvency, credibility and technicality. However, it is frequently the case that insurance companies are not in a position to assess by themselves the situation of their reinsurers for a variety of reasons ranging from the inability to obtain detailed information to lack of experience in this particular field. None the less, the principle of "caveat emptor" all alone cannot present a sufficient basis for the choice of reinsurers, since several interests other than those of the insurer are at stake. It would be appropriate that the regulatory authority contribute also to the screening work in the field of the choice of reinsurers in an attempt to round off the system of protection of policyholders and to avoid possibilities for direct insurers to be dragged into dangerous zones which could threaten their very existence.

21. Obviously, for regulatory authorities to have a say over the choice of reinsurers by ceding companies, it is necessary to put ceded reinsurance under some type of control and to give the regulatory authority the power to prevent ceding companies from entering into business relations with doubtful or insolvent reinsurers, provided that this can be achieved without destroying the international concept of freedom of reinsurance trading and the international character of reinsurance.

Chapter I

SECURITY ASSESSMENT BY CEDING COMPANIES

How to look at security

22. Reinsurance contracts are agreements based on mutual good faith. The ceding company counts upon the reinsurer for the parts of the risks or losses which the latter has assumed. It is therefore of the utmost importance that the ceding company risks are placed with reinsurers able and willing to meet their commitments promptly and equitably. Despite the paramount importance of reinsurance security, many ceding companies in the direct market still attach more importance to reinsurance costs than to the security of the reinsurer. To save in reinsurance premiums they place their risks with reinsurers who offer the lowest price. Cheap reinsurers are often the least secure and most inadequate. However, the current reinsurance crisis, the failure of many reinsurers, and the series of frauds which have taken place have proved that it is vital for reinsurance buyers to check the security of their reinsurers, particularly in view of the fact that such checking involves a modest expense compared to the very high cost to be borne if a reinsurer fails to pay his dues.

23. Failure is not taken to mean simple insolvency. The moment a reinsurer's trading becomes seriously unprofitable and financially damaging, the reinsurer becomes potentially insecure and it would be hazardous for a ceding company to resort to it for reinsurance facilities. The procedure of security analysis attempts to shed light on such situations, predict the consequences and take action to avoid dealing with insecure reinsurers.

24. Ideally, the exercise of security analysis needs a large amount of information to be centrally recorded and to be available to the market. However, as the reinsurance industry in many markets is not subject to control or is subject to a liberal system, ceding companies are compelled to rely basically upon the financial information published by reinsurers themselves. Such information has to be translated into percentages and ratios in order to assess performance and solvency. In addition to this, direct insurers have to review the business background of the reinsurers' subsidiaries and affiliate companies, management, reputation, etc.

25. In considering the criteria and the various pointers which can serve as a basis for security analysis, due weight should be attached to two types of information, the first related to the reinsurer itself, the other related to its country of domicile.

A. Information related to the reinsurer

The quality and reputation of staff

26. In considering reinsurance security and in setting up systems and procedures to evaluate companies, the question of trust and integrity must be paramount. There is little point in calculating solvency margins if there is a question mark over the honesty of underwriters or people who manage the business or if a reinsurance company has given its pen away to a poor manager or an agency which may not have the same long-term commitment to the

business. Given integrity, then the experience and past record of people is vital. Reinsurance is a long-term relationship of trust and judgement. Experience in the business is essential. It simply does not compare with, say, selling consumer goods. For example, the very long-tail business involved in some classes of reinsurance means that an underwriter's record, over a long period, must be proven before true faith can be accorded to him. In essence, an assessment of the character, intelligence and experience of owners, directors, underwriters and managers is the first test of the solvency of any reinsurance operation and can be more important than figures. 7/

Technical and management skills

27. In the field of security assessment, a certain degree of knowledge of the quality and reputation of the reinsurer's management is required. The skill and the experience of such management is reflected in the long and continuous business relationship that ceding companies have with the reinsurer. Also, the diligence of the reinsurer in underwriting the risk and settling claims indicate the degree of professionalism of the management. Finally, the continuity of the reinsurer's management can be seen as an indication of the reliability and stability of its business policy.

Ownership and inter-company relationships

28. One of the important elements in assessing reinsurers is determinating who really owns and controls the reinsurer. Is he a part of a conglomerate? Light must be thrown on the relationship between parent and subsidiary. If the reinsurer is a subsidiary of an insurance company, it is necessary to determine the value of the guarantee of the parent company. If the insurance company is a subsidiary of the reinsurer, one has to determine the extent of damage to the reinsurer which would be caused by the failure of the subsidiary.

Past record of the reinsurer

29. The past is a good guide to the future. In order to study the past it is necessary to obtain financial information from the annual reports or statutory returns of the companies concerned. Annual reports are usually a good source of information, though many of them seem designed to conceal information rather than to display it. Among the shortfalls that often characterize annual reports are the following:

(a) No gross premiums being given in the annual reports, although the relationship between the gross and net premium and indeed the gross premium and the net worth is probably the most important test of the strength of a reinsurer. Many companies omit this figure and in many others it is hidden;

(b) No split of activities either geographically or by class of business. This makes it difficult to establish what type of business the company writes;

(c) A lack of standardization in calculating reserves. Standards of reserving vary widely and most companies do not choose to disclose their reserving policy in detail; 8/

(d) An inadequate split of investments or an inappropriate valuation of these investments.

Analysing trends

30. In looking at the past record, the most important trends to consider are: growth in premiums, at both the gross and the net level; changes in underwriting profits or losses and their relationship; investment income; and movements in technical reserves.

Premium and retention growth

31. The first test in this respect is to make sure that the reinsurer commands a reasonable volume of business. A progressive reinsurance company should show a growing volume of business rather than a redundant or falling account. This is a minimum yardstick suggesting that the reinsurer is in good shape. Moreover, it is essential that the volume of business written by the reinsurer emanates from different countries in order to guarantee a reasonable degree of diversity and spread. It is generally admitted that a reinsurer having the bulk of its premium income deriving from one country (most probably his country of origin) and in its local currency may not be very attractive to reinsure with on a large scale. Special attention should also be given to the retrocession policy of the reinsurer. A sound and safe reinsurer is the one who retains for his net account a sizeable proportion of his acceptances. A small proportion of retention may indicate that the reinsurer is not at the level to operate as a risk carrier, and that his sole interest is to earn commissions.

Underwriting profits or losses

32. Second in the field of analysis of underwriting performance is the review of the past record of technical profitability. A reinsurer with consistently poor underwriting results is a potential insolvent, even if his investment yields have been able to make good the negative underwriting results. This is simply because losses may increase to an extent that investment yields would not be sufficient to cover them. However, insurance as a whole has been largely unprofitable for several years now, and companies have been looking at the total returns from underwriting business. In other words, they take investment income into account. It is, of course, necessary to consider pre-tax profitability as well as profitability from underwriting and to see how dependent the company is on investment income and capital gains. An unprofitable company is unlikely to merit additional funds from its parent company. The security issue becomes even greater when such a parent is receiving significant dividends from that company. This situation begs the question of whether the company was set up to try and make an underwriting profit or perhaps as a financial facility designed to move premium funds upstream to a parent as a cheap form of borrowing (at least until losses begin to occur).

Reinsurers' assets

33. The assets of the reinsurer should be of a type that can be readily liquidated so that claims and potential claims can be paid. An excessive proportion in any one country or type of asset has dangers. Stock markets can go down and can close in certain countries. Property prices can slump, not only through supply and demand but through rent controls. Where potential liabilities and actual assets are in mismatched currency there are significant dangers through currency movements.

Valuation of assets

34. In looking at assets it is necessary to establish the basis of valuation and to identify their real value and eventually to determine their admissability.

Technical reserves

35. In examining the solvency of the reinsurer it is essential to examine the size of his technical reserves and to make certain that they are adequate to meet his liabilities on the business he has already written. Technical reserves comprise the unearned premium reserve, the reserve for the known outstanding liabilities, and the reserve for incurred but not reported liabilities, i.e. IBNR. The first two reserves are normally factual provided good records are kept. IBNR reserves present a major problem in analysing reserve adequacy of a reinsurer. To judge the adequacy of all these reserves, it is necessary to look to the historical record of reserving of the reinsurer as evidenced by his returns over a period of years. If such returns constantly show a negative balance on the revenue account for business relative to previous years, this can be taken as *prima facie* evidence of the inadequacy of technical reserves.

Test ratios

36. In the examination of the reinsurer's security, the analysis should cover a variety of test ratios which help to evaluate periodically the financial position of the reinsurer. Such test ratios include the solvency margins, changes in net premiums, reinsurance ceded to gross premiums, combined loss and expense ratio, technical reserves and shareholders' funds in relation to net premiums.

