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REINSURANCE SECURITY FOR DEVELOPING COUNTRIES

Report by the UNCTAD secretariat
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The role of reinsurance brokers in developing countries: study prepared by Mr. M. Habib Makar at the request of the UNCTAD secretariat
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I. DEVELOPMENTS AFFECTING REINSURANCE SECURITY

1. While in the past decades practically all developing countries have established national insurance companies to meet their own insurance needs, their reliance on foreign reinsurance is still high. Structural, financial and technical constraints such as undercapitalization of companies, the small size of markets, the imbalanced nature of insurance portfolios, and the lack of sufficient experience and know-how are among the main reasons for this phenomenon. Nothing indicates that the degree of dependence will diminish in the near future: the development efforts of these countries are giving rise to ever-growing values and complexities of new risks underwritten, and this is likely to lead to an increased need for reinsurance facilities. Effective management of reinsurance requirements is, therefore, central to the success of national insurance enterprises.

2. A growing demand for reinsurance all over the world and expectations of an attractive return on such business has spurred the establishment of many new reinsurance companies during the last two decades. Their number was further augmented by the emergence of numerous captive insurance companies which today offer reinsurance facilities on an international scale.

3. Traditionally, there were only a few major markets which were in a position to offer reinsurance facilities on a worldwide basis. Today, however, new markets have emerged, particularly in free zones and in countries that offer offshore facilities, among them several developing countries. As a result of this surge of new suppliers domiciled in a great number of countries, international reinsurance markets have become very diversified and complex.

4. The choice among possible reinsurers has consequently widened. The emergence of new reinsurance companies has undoubtedly had its advantages, as it has increased competition among them, leading often to a buyers' market with resultant pressures on premium rates. This was helpful to ceding companies, which need continuously to make an optimum choice as regards the terms and conditions of their reinsurance contracts. Yet these developments have also engendered certain dangers.

5. Much of this new capacity has in certain respects been both unknowledgeable and inexperienced, with many of the new companies viewing reinsurance underwriting mainly as a vehicle for building up investment funds. As a result, risks accepted have been of a substandard quality to an undue extent, and the keen competition has led reinsurers to accept exposures at rebate rates, with high yields on investments being counted on to compensate losses in technical results.

6. However, as interest rates constantly fluctuate on international capital markets, the investment earnings of reinsurers are unpredictable and subject to contraction. The prices of items upon which indemnities are based tend to be sticky, so that the financial viability of reinsurers could suffer during periods of falling interest rates.

7. So far financial collapse among reinsurers has been rare, as insurance markets have usually acted to mobilize short-term support, recognizing that the collapse of a reinsurer could lead to a chain reaction pulling down sound reinsurers together with unsound ones. But concern about the stability of
many reinsurers remains. One of the signs of the financial difficulties which reinsurers are presently facing is the delay in their settlement of reinsurance balances. This could put direct insurance companies responsible for the payment of claims to their insureds under considerable strain. The seriousness of the situation is further evidenced by the fact that very substantial sums of uncollected reinsurance recoverables are in dispute or are being written off.

8. Problems of security are exacerbated by the fact that international reinsurers are now bringing intense pressure to bear on ceding companies as regards the practice of withholding premium reserves. The retention of such reserves could be the result of a contractual agreement between insurer and reinsurer or the consequence of legal requirements to that effect which exist in many countries, including developed countries. However, this practice is now increasingly being challenged on the grounds that it blocks reinsurers' assets, adds to their costs and reduces the availability and flexibility of international reinsurance.

9. All these developments have contributed to causing apprehension throughout the world regarding the security of reinsurance, stimulating discussion of how to deal with the problem. While much of the discussion takes place in developed countries, it is insurers in developing countries that are likely to be most vulnerable to any negative effects which might result from insufficient reinsurance security.