Solvency margin

37. This ratio indicates the extent of the company's trading or overtrading in relation to the net worth or shareholders' funds. Net worth is normally considered to be the initial investment of the shareholders and the accumulated undistributed profits over the years of operation. As a generic term it covers capital funds and surplus shareholders' equity, free assets and free reserves and sometimes policyholders' funds. The higher the net premium to net worth the larger the impact of losses on net worth. It should be appreciated that a company with a relatively high net worth can safely write a higher ratio of premium to net worth. For example, a company with shareholders' funds of $3 million can safely write a net premium of $6 million while a company with a net worth of $20 million could safely write a net premium of $65 million.

38. This ratio, and indeed other ratios derived from the annual report, must be considered in the light of the territory in which the insurance company is operating. Different levels of disclosure exist in each country and account must be taken of insurance regulations and accounting practices in each. In the Federal Republic of Germany, for example, insurance companies are very conservative regarding their assets and consequently net worth, so that in reality they are writing in a much more cautious way than the ratios suggest or is customary elsewhere.

39. It is also necessary to consider the type of business being written. For example, a company specializing in United States catastrophe covers will be expected to have a more modest and conservative ratio than one writing a short-tail fire account in Kenya.

40. In looking at the relationship between premiums and shareholders' funds one must remember that the actual amount of shareholders' funds and the minimum ratio required by statute in many territories is modest. To be told that a company's solvency ratio satisfies statutory requirements may not in itself be a sufficient test of security.

Changes in net written premium

41. This ratio focuses on a company's stability. Major changes in premium flows, be they an increase or a decrease, are worthy of investigation. Substantial increases or decreases may be a consequence of changes in underwriting policy, the lines of business written and even underwriting philosophy. It is appreciated that a new company will be increasing at a faster rate than a more stable mature company. However, when a reinsurer substantially increases net premium, one must question, in the light of the poor profitability of reinsurance companies, where this additional business is coming from. Is substandard business being purchased? Are higher commission rates being paid or has the company diversified into new classes of business? In the event that premiums have experienced a decline, one must question how the overheads of the business will be spread.

Reinsurance ceded to gross written premium

42. This ratio questions the extent of a reinsurance company's reliance upon retrocessionary covers. Where it retrocedes more than 40 per cent of its gross incoming premium it clearly has a substantial dependence on the continued health and indeed existence of its retrocessionaires. It is an unfortunate fact of life that too many reinsurers retain only a very modest part of the premium they write and retrocede the vast bulk of the risks. Such companies are effectively brokers or wholesalers and not genuine reinsurers. In view of the current capacity crunch, such reinsurers are fast disappearing as they find themselves unable to protect themselves adequately. Where companies retrocede substantially it is necessary to enquire as to the stability of the ultimate risk carrier and perhaps request a "cut-off" clause as it would be apparent that the ceding insurer or reinsurer would not be able to pay claims until full recoveries had been received.

Combined ratio

43. The combined ratio is the sum of the loss and expense ratio. The majority of insurance and reinsurance companies throughout the world today have a combined ratio in excess of 100 per cent, i.e. they are making an underwriting loss. Where investment income is not greater than the underwriting loss an overall loss situation will exist which, unless there are exceptional circumstances, will begin to erode the capital base of the company. In looking at some of the combined ratios for United States reinsurers, average combined ratios of more than 120 per cent have not been uncommon in recent years, and this trend has shown itself in the substantial reductions in the net worth of companies. 9/

Technical reserves and shareholders' funds in relation to net premium

44. The ratio above compares the net written premium with the total balance sheet reserves, i.e. all the technical reserves and all the shareholders' funds, which might under exceptional circumstances be available to pay claims. A company with a low level of these reserves clearly would have a "lower ultimate claims paying ability" than one with a higher level, though once again the type of business that is written must determine the extent of the reserve requirement. A rule used by many security analysts is that technical reserves plus shareholders' funds should be at least 150 per cent of net premium. A higher percentage may be required for long-tail business. This rule presumes that the assets in the balance sheet are not significantly understated and the company is writing a general book of business and not just a predominantly short-tail account.

B. Information related to the country of origin of the reinsurer

45. Such information relates to two main fields. The first concerns the government supervision and regulation applicable to the reinsurer in his country of domicile. The second relates to the economic situation, currency regulations and fiscal provisions in the same country.

46. The assessment of security would be incomplete if the government supervision laws and regulations in the country of domicile of the reinsurer are not examined carefully. Obviously, if reinsurers are regulated in their countries of origin, they may have to adhere to certain requirements. They may have to be up to certain standards of solvency, and they may also be required to file financial information with the supervisory authorities. The existence of such regulation and supervision would create additional elements which can reinforce the feeling of security in the ceding companies, though they do not preclude security tests being carried out by the ceding companies themselves.

47. Reinsurance implies transactions and transfers of funds from one country to another. The ability of reinsurers to meet their obligations abroad depends to a large extent on the country's solvency. This is of particular importance at the present time because an increasing number of countries are defaulting in the payment of their debts. Thus financial uncertainty in a country may render its reinsurers unable to meet their commitments. It is also essential before the selection of a reinsurer to check currency regulations in the country of the reinsurer and to see if there are laws limiting the free passage of funds. Finally, it is also necessary to examine the fiscal policy of the country of the reinsurer to ascertain that no fiscal charges or withholding taxes are applied to amounts due to ceding companies abroad.

C. Sources of information for security assessment

48. Ceding companies, in order to analyse the security of their present or eventual reinsurers, should gather all possible information relevant to them. Annual reports, balance sheets and accounts are usually the main source of information about reinsurers. However, as accounts and reports published by reinsurance companies do not always reflect all the aspects which it is necessary to examine, it may therefore be necessary in some cases to seek additional or alternative sources of information such as statutory returns to

local supervisory authorities if disclosure and recording are required by law. It may also be useful to examine information about the reinsurer in insurance and non-insurance press publications and periodicals, as well as consistently reliable information in the marketplace. Furthermore, personal contacts with managers and staff of the reinsurer could help to disclose the ability and the reliability of the latter.

49. Reinsurance brokers, particularly the major ones, establish standards of their own in the selection of those with whom they are prepared to place their business. To this end, some large brokers have security committees to maintain records on reinsurers they deal with, and they often produce security lists containing names of reinsurers usually divided into three categories, namely the ones to use, the ones to use after consultations with the ceding company, and finally the ones to avoid. Obviously, such lists are confidential and used exclusively in cases where the broker is required to place a business of a ceding company.

Statistical services provided by independent organizations

50. Apart from security assessment services offered by some brokers, there are firms in the United States and United Kingdom which have established security reporting and assessment services.

51. One of the well known services is the "Best's" insurance report in the United States which reviews data of many companies and allots every company a rating category ranging from "Excellent" to "Fair" and "Omitted". The "Best's" serves as a guide for anyone wishing to see the history, management structure, technical and financial information of every company which transacts insurance and reinsurance business in the United States. This publication can be produced thanks to the fact that all insurance and reinsurance companies in the United States are required to file their returns with regulators on a predetermined and standardized basis.

52. In view of the need for information to be made available to the insurance market as a whole, three specialized organizations have made it their business to provide such information and to prepare reports on the financial stability of insurance and reinsurance companies, their solvency status and a host of other details. These three organizations are: Insurance Solvency International, International Insurance/Financial Service, and Financial Intelligence and Research.

Insurance Solvency International 10/

53. Insurance Solvency International (ISI) is the first European-based security analysis service. It presents and publishes key financial data on non-life insurance and reinsurance companies in a standard and easily used form. This London-based organization is designed primarily to assist ceding companies and reinsurance brokers in evaluating the security of reinsurance companies. Their publication includes about 1,000 companies in some 60 countries, covering the vast majority of world-class names. The analysis transforms a mass of statutory numbers into a single standarized presentation enabling security analysts to focus on investigation and judgement rather than on spread sheet analysis. Each company report is in two parts. First, the company performance and outline shows financial performance over three years as measured by eight ratios. These cover solvency, technical reserves,

reinsurance ceded, premium growth, underwriting losses (as related to investment income) and movements of capital and liquidity in relation to reserves. These ratios are tracked against a set of standard ratios, regarded as generally accepted in the market. The level and growth rate of premiums, capital, reserves and assets are also highlighted. A descriptive section covers key facts concerning the companies' ownership and trading profiles and also comments on the highlights of each company's performance. The second part, the statistical record, displays key figures which facilitate comparisons between different sections of the balance sheet and income statement. This part varies in completeness according to availability of data. The format is standard. For each country, in addition to producing individual company reports, a brief "Country Profile" is provided touching on the structure of insurance, regulation and accounting practice in each country or region and adding some historical notes where helpful.

International Insurance Financial Service (IIFS) 11/

54. IIFS, based in Stamford, Connecticut, provides a service similar to ISI and evaluates the financial strengths and weaknesses of companies domiciled outside the United States. While their coverage and speed of reporting cannot compete with ISI, some analysts prefer their style and the classification they offer. Their information is taken from the annual reports of the companies rather than from the accounts which are submitted to the regulatory authority. In addition to the standardized financial information, there are paragraphs dealing with the business background of the company concerned, and its major subsidiaries or affiliates.

Financial Intelligence and Research (FIR) 12/

55. This service analyses the principal companies authorized to accept business in the United Kingdom. The information it produces is available to international subscribers who wish to have access to the FIR data base. The data provided are generally based on information filed to regulatory authorities in the United Kingdom but could also cover information regarding overseas subsidiary companies.

D. Validity of the assessment exercise

56. After having enumerated the judgmental yardsticks for assessing the security of reinsurance and highlighted the possible sources of information on reinsurers, it may be necessary to evaluate the effectiveness and cost of such an exercise when carried out by ceding companies or by their brokers, particularly in the context of insurance markets in developing countries.

57. The exercise of security assessment carried out by ceding companies is a complex and uncertain task which deserves special attention. Complex, because the reports, accounts and statements published by the reinsurers do not reflect all the financial and technical realities relevant to them. A great deal of information needed for the assessment of security is not even contained in these published accounts. Uncertain, because security analysis is still far from being a science or a perfect technique. Here it must be appreciated that the information on the basis of which the analysis is done 13/ is of a subjective nature. Because of the absence or inadequacy of supervision of reinsurance in many countries, reinsurance companies often take full advantage of such freedom or flexibility to present their accounts in the

manner they want. Even if they are subject to certain regulations, nothing prevents them from interpreting these regulations in different ways. Also, due to the fact that most countries do not subject reinsurers to specific control similar to that of direct insurers, there are no public files on reinsurers from which ceding companies can elicit additional information for evaluation purposes. In addition to the above considerations, there remains the fact that retrocessions follow the first reinsurance, probably through several generations of reinsurers and across several frontiers. Beyond the first reinsurers the ceding company is not in a position to check the security of the retrocessionnaires. Given these constraints, the security exercise probably needs more than mere assessment by ceding companies.

58. Even supposing that adequate information regarding reinsurers is available, not many ceding companies, particularly those in developing countries, may be able to cope with the tasks and the requirements of evaluating reinsurers by themselves. Such evaluation requires, among other things, a highly qualified and experienced staff with a sufficient grasp of and in constant touch with developments in the world reinsurance markets. Although such personnel, for individual and small companies, is extremely difficult to obtain and very costly to maintain in house, it is in the interests of insurance companies to do their best to train their staff to fulfil such tasks.

59. Many insurers, particularly in developing countries, recognizing the difficulties involved in carrying out the assessment exercise by themselves, resort to brokers for placing their reinsurance abroad. Naturally, the broker should examine the security of the reinsurer with whom the business is to be placed. Brokers are obviously in a better position than most ceding companies to appraise the security and solvency of reinsurers because they are, by the nature of their work, in constant contact with the international reinsurance markets. Yet how safely can insurers rely upon the judgement of their brokers? The past few years have shown a constant trend towards the disappearance of the financial independence of brokerage firms. Many reinsurance brokers have been acquired by insurance and reinsurance companies. Inversely, some brokers have acquired interest in insurance and reinsurance companies. The latest cases of fraud in the reinsurance world scene have revealed that many insurance and reinsurance entities have become mere subsidiaries of broker's conglomerates. Thus the independence of the brokers, which is the very essence of their profession, is becoming more of a fiction than a reality.

60. It has also been observed that some brokers select reinsurers and exclude others on merely political grounds, a situation which does not match with their duty to remain independent, compromises the need to have open markets and finally undermines their commitment to choose the most reliable reinsurers with the keenest price for cover.

61. Finally it should be pointed out that, in principle, brokers do not incur any legal liability in the event of the default or the insolvency of reinsurers selected by them (case law is very deficient in this area). All these considerations make the selection of the reinsurance broker himself a matter of crucial importance to the ceding company. Until the situation is resolved either by some measure of control or by some other means, the choice of the broker by the ceding company has to be guided by the "caveat emptor" principle.

62. The choice of the reinsurer, as explained earlier, has a direct impact on the ability of the insurer to meet his obligations towards policyholders. To ensure that ability, and in view of the shortcomings which insurers face in this field, it may be necessary for insurance regulators to provide assistance in the field of reinsurance security. In other words, the regulation of insurance may have to be extended to cover ceded reinsurance by direct writing companies. However, such regulation and supervision may not be the panacea for the problems of security. Such regulatory involvement, which would take place at source, is not meant to interfere with the privilege of the insurer with regard to selecting his reinsurers, or even to monitor his choice. It is mainly designed to oblige the ceding company to require certain guarantees which would spare it the negative effects of a reinsurer's failure or insolvency. Nothing, however, prevents the regulatory authority from playing a certain role in the selection process of the reinsurers.

Chapter II

SUPERVISION OF CEDED REINSURANCE

Objectives of insurance control

63. Supervision of insurance generally aims at achieving two objectives. The first and principal objective is to protect the policyholder and the individual members of the public. The second objective is to optimize the advantages which the national economy can draw from the insurance sector.

64. Regulators all over the world, notwithstanding the different systems of insurance supervision, concentrate their regulatory and supervisory efforts on the organizational, financial and transactional aspects of insurers' activities which fall under their jurisdiction. It will be agreed, however, that such aspects of regulation and supervision all alone cannot guarantee full protection for the consumer and for the national economy if a considerable portion of the insurers' business passes through reinsurance to other insurers, particularly those domiciled outside the scope of jurisdiction of the supervisory authority.

65. The insurer may enter into reinsurance agreements with an insolvent or unreliable reinsurer. Such a situation would undoubtedly affect the interests of the policyholder and put in doubt the protection he sought. Also, the individual direct insurer may suffer from unfair treatment by a reinsurer. Such treatment may undermine or weaken his solvency and may lead to depriving the national economy of certain benefits which can be drawn from the insurance sector. It could eventually cause an undue burden on the balance of payments of the country to which the insurer belongs.

66. Hence the necessity for the insurance supervisory authority to have a look at the reinsurance arrangements of insurance companies. Such checks are proposed not because it is thought that insurers are not able to look after their own interests when placing their surpluses in reinsurance, but because this is practically the only way to round off the system of protection of the policyholder and the national economy.

67. Control of the reinsurance programmes of primary insurers can be achieved through the obligation to report the details of these programmes and the lists of reinsurers selected. Some countries require the prior approval of such programmes before they become effective. Others do not require such approval but the obligation of disclosure is maintained. In a third group of countries remittances under reinsurance contracts are not allowed before the approval of such arrangements by the financial authorities of the countries' "Central Banks" and the like.

Supervision of reinsurance terms

68. In practice most supervisory authorities make no attempt to scrutinize such programmes in detail. Probably the reason for this is that detailed supervision is likely to be ineffective. Reinsurance contracts are in fact tailor-made for each insurer. The structures and terms of such contracts stem from particular factors inherent to the insurer himself, his capitalization, portfolio, experience, expectations, staffing, etc. ... No supervisory authority can replace an insurer in making choices. Attempts by the

supervisory authority to impose changes in a reinsurance programme may have an adverse impact on the ability of the insurer to meet his commitments. It is also to be appreciated that if effective control is to be exercised on a reinsurance programme, a welter of information has to be provided to the supervisory authority. This would create an unbearable burden for both insurance industry and supervisory authority. Moreover, for the supervisory authority to translate this information into effective action would need a large number of skilled staff who may after all not be able to give a flexible and speedy judgment on the matter.

Supervision of the choice of reinsurers

69. It is reasonable to assume that the choice of reinsurers belongs to the reinsurance buyers, not only because they have the greatest interest in checking the solvency and reliability of their reinsurers but also because this prerogative is essential for their functioning. Given the huge increases in values at risk and the continuous emergence of new and technological risks which require both know-how and capacity, it is of the utmost importance to allow primary insurers the liberty of utilizing the international reinsurance markets and to maintain the ability to shift from one reinsurer to another to take advantage of the best deals and the most appropriate terms and services. This implies the least possible intervention on the part of the supervisory authority in the choice of reinsurers.