II. PROBLEMS OF CHOOSING A RELIABLE REINSURER

10. In response to such concerns, the Committee on Invisibles and Financing related to Trade at its eleventh session 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 study entitled "reinsurance security" (TD/B/C.3/221 and Supp. 1) was presented to the twelfth session of the Committee. Commenting on this study the Committee suggested that more detailed consideration should be given to the important role of brokers in the placement of reinsurance of developing countries. Following this suggestion, the UNCTAD secretariat commissioned a study on the role in developing countries of reinsurance brokers, which is annexed to the present document.

11. Both studies deal with the problem of improving reinsurance security through the right choice of reinsurer. This choice is made by the insurer either directly or with the help of an intermediary. In the first case the insurer enters into direct contact with the reinsurer from whom he buys his cover. In the second case, the choice of the reinsurance company is made through a reinsurance broker who brings his wide knowledge and experience of international reinsurance markets into play.

12. In both cases, the ceding company is faced with a problem of effecting a judicious selection. In the first case, it is the choice of a suitable and sound reinsurance company. In the second case it is the choice of a reliable broker who in turn can give a reasonable assurance that the selection of the reinsurance company is based on solid criteria and a professional evaluation, and that his financial obligations towards the ceding company will be fulfilled.
13. In both cases the insurance company faces the problem of having to choose among a multitude of suppliers offering their services in an imperfect and highly diversified market which is subject to rapid change. The exercise of judgment in choosing among alternatives is complicated by the dearth of available factual information or by the fact that the quality and significance of the information which can be obtained varies according to its source. As a result, it is difficult, if not impossible, for insurers in developing countries to exploit the international market for reinsurance effectively.

III. IMPROVING REINSURANCE SECURITY

14. There are two main aspects to reinsurance security. One relates to the withholding of deposits by ceding companies. The second aspect concerns the choice of the reinsurer or the broker. As regards the latter aspect, measures which would enhance the information at the disposal of the ceding company would augment its prospects of making a sound choice and improve the functioning of the market for reinsurance in general.

A. Withholding of deposits

15. Traditionally, ceding companies have tried to obtain a certain degree of security by withholding reserves from the reinsurer. The withholding of such reserves, based on their calculation on a gross basis, may in fact be the only option available to insurers to secure the collectibility of reinsurance recoveries from their reinsurers. This practice acquires additional importance for developing countries, because it increases the domestic savings available to finance domestic investment and thus contributes to the development process. However, while the withholding of reserves is a necessary measure to improve reinsurance security, it is not a sufficient one. It offers only partial protection to the ceding company, which has to reckon with the fact that the amount of losses is usually well above that of deposits. Further and more effective measures are therefore required to improve the security of reinsurance.

B. Enhancing the availability of information

1. The direct placement of reinsurance

16. In stressing the need for the direct insurer to choose his reinsurance partner carefully, the study on reinsurance security explains the various types of information which may serve as a basis for analysing the latter's reliability and security and the weight which might be attached to these considerations. It points out that decisions should be based on two types of information: the first relating to the reinsurance company itself, and the second to its country of domicile. The first would include information regarding the quality and reputation of its management and staff, ownership and inter-company relationships, the past record of the company, its underwriting performance and its assets, premiums and reserves. An evaluation of certain test ratios could be of much help in appraising the technical and financial position of the reinsurer.

17. The second relates to the economic situation, currency regulations and fiscal provisions in the reinsurer's country of domicile, as well as to government supervision and regulations in force there.
18. Even assuming that the insurers in developing countries have access to this information, which in practice they often do not, the exercise of conducting a security analysis remains a complex and uncertain endeavour; complex because the reports, accounts and statements published by the reinsurers do not necessarily reflect all relevant financial and technical realities; uncertain because the technique of security assessment is still an imperfect one. Such an assessment would require, among other things, that the institutions undertaking it keep in constant touch with developments in the world reinsurance markets. This, in turn, would require a highly qualified staff with sufficient experience and sophistication to get a good grasp of salient developments and arrive on that basis at well-founded judgements.