70. The freedom which ceding companies should enjoy in choosing their reinsurance partners should not in principle preclude reasonable control by the supervisory authority to see that law requirements concerning cessions to local and/or regional reinsurance institutions or pools are fully implemented. 14/ The supervisors also have to intervene to guarantee the utilization of local market capacity before foreign reinsurers are used in the cases where laws or regulations so require. They may also intervene in the placing of reinsurance to guarantee an appropriate distribution of shares of treaties between several reinsurers and several markets with a view to minimizing the impact of political or monetary upheavals which may occur.

71. Insurance supervisors may also be entitled to intervene on a formal or informal basis in cases where insurers under their jurisdiction cede shares of their business to reinsurers who are known to have become insolvent, or when there are serious doubts about their capacity to meet their obligations. In such cases the supervisory authority should be empowered to terminate the reinsurance agreements with these reinsurers or possibly to reduce their respective shares. 15/

72. From what has been explained earlier, it is clear that the role which could be played by the supervisory authorities in the shaping and distribution of the reinsurance programmes of companies is rather minimal. Yet since the protection of the insuring public and the industry remains the main preoccupation of the supervisory authorities, it is understandable that greater attention is paid to certain requirements in the reinsurance contract, the most important of which is the withholding of funds backing ceded reinsurance. The gist of this withholding is to make certain that such funds are not usable by the reinsurers, as they are earmarked to discharge specific liabilities. The ceding insurer brings such funds into settlement only after they have been fully earned by the reinsurer.

Withholding of reserves

73. Insurance regulators can formalize the practice of withholding reserves in two ways: directly, by expressly requiring the technical reserves corresponding to the share of business ceded to the reinsurer (premium reserve and loss reserve) to be withheld by the ceding company; or indirectly, by requiring technical reserves constituted by the insurer to be calculated on gross basis without credit being given for the cover obtained from the reinsurer.

74. Reinsurers consider the requirement of withholding premiums from them as a deviation from the principle that a reinsurer is entitled to his full premium from the moment of inception of liability until the next annual premium falls due under the original policy. They also object to the withholding of outstanding loss reserves on the basis that the reinsurer is not obliged to indemnify the ceding company until the latter is obligated to indemnify the policyholder or the aggrieved third party. They feel that the deposit of outstanding liability reserves for at least 12 months does not take into consideration the situation where a reinsurer would have settled a good part of the claims to which the reserves for outstanding liabilities relate. Furthermore, the reinsurers claim that the funds blocked in deposits are exposed to the exchange risk as far as they exceed the final obligations. Moreover, those funds often earn less income than would be possible with normal investments in the market. Also, since the exchange risk and the interest level are interrelated, cash deposit interest rates not commensurate with the market are of the utmost importance, particularly when the currency of the country concerned is weak. An interest rate governed by the capital market level in the country involved is therefore of particular significance for cash deposits. The most serious disadvantage, as put forward by reinsurers, is that, due to the withholding of deposits, funds are withdrawn which they need to fulfil their treaty obligations, i.e., to pay claims. They argue that by securing each individual case the efficiency of reinsurance as such is affected, which is in the interest of neither the direct insurer nor the reinsurer.

75. Despite the fact that the measure of withholding reserves, all alone, does not offer the protection which ceding companies seek, particularly in the case of large losses, many regulators and many ceding companies realize that in the absence of adequate solvency controls exercised over reinsurers by supervisory authorities, the withholding of deposits from reinsurers becomes the only option available to the insurers to guarantee the collectibility of their reinsurance recoveries. In special cases such deposits may also serve to minimize the risks which might result from possible unforeseeable political and financial upheavals in the country of origin of the reinsurer which may render his guarantees inoperative or uncertain (state of war, currency restrictions, etc.). Such deposits could also partially protect the ceding company in cases where the reinsurer either is unable or refuses to honour his commitments.

76. Despite this flurry of arguments and counter-arguments concerning the principle of withholding deposits from reinsurers, a tacit understanding was reached between OECD countries, to which most reinsurance suppliers belong, on the subject of these deposits. This understanding considers the statutory requirements which oblige the reinsurers directly or indirectly to deposit with their ceding companies the part of underwriting reserves pertaining to

the risks received with them not as a restrictive measure limiting the freedom of reinsurance. 16/ The understanding in fact acknowledges the validity of the motives behind withholding deposits.

77. Finally, it is to be noted that the withholding of deposits from reinsurers applies only to proportional reinsurance treaties. For facultative business as well as for non-proportional treaties the withholdings of deposits is not common. There are, however, some cases where outstanding loss reserve deposits are provided for in non-proportional treaties when insurers are statutorily required to establish gross outstanding loss reserves.

Forms of deposits withheld

78. The most common form of deposits withheld by ceding companies is cash, and the two parties to the reinsurance contract determine the rate of interest which the reinsurer receives on the deposit. However, in some cases reinsurers may offer a securities deposit instead of cash. Such deposits may satisfy the direct insurer from the security point of view but do not allow him to earn any money, since the interest or dividends corresponding to these securities accrue exclusively to the reinsurer. This is why several countries have regulations requiring the presentation of reserves of direct writing companies exclusively in local investments, a matter which excludes the practice of depositing foreign securities.

79. Some countries accept, as a substitute for deposits, letters of credit issued by certain locally accredited banks. Such letters of credit pledge these banks to pay the ceding company a certain amount upon demand. In order to be acceptable such letters of credit have to be irrevocable and unconditional and must specifically state that the letter of credit is payable upon the presentation of a sight draft without the requirement of presenting any other document. The system of letter of credit has been adopted in many states of the United States and is used in transactions between ceding companies and reinsurers which are not admitted in the State in question. In Europe, letters of credit have been used in very exceptional cases, since cash or security deposits covering technical reserves normally suffice to cover the ceding companies' needs for security. 17/

Fronting

80. It is theoretically possible for an insurer, by way of reinsurance, to cede a very large proportion or even the whole of the business or risks he writes. There may be good technical and commercial reasons for the insurer to do so. However, such fronting creates a situation where the insurer takes a risk of unprecedented magnitude because of his complete reliance on a reinsurer to meet his commitments to the policyholder. It would inevitably be catastrophic to the insurer if his reinsurer became insolvent or defaulted payment. This is why in several countries supervisory authorities, in the normal course of their duties, seek explanations as regards cases of fronting. Some countries go even further and fix a minimum retention for the ceding company. 18/

Chapter III

REGULATION AND SUPERVISION OF REINSURANCE SELLERS

81. Reinsurance activities are practised either by mixed insurers, that is to say those who accept reinsurance business beside direct insurance, or by specialized reinsurers whose business is reinsurance exclusively. In most countries mixed insurers are treated as if all their business is direct business and as such they can be considered fully supervised. 19/ Contrary to mixed insurers, specialized reinsurers have so far been largely unencumbered by State regulation or have received in practice more lenient treatment. The reasons for this lie in the very special nature of reinsurance and its logic. 20/ The principal consideration for such an approach is that specialized reinsurers have no dealings with the public. The policyholders or aggrieved persons who are the very subject of protection by supervisory systems or direct insurance have no title or links with the reinsurers.

82. Moreover, direct writing companies, in their quality as ceding companies, do not need the same protection as policyholders. In fact, they enjoy a knowledge and expertise in technical and financial matters comparable to that of their reinsurers, which qualifies them as equal business partners.

83. In most countries insurers are subject to State supervision which applies to their gross portfolios, i.e. gross premiums and gross liabilities. Such comprehensive control is viewed as an optimum security, making the supervision of reinsurers an unnecessary and superfluous exercise.

84. A fourth consideration justifying a less restrictive approach to reinsurance is that reinsurance transactions are by nature, as well as by necessity, international in character. Thus, subjecting reinsurers to local regulations would defeat or obstruct the main objective of reinsurance which is the spreading of risks, and may have an adverse impact on the competitivity of the reinsurer.

85. There are other factors which have deterred Governments from treating reinsurers in the same way as direct insurers. The ability to check reinsurers' activities requires a great deal of information permitting not only a quantitative analysis but also a qualitative appraisal of their activities. It is hardly possible for a Government or a supervisory authority to check the countless international dealings of reinsurers. The fulfilment of such a task would require, among other things, a thorough knowledge of different markets, their laws, structures, currency risks, investments, etc. Monitoring all those elements would virtually amount to the supervisory authority running the business itself.

86. Even supposing the ability of the supervisory authority to monitor and control the performance of reinsurers, such control would depend greatly on the timely input of information which the reinsurers should provide. Given the world-wide scale of reinsurance transactions and the endless chains of retrocessions, returns to be provided to the supervisory authority would inevitably be too belated to serve as basis for a useful and up-to-date judgement. Accordingly, the chances of the supervisory authority immediately remedying any adverse situation are in practice rather remote.

87. In the light of these considerations, many countries with well developed local reinsurance markets have refrained from regulating the activities of reinsurance companies. This is the case of countries such as Belgium, France and Luxembourg.

88. Other countries, some of them the home of large specialized reinsurance companies, do not require local specialized reinsurers to be licensed. However, reinsurers have to comply with certain requirements such as disclosure and reporting in order to ensure that their business is conducted with due diligence. This system is applied in Austria, 21/ the Federal Republic of Germany and the Netherlands.

89. In the United Kingdom, the supervision of local specialized reinsurers extends beyond licensing and reporting. It also includes control over the reinsurer's solvency, and the supervisory authority is entitled to intervene in the affairs of a reinsurer by, for example, stopping him from taking on further business or petitioning for his winding up on grounds of insolvency.

90. Other variations of regulation and supervision exist in Italy, Sweden, Switzerland and the United States of America. In Italy, specialized reinsurers, before being allowed to operate, are subject to prior technical authorization. During their operation they are also supervised. In Sweden, local direct insurers and specialized reinsurers are subject to the same form of supervision. However, the Government may allow certain exemptions from supervision requirements in respect of reinsurance. In Switzerland, local insurers and reinsurers are regulated by a Federal law which provides for authorization and licensing procedures and the constitution of technical reserves. However, in contrast with direct insurance, solvency margins are not specified for reinsurance business. In the United States, the regulation and supervision of insurers and reinsurers are not federal matters but are performed at the State level. Generally, a domestic reinsurer has to apply for authorization before being allowed to accept business. For authorization and admission purposes he must give evidence of solvency and competence. Once it is admitted he becomes subject to reporting requirements. Such reporting is thoroughly scrutinized. Alien (non-American) specialist reinsurers do not need a licence to operate in the United States. However, if they sought a licence they would be subject to the same laws regulating the United States insurers and reinsurers. For reinsurance ceded to reinsurers licensed locally, whether local or alien, financial credit is recognized allowing the ceding insurer to reduce his unearned premiums reserve and loss reserve to the extent of reinsurance recoverables. In all other transactions with reinsurers not licensed in the state such credit is not given, and ceding companies are required to withhold full premium and loss reserves.

91. Regulation of reinsurance in the developing world varies from country to country. However, as most of these countries are more buyers than sellers of reinsurance, and since they invariably suffer from heavy dependence on foreign reinsurance, their regulatory systems are principally marked more by considerations related to the necessity of curbing such dependence which causes an increased outflow of funds rather than concerns about reinsurance security. In many of these countries laws and regulations limit the freedom to place reinsurance outside national boundaries through the imposition of compulsory or legal cessions to local reinsurers as a device to minimize foreign exchange outflow. Some of these reinsurers are State-owned, while some others are private or mixed but enjoy State backing. In most cases such

local reinsurers are subject to special legislation which specifies their purposes and their methods of operation. 22/ Beyond these measures aiming at curtailing excessive resort to foreign reinsurance and the promotion of use of local capacity, there are hardly any frameworks in developing countries providing control over reinsurers' activities.

Reinsurance regulation versus reinsurance freedom

92. It would be difficult to challenge the validity of the arguments in favour of reinsurance freedom. Indeed, such freedom has contributed and still contributes largely to the development of insurance markets and to producing the capacity needed to cover the world's complex and expensive risks. However, it has to be emphasized that reinsurance freedom is not an abstract concept. It can only remain valid to the extent that reinsurance security is maintained. Unlike insurers, reinsurers have all along been given wide freedom in doing their business. However, the reinsurance market has been changed greatly in recent times by the many new entrants to the marketplace and by the growing complexity of the corporate entities involved in such transactions. These recent developments have been associated with failures, abuses and frauds involving some reinsurance practitioners. Insurance supervisory authorities all over the world have been alerted by such negative developments. They realize that monitoring the solvency of direct insurers while assuming that the world's reinsurance market is self-disciplined and professional is no longer valid. They are becoming aware that their old ideas about reinsurance freedom may have to change in the light of the changing marketplace and that some element of control over reinsurers should become a part of the supervision of insurance companies. Not surprisingly the United Kingdom, home of the biggest reinsurance market in the world, has taken the initiative of subjecting reinsurers to stricter controls. Also regulators in the United States, faced with financial woes involving reinsurers, are considering ways and means of imposing stronger measures to ensure the security and financial stability of reinsurers. In many other countries calls are being made for tighter regulation of reinsurers.

93. The need to regulate local and international reinsurance is more pressing in less developed insurance markets than in the developed ones. One must bear in mind that reinsurance buyers in advanced markets have more expertise and more access to the information serving as a basis for security analysis. With an abundance of published material available concerning international reinsurance companies and their performance, reinsurance buyers in developed countries are more or less in a position to monitor and to review the security of their reinsurers. The situation is totally different in less developed markets. Information about reinsurers is hardly obtainable, and companies do not generally have either the resources or the know-how to proceed by themselves to security analysis. In many cases they have to rely on brokers for this job, a matter which involves a certain degree of risk. Under such circumstances a centralized approach to security analysis becomes a logical necessity. Action taken by the Government to protect its own insurance market becomes understandable, especially if the market's ability to protect itself is in doubt.

Regulatory concerns

94. With this broad objective in mind, a number of specific concerns emerge. If reinsurance is to be regulated and supervised, such regulation and supervision should apply to both domestic and foreign reinsurers alike. It is

obvious that regulation and supervision of local reinsurers are easy to implement. However, unlike insurers who need to have a local set-up in every country where they intend to operate, in most cases foreign reinsurers do not have such a local presence. They procure their business centrally from their head office or through reinsurance brokers. Obviously, if a reinsurer opts for establishing a branch office in the country where he contemplates writing business, he will then have to comply with the supervisory, fiscal and monetary regulations of that country. However, if there is no such presence there is in practice very little that can be done to compel the reinsurer to comply with the laws or regulations of the country.

95. Of equal concern in regulating reinsurance is the need to avoid as far as possible, in the pursuit of security, unnecessary restrictions on the freedom of reinsurance. Drastic and hasty measures in this respect may put local companies in difficulties when reinsuring their surpluses, particularly in the field of high valued and complex target risks. This consideration obviously does not refer to measures taken by some countries to reduce hard currency expenditure on foreign reinsurance or to reserve some share of ceded reinsurance for the local market.

96. Finally, it has to be realized that any regulation of reinsurance activities could never establish complete control. Because reinsurers retrocede extensively, the regulator faces the reality of having local risks channelled through retrocessions into the larger international market. Once they pass outside his jurisdiction, the security can no longer be ascertained. Moreover, given the diversity of the legal, structural, financial and accounting background of reinsurers from different countries, the problems of bringing them under one order would be enormous.

Possible forms of reinsurance regulations

97. With all these concerns in mind, State regulation of reinsurance can still be directed to making parties seeking reinsurance aware of the characteristics of the reinsurance companies they intend to deal with. This can be achieved by compelling reinsurers willing to write business in the market to provide information about themselves and thus become listed. Such information would then be put at the disposal of reinsurance buyers to help them in selecting their reinsurers. This form of regulation is in fact a quasi-passive one.

98. Another possible form of State regulation consists in requiring licensing for reinsurers, coupled with non-discriminatory standards for admission which would assure the solvency and competence of those permitted to write business in the country. Moreover, such regulation would facilitate surveillance by the supervisory authority of standards and requirements, as well as enhance the ability to impose sanctions for failure to perform. This form of regulation is obviously an active one.

99. While active regulation and supervision of reinsurers may contribute to making certain that the reinsurers can meet their commitments and are solvent and soundly managed, passive regulation would only provide limited benefits to the market. This is because passive regulation does not provide the basis or the means for financial or technical control over reinsurers. It only permits ceding companies to have detailed information regarding their potential reinsurers. Often such considerable reliance on the judgement of ceding

companies is disappointing, firstly, because many of these companies, especially in less sophisticated markets, are unable to use this information to reach appropriate conclusions, secondly because such companies are under no obligation to report to the supervisory authority on their findings, and thirdly because the supervisory authority has no power to exclude reinsurers from the market unless there is an apparent breach of certain obligations. This is why, to an increasing extent, active regulation has come to be seen as being a more suitable framework for reinsurance activities. However, the choice between these two forms of regulation depends very much on the leverage which a given market enjoys in relation to international markets and also on the ability of the supervisory authority to take on the responsibility of evaluating and monitoring the reinsurers, with all that this implies in terms of controls and checks.

Reinsurance regulation in the context of developing countries

100. The greater part of reinsurance cessions in developing countries is transacted by foreign reinsurance companies. However, in some of these countries locally incorporated reinsurance institutions also operate. Thus any reinsurance regulation should in principle apply to both local and foreign reinsurers. However, since foreign reinsurers seldom have local representation in the countries from where they receive their business, they may have to be subject to a different type of control. It is, however, necessary in this respect to caution against burdening local reinsurers with requirements that could put them at a disadvantage in comparison with foreign reinsurers. It may be advisable for the extent of regulation to be limited as far as practicable to the questions of solvency, reliability and technical expertise in order to allow domestic reinsurers a reasonable margin of flexibility and freedom in transacting business and in competing with foreign reinsurers.

Case of direct insurance companies writing international reinsurance business (mixed reinsurers)

101. The first measure which may be proposed in this respect is to make such companies subject to prior licensing procedures before they can engage in international reinsurance acceptances. Companies which do not show both enough capitalization and sufficient expertise in this field may be barred from transacting reinsurance. This is not only to protect their ceding companies but also to protect their own policyholders from the risks of insolvency. If a licence is granted to a direct insurer to transact international reinsurance business, the reinsurance transactions should be treated as a distinct class of business, thus maintaining the corresponding premiums, reserves and investments separate from other accounts. The reason for this is to protect direct insurer policyholders who could be prejudiced by the effect of the instability of the accepted reinsurance account.

102. Regulations may also envisage the possibility of intervention on a formal or informal basis with direct insurers accepting international reinsurance business to restrict the size of their acceptances to a level commensurate with their net worth in order to avoid the risk of their insolvency.

103. Insurers accepting international reinsurance business have technical liabilities which must be covered by adequate reserves subject to verification by the supervisory authorities.

Case of locally incorporated specialized reinsurers

104. Companies incorporated locally to carry out reinsurance business exclusively can equally be subject to some sort of licensing and their activities can be supervised. Such supervision will be of particular importance in the case of companies provided with obligatory legal cessions, as is the case in many developing countries. In this instance the State which rendered such reinsurance compulsory has a particular responsibility to ensure that the obligatory reinsurance covers are provided with absolute security. By failing to provide such a guarantee, the companies in the market may find themselves in a position where they are compelled by law to cede business to reinsurers which are insolvent or unreliable. On the other hand, the fact that a reinsurance company belongs to the State, or has State backing, does not preclude the necessity of regulation and supervision. A mere government guarantee may not always be sufficient, particularly in case of large losses which the State budget would not be able to afford. Moreover, subjecting State reinsurance companies to regulation and supervision, may help to give them more credibility in their international reinsurance transactions.

Capitalization

105. The first step in regulating local reinsurance companies is to introduce a system of licensing which entails the fulfilment of certain requirements, amongst which is the minimum share capital. At the outset a reinsurance company needs sufficient paid-up capital to develop its risk-carrying capacity. This capital also serves as an initial guarantee to cover unexpected losses, deficient claim reserving, losses due to currency fluctuations, etc. However, as this share capital will soon become insufficient to cope with the expanding premium income and the increasing commitments of the reinsurer, it may therefore be necessary for the supervisory authority to ensure that the reinsurer constantly increases his capital base, particularly through the requirement that sufficient portions of profits be earmarked to constitute free reserves. The free reserves could also be catered for from the investment income of both technical and free reserves, as well as from the appreciation of investments.

Technical reserves and IBNR

106. A reinsurance company has also to set up and to maintain technical reserves, i.e. unearned premium reserves and outstanding loss reserves, as well as a reserve for incurred but not reported losses (IBNR). In respect of unearned premium reserves, its methods of calculation are similar to those of direct writing companies and the reserves should normally be equal to those corresponding to direct business accepted. However, in certain cases, business accepted by the reinsurer may have less or no premium reserve. Examples of these cases are excess of loss and stop loss treaties whose premiums are normally fully earned during the year. Another case involves proportional treaties which are accounted on an earned basis.

107. As for the reserve for outstanding losses, it should in principle follow the estimates made by the ceding companies in their accounts. However, nothing prevents a reinsurer from reassessing his liabilities, in particular in cases of large losses or in the case of past experience of unreliable estimates made by some ceding companies.

108. Regulatory initiatives could also be directed towards ensuring that local reinsurers take the element of IBNR into consideration when calculating their liabilities. Many claims falling under the scope of the reinsurance cover may not be known and reported to the reinsurer for years. This is particularly true in respect of excess of loss treaties and long-tail business.

109. In spite of all the precautions which may be taken by the reinsurer to ensure a correct estimate of his technical reserves, these seldom give a true picture of his liabilities at a given moment. This is mainly because of the considerable delay in the submission of reinsurance accounts by ceding companies. To present a picture nearer to reality, the reinsurer may be urged to use his run-off statistics to estimate the figures of technical reserves and the IBNR for the accounts which are not available at the time he is establishing his balance sheet.

Solvency margins

110. A principal regulatory tool for effective control over the financial standing of insurers is the requirement of solvency margins. The significance of the solvency margin is that, because it is represented by the capital and free assets of the company, it provides a capital base which should be sufficient to ensure protection against a protracted deterioration of operating results, a major underwriting catastrophe or an investment collapse. Without such a capital base the insurer would be at risk. The application of the concept of a solvency margin to professional reinsurers, especially the small and the less experienced ones, could be very beneficial in the sense that it fixes for them parameters for the volume of business which they can more or less safely retain for own account. Should these parameters be exceeded the supervisory authority may have to intervene to take quick action to restore the required margin. It could also be useful in the calculation of the solvency margin of the reinsurer to fix an upper percentage for retrocession which would be deducted from the reinsurer's gross premium income. This upper percentage is aimed at preventing reinsurers from indulging in excessive retrocession and from acting as brokers rather than as real risk carriers. However, flexibility should always be the rule, particularly with regard to certain types of target and complex risks and with due regard to the concentration and aggregation of values.

Investment of reinsurers' funds

111. Regulatory authorities may also supervise the methods of investment of reinsurers' funds. However, it would not be advisable to establish percentages to be placed in real estate, bonds, stocks, bank deposits, etc., since conducting reinsurance business requires a great deal of flexibility to cope with reinsurance commitments. However, in supervising the investment policy of reinsurers, it is essential to take into consideration the fact that their assets should be placed in secure investments which give the optimum yields, since technical profits in reinsurance are scarce or infinitely thin, and it is only through investment income that a reinsurance company can survive and flourish. It is also important to see that reinsurance funds become readily marketable and realizable. Finally, such funds as well as other assets of the reinsurer, should be diversified and should not be placed in investments which form a second risk situation. However, as a large part of the investible assets of the reinsurer may remain outside his control

because they are withheld by the ceding companies, the reinsurer will have to rely in many cases on the type of investments imposed by those ceding companies.

Valuation of assets

112. Regulatory initiatives should be directed principally towards setting up adequate and clear systems of valuation of assets of the reinsurer, since such valuation is a crucial factor for the calculation of the reinsurer's solvency. In fixing such systems, regulators, particularly in developing countries, should take into consideration the fact that often money markets and stock exchanges do not exist in their respective countries, a situation which renders the task of valuation of assets extremely delicate. Perhaps the safest and most prudent method of valuation under such circumstances is to take as a basis the cost of purchase less depreciation if the current value of an asset is lower than the cost of its purchase. If the value of the assets is more than the cost of purchase, then the cost of purchase has to be retained as the basis of valuation. Such a system, if applied, would help towards the creation of invisible reserves which could strengthen the reinsurer's security.

Reporting to supervisory authority

113. Once a reinsurance company has been licensed, it may be supervised through the scrutiny of its annual returns submitted to the supervisory authority. Such returns should therefore be as informative as possible. The prime objectives of analysing such returns are: (1) to ascertain that the technical reserves are adequate to meet current liabilities; (2) to make sure that with regard to future liabilities the reinsurer has sufficient free funds to support his contemplated underwriting; (3) to ascertain that the retrocessions of the reinsurer are reasonable and represent appropriate financial security.

114. At this point, it is important to underline that the regulation and supervision of local reinsurers should be made as flexible as possible and should not subject them to stringent conditions which could put them in a difficult position negatively affecting their performance. Moreover, it would be extremely vital for these local reinsurers to have specific exemptions from exchange control regulations and to have specific facilities for the settlement of balances corresponding to their reinsurance liabilities. Though local reinsurance companies should keep and invest their funds in their countries of origin for development purposes, it would be prudent for these companies to be allowed to invest a portion of their funds abroad to match their foreign liabilities. Finally, local reinsurers should benefit from appropriate fiscal treatment, particularly as regards the IBNR and other contingency reserves which they may think necessary to set aside for security.

Regulation of foreign reinsurers

115. As mentioned earlier, regulation of foreign reinsurers is rendered difficult by the fact that they do not have a local presence in every country where they wish to receive business from. Requiring such a presence as a condition for placing business with them may result in restraining the free flow of reinsurance which is necessary for the coverage of risks. Yet since not all reinsurers operating in the international scene are technically and

financially fit, it would seem necessary for regulators to do something to make sure that foreign reinsurers entering into business relations with locally licensed insurers are adequately screened by the latter. The type of information necessary has to be determined through regulation.

116. In the light of these constraints, a simple and feasible way in which regulators can intervene is to establish a register of listed foreign reinsurers. Foreign reinsurers wishing to write business in the country would have to provide financial and technical information about themselves, as mentioned in the following paragraph. The role of the supervisory authorities would then be confined to checking to see if the information provided was sufficient to serve as a good basis for objective security assessment by the ceding companies.

117. Under such a proposed system, foreign reinsurers seeking admission would be required to file with the supervisory authority a copy of their constitution, their articles of association or act of incorporation, copies of rules governing their activities, current lists of their controlling shareholders, the names, qualifications and designations of persons entrusted with top management, etc. They would also provide statements showing that their capital and surpluses were at least equivalent to those minimums required under the laws of their domiciliary jurisdictions. They might also be required to provide the supervisory authority with copies of their annual accounts and balance sheets for the last five years, certified by an accounting or auditing firm in their countries of domicile, and this in order to assess their underwriting and financial performance.

118. The supervisory authority might also require from foreign reinsurers seeking admission a written agreement to abide by the laws and regulations of the country and the terms of reinsurance treaties with their ceding companies, including the concept of the withholding by ceding companies of deposits as security for the fulfillment of foreign reinsurers' obligations under the relevant treaties.

119. In line with the purpose of ensuring the security of reinsurance, the supervisory authority might also require reinsurers seeking admission to present sufficient proof that no laws, regulations or practices in their countries of domicile would hamper the prompt settlement of balances and claims due under the reinsurance agreements. After their admission, reinsurers should be under the obligation to advise the relevant supervisory authority of any measures taken in their countries of domicile which would affect the transfer of such balances.

120. To enforce such a system of admission of foreign reinsurers, it may be necessary to restrict the right of local insurers and reinsurers to enter into contractual relations with foreign reinsurers whose names have not been included in the register of admitted reinsurers. In practice this means that foreign reinsurers willing to accept business from local companies have to apply for admission and consequently submit all the necessary information about their solvency and competence. 23/

121. The act of admission should be subject to periodic review. If at any time after the admission of a foreign reinsurer the supervisory authority has reason to believe that the reinsurer is knowingly in breach of his obligations under the country's laws and regulations or if the reinsurer does not settle

balances under reinsurance agreements within a reasonable time, the admission act may be repealed, and such cancellation has to be notified to the reinsurer. The latter would, however, be entitled to appeal against the decision repealing its admission.

122. In the choice of reinsurers, the final responsibility rests always with the ceding company that makes the choice, and the supervisory authority does not incur any liability, nor does it guarantee the solvency or the financial viability of the reinsurer.

Chapter IV

INTERNATIONAL CO-OPERATION IN REGULATION AND SUPERVISION OF REINSURERS

123. Bearing in mind that regulation is not necessarily a guarantee of the security and credibility of the reinsurer, it is in the interests of both reinsurers and ceding companies that reinsurers provide the maximum information necessary to permit ceding companies to satisfy themselves about the security and credibility of the reinsurer in question. Unfortunately, there are doubts as to whether all reinsurers dealing with the developing countries have been prepared in the past to provide such information. All the more so because there are no recognized standards of information for this purpose.

124. Also, one must question whether in today's volatile and ever-changing world reinsurance market it is possible to conceive, through co-operation between supervisory authorities, an international system of reinsurance regulation, under which the supervisory authority in each country would contribute by ensuring that reinsurers under its jurisdiction operate on a sound basis and remain financially solvent. If such a system was established, no doubt a large part of the worries on reinsurance security would disappear.

125. Agreements or co-operation between supervisory authorities are far from being unusual in finance, banking, fiscal sectors and insurance. In banking, finance and fiscal sectors, such agreements are commonplace. Moreover, international agreements in this respect, may help to prevent individual governments from acting individually in restraint of trade or interfering with the free flow and transaction of business.

126. At the basis of such a proposed system there would be an international agreement whereby governments would undertake to bring reinsurers within their jurisdiction under some form of licensing procedures and statutory surveillance. The aim of such measures would be to ensure the solvency and stability of reinsurers and to provide a reasonable assurance of the reliability of information which ceding companies use for the selection of their reinsurers.

127. Each country adhering to this international system would undertake to recognize licences granted by other countries joining the international system by giving full credit to reinsurers with reinsurers' licences in their country of domicile. In other words, licensing in one country would *ipso facto* be taken as licensing in other countries joining the system. Reinsurers not satisfying the licensing requirements in their own countries would therefore be automatically barred from other markets. This arrangement would have far-reaching effects on the problem of reinsurance security. Reinsurers domiciled in off-shore areas where no effective and serious regulation existed would be deprived of the possibility of operating in world markets.

128. As an international agreement on reinsurance regulation and supervision should not affect the prerogatives of every country to enact its insurance laws and to set up its own supervisory system, it might be necessary for such an international agreement to be based on common regulatory standards. These standards should obviously take into consideration both the international character of reinsurance and the broad objectives of reinsurance supervision.

Steps towards international reinsurance regulation system

129. Promoting international co-operation and international standardization in the field of reinsurance supervision is clearly the responsibility of governments. UNCTAD, being a forum for inter-State negotiation, could serve as a vehicle for initiating action in this respect. It could convene an international working group representing the various interests involved in the reinsurance business in developed as well as developing countries to discuss the various aspects of reinsurance security and its requirements.

130. Such a working group could then address itself to the idea of reinsurance regulation as an instrument for dealing with reinsurance security issues which cannot be tackled otherwise. Admittedly the divergent interests and the keen competition in the reinsurance business would make it difficult to conceive solutions which satisfy everybody. However, despite that, at a certain point it would be realized that there are common concerns about reinsurance security and that through an international co-operative effort these concerns or some of them can be resolved. All in all, it would be difficult to imagine any coherence in the supervision of international reinsurance if such inter-State co-operation did not exist.

131. If the idea of an international system of reinsurance supervision made headway in the working party, the latter's next task would be to work out a certain standardization for licensing procedures, disclosure, accounting, investments and evaluation. To get the best results in this respect, there would have to be a co-operative effort on the part of the reinsurers, as well as the entire insurance industry,in establishing such standards.

132. The findings and recommendations of the working party in the field of reinsurance supervision should be discussed by an international conference, possibly called by UNCTAD. The ultimate aim of such a conference would be to achieve an international agreement in which individual governments would confirm the viability and the financial strength of reinsurers domiciled in their jurisdiction. Such confirmation would be based on a system of domestic supervision of reinsurers deriving its main characteristics from internationally agreed criteria.

133. Even if difficulties arose preventing a concensus being reached on the proposal for a co-operative international system of reinsurance regulation and supervision, it might be possible to secure agreement on some international standards for reinsurance performance and accounting. Clearly this would be less effective than agreeing on a comprehensive international system of regulation and supervision, yet such standards might still help to deal with many of the problems of the security of reinsurers and might pave the way in the future for such international agreement.

134. It would be of course an illusion to think that regulation and supervision of reinsurance would prevent all future failures, insolvencies and fraud. The causes of these phenomena are many and various. None the less, any serious effort by regulatory authorities in co-operation with each other can undoubtedly serve to improve the security, stability and quality of reinsurance worldwide.

SUMMARY AND CONCLUSIONS

135. The insurance markets of developing countries are, in relative terms, large consumers of reinsurance facilities which are mainly provided by international reinsurance centres. Such overdependence on reinsurance is explained by various factors related to the size of insurance markets in developing countries and to those countries' stage of economic and insurance development.

136. The extensive use of reinsurance, and in particular foreign reinsurers, makes it vital for ceding companies in developing countries to rely upon secure and credible reinsurers simply because these reinsurers are in fact the real carriers of the risks of these countries or the major part thereof. The failure or insolvency of a reinsurer would inevitably cause a chain reaction putting in jeopardy the very existence of the ceding companies, as well as the rights of their policyholders.

137. For a relatively long time, ceding companies did not need to check the security of their reinsurers. This was because the market was served by a fairly limited number of well established reinsurers whose solvency, credibility and self-discipline were beyond doubt. This rosy picture of the reinsurance scene has changed considerably in the last two decades. The increasing demand for reinsurance covers has lead to a sharp increase in the number of reinsurers everywhere. Obviously, not all these reinsurers are technically fit to compete in a risky field such as reinsurance. In the last few years, extensive competition between reinsurers has prevailed and reinsurance terms have been forced to uneconomic levels. Not surprisingly the reinsurance experience has deteriorated sharply and some reinsurers have experienced difficulties in meeting their commitments. Also, cases of insolvency have been reported, causing delays or non-payment of reinsurance balances and recoverables.

138. In parallel, the international reinsurance market has been hit by several scandals and abuses involving well known reinsurance operators, and this has wrecked the credibility of the reinsurance profession. All these developments combined have had the effect of alerting insurers and supervisory authorities all over the world to the need to monitor reinsurers' security.

139. It is obvious that the task of monitoring the security of reinsurers falls principally upon ceding companies, since it is up to them to choose their reinsurers. To carry out such an exercise they need to collect all possible information regarding their reinsurers and to translate that information into pointers and ratios which shed light on the reinsurers' past performance and on future trends. On the basis of such an analysis the ceding companies can select their reinsurers from among the soundest ones.

140. It is, however, to be recognized that security analysis carried out by ceding companies is not always conclusive. This is either because of lack of necessary data to serve as a basis for assessment or because of the inability of the ceding company to use the available data to obtain an appropriate picture of the reinsurers.

141. Such drawbacks make it necessary for the insurance supervisory authorities to exercise some control over the choice of reinsurers by the ceding companies to ensure the good security of chosen reinsurers. However,

such control will be ineffective if the supervisory authority itself lacks sufficient knowledge of the international reinsurance markets and international reinsurance practices.

142. Given this pattern of circumstances, insurance supervisory authorities in many countries tend to concentrate their efforts on measures improving the security of the ceding companies and their policyholders. To play safe, many countries require that ceding companies withhold funds backing reinsurance. This act of withholding of deposits ensures that, in the event of insolvency or failure of a reinsurer, such deposits can serve to discharge the liabilities of the reinsurer.

143. Despite the fact that the withholding of funds from the reinsurer gives the ceding company a certain degree of security, that measure alone cannot offer sufficient protection, particularly in cases of large losses. This is why there have been calls from many quarters concerning the need for some form of supervision of reinsurance sellers. This need is reinforced by the fact that the bulk of reinsurance business is often done with reinsurers from other markets with different degrees of reinsurance regulation.

144. Government supervision over domestic reinsurance companies does not present particular problems, since those companies are subject to the authority of the State where they are domiciled. The insurance supervisory authority can compel them to abide by certain financial and technical requirements such as minimum capitalization, solvency margins and constitution and investment of technical reserves.

145. However, in respect of foreign reinsurers, supervision is more difficult to implement because they are domiciled outside the jurisdiction of the government. Thus, different formulae have to apply to them if they are to be supervised.

146. The feasible measures which can be introduced in this respect include establishing a register of listed foreign reinsurers with which local insurance companies would be allowed to cede business. Admission to such a list would be conditional upon the provision of certain financial and technical information about the reinsurer seeking admission. The role of the supervisory authority in this case would be confined to checking the sufficiency of such information and determining whether it could eventually serve as a good basis for an objective security assessment by local ceding companies.

147. Supervision of reinsurance sellers could also extend beyond disclosure and reporting. However, this depends on the ability of the supervisory authority to handle such a task properly without restricting or hindering the free flow of reinsurance and on the leverage which a given market enjoys in relation to international markets.

148. In view of the limited possibilities of effective governmental control over foreign reinsurers, it may be in the interests of all parties involved in the reinsurance business, i.e. insurers, reinsurers and supervisory authorities, to develop an international agreement under which the supervisory authority in each country would supervise reinsurance sellers domiciled in its jurisdiction to ensure that they operate on a sound basis and remain financially solvent.

149. Each country adhering to this agreement would undertake to recognize licences granted to reinsurers by other countries joining the agreement by giving full credit to cessions made with them. This would inhibit any encroachments on the freedom of reinsurance, which is a basic factor in covering risks.

150. Such an international agreement would, however, require some minimum common regulatory standards which would have to apply to all reinsurers.

151. If such an approach is acceptable, UNCTAD would be the appropriate forum to initiate such negotiations and to provide the necessary support.

Notes

1/ See in this context, Gerathewohl, *Reinsurance Principles and Practice* (Karlsruhe, Verlag Versicherungswirtschaft e.V., 1980), vol. 1, on functions of reinsurance.

2/ See paper by Godfrey Hodgson, presented to the Seminar on Reinsurance Security 1984, entitled "The historians' view".

3/ See UNCTAD study "The impact of captive insurance companies on the insurance markets of developing countries, 1984" (TD/B/C.3/192).

4/ For a list of specialized reinsurance companies as at the end of 1978, see Gerathewohl, *op. cit.*, Appendix B.10.3.

5/ The growing interest in security analysis is best illustrated by the increasing number of reinsurance conferences devoted to the subject.

6/ See UNCTAD document on reinsurance problems in developing countries (TD/B/C.3/106). Also see UNCTAD study on large risks in developing countries (TD/B/C.3/137).

7/ Robert Kiln in his book *Reinsurance in Practice*, (London, Witherby and Co., 1981), p. 294, says "unless the reinsurance operation is conducted by people of honesty and integrity, there is no point in going any further".

8/ See paper by C.D. Daykin on the "Solvency of General Insurance Companies", published by the Institute of Actuaries, United Kingdom, February 1984.

9/ See the *United States Reinsurance Report* (Combined Ratio 1985), September/October 1986.

10/ For more information on ISI see *ReActions*, March 1984, p. 20.

11/ For more information on IIFS, see Michael Miron paper entitled "Data is good, but information is better" presented to the Reinsurance Security Seminar, 1984, organized by *ReActions*.

12/ For more information on FIR, see *ReActions*, March 1984, pp. 20 and 21.

Notes (continued)

13/ See paras. 26 to 47.

14/ In Western Europe, regulators do not impose any restrictions as to the identity or nationality of the reinsurers of direct insurers in their jurisdiction. However, in a few cases there are some precise rules restricting the choice of reinsurers. In Denmark, life business may be ceded only to a local reinsurer or to a foreign reinsurer which has lodged a security accepted by the supervisory authority. In France, French risks may only be placed with a reinsurer licensed in the EEC countries. For reinsurers of other countries wishing to write French risks they have to be specially authorized. In Iceland, there is a regulation that reinsurance of small fishing boats has to be placed with a local pool managed by a State reinsurance company. In Spain, reinsurance may only be ceded to local reinsurers as well as locally licensed foreign reinsurers. In Italy, legal cessions to the National Insurance Institute (INA) have to be made in respect of life business. In Switzerland, the supervisory authority endeavours to ensure that an important part of life business is reinsured locally. In Turkey, insurance companies have to cede 30 per cent of their surplus to a State reinsurance company (Milli Re).

15/ In the Federal Republic of Germany, the supervisory authority (BAV) carries out the task of supervising all operations of direct insurance companies, including their outward reinsurance arrangements. Whenever BAV has any doubt about the financial capability or solidity of a reinsurance company, it may, within the practised system of indirect reinsurance supervision, require a reduction in the business ceded to that reinsurer or terminate such reinsurance altogether.

16/ In recent years a special working party of the OECD Insurance Committee has not only questioned the assumptions behind this understanding but has also stressed, among other things, that freedom of reinsurance is seriously restricted by compulsory gross reserving. This shift in philosophy does not however seem to have been reflected in the regulatory level in the OECD countries.

17/ It should be recognized that the use of letters of credit has certain merits. Although it may involve an additional cost for reinsurers which would make reinsurance more expensive, it can help to release their funds withheld under treaty arrangements. From the standpoint of the ceding companies, it can help to remove any doubt about collecting dues from the reinsurers and could generally hasten the departure of dubious security from the market place through banks' controls.

18/ The Swiss supervisory authority takes 10 per cent as the norm for minimum retention by the insurer.]

19/ This is the case in the Federal Republic of Germany, the United Kingdom, the United States of America, Switzerland, Italy and Japan. It is also the case in France, the Netherlands and Spain, but no specific licence is required for exercising reinsurance activities.

Notes (continued)

20/ See, in this context, Klaus Gerathewohl, *op. cit.*, para. 3.2. See also Prof. Marcel Grossman, "Freedom of international reinsurance", *The Review*, 22 November 1963.

21/ It seems that Austria will be changing its laws to subject reinsurers to the obligation of prior licensing.

22/ "Insurance legislation and supervision in developing countries" (TD/B/393), chapter VIII, pp. 71 and 72.

23/ In the case of special risks, the supervisory authority may authorize a ceding company to reinsure with unlisted reinsurers.

Annex

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