19. Given the limitations under which the ceding companies in developing countries work, the study argues that they should not be left alone in performing the difficult task of assessing the suitability of reinsurers, but should receive the active support of their country's supervisory authorities in vetting their reinsurers. Such support seems all the more justified as it concerns the safeguard of policyholders as well as the interest of the national economy, since many of these contracts are concluded to protect valuable assets of the country. It has also to be borne in mind that claims may arise long after the original contract has expired, which gives added weight to the choice of a reinsurance company with sufficient long-term stability and strength.

20. The study proposes that the relevant authorities should help improve the functioning of markets by establishing procedures to enhance the quantity and quality of information available to the local market. To this end, the supervisory authorities could invite reinsurers to provide them with a body of information, discussed below, and would undertake to inform national insurance entities of the availability of this information. Insurers would continue to be free to deal with whichever reinsurer they wished, but the evident advantages to them of the information provided would undoubtedly lead to a high and growing part of their reinsurance business flowing to firms that had made information available.

21. According to this proposal, foreign reinsurers would 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, and the names, qualifications and designations of persons entrusted with senior management. They would also provide statements showing that their capital and surpluses are at least equivalent to those minima laid down under the laws of their domiciliary jurisdiction. They should further provide the relevant authority with copies of their annual accounts and balance sheets for the last five years, certified by an accounting or auditing firm in their country of domicile, so as to enable potential buyers of their services to assess their underwriting and financial performance.

22. The presence of a specific reinsurer on the list of companies that have provided the required information, and the information provided, should be subject to periodic review. If, at any time after the admission of a foreign reinsurer to the list, the relevant authority obtained information to the
effect that a certain reinsurer had not settled balances under reinsurance agreements within a reasonable time, such information could be added to that available to ceding companies. In the event of a breach of its obligations under the country’s laws and regulations, the specific reinsurer committing such a breach could be removed from the list. In the latter case, the reinsurer concerned would be notified and would be entitled to appeal against that decision.

23. The fact of notifying domestic insurers that a reinsurer has made available all the required information and that this is at the disposal of insurers would not imply a guarantee on the part of the supervisory authority that the information supplied was correct, although the authority could be expected to take all reasonable measures to ensure that it was. It would also not absolve the ceding company from applying its experience and judgement in evaluating the information available, nor from making reasonable efforts to secure additional information on the reinsurer if this seemed necessary. The final responsibility for choosing the appropriate reinsurer thus remains firmly with the ceding company, which continues to be held liable according to the *caveat emptor* principle.

24. The freedom of choice of the ceding company within an appropriate regulatory framework is essential for its own proper functioning. Given its responsibility to obtain the most appropriate cover for its own risks, it is of the utmost importance to allow insurers the liberty to shift from one reinsurer to another in order to take advantage of the best deals and receive tailor-made protection for the risks at stake.

25. Since the company remains free to judge, within a given regulatory framework, which reinsurers would best provide the special services it requires, the setting-up of a list of reinsurers would not in any way impede the establishment of a long-term relationship of mutual trust and co-operation between insurers and reinsurers. In fact, the experience thus gained from a long-term relationship could be added to the stock of information the relevant authority would collect over the years, and would thus be of benefit to all insurers in the country.

2. The placement of reinsurance through intermediaries

26. The difficulties faced by insurers of developing countries in securing access to and properly evaluating all factors relevant to making a sound choice of their reinsurers explains their frequent recourse to the services of international reinsurance brokers. An experienced and reputable broker possesses the intricate knowledge of the various forms of reinsurance, as well as of the detailed characteristics of reinsurance markets, required for such a choice. Due to the huge increase in the values at stake and the continuous emergence of new forms of risks, the handling of reinsurance requires a growing specialized professionalism, a fact which lends increasing weight to the role played by international reinsurance brokers. Also, brokers' activities often go beyond assistance in the placement of reinsurance to include the provision of advisory services on such matters as risk inspection, underwriting, claims handling and loss settlement, documentation and staff development. All this makes them valuable partners, especially for small and inexperienced companies in developing countries.
27. How safely, then, can insurers rely upon the judgement of their brokers regarding a security assessment of reinsurers? This question arises in part because of the disappearance of the financial independence of brokerage firms. Many reinsurance brokers have acquired an interest in insurance and reinsurance companies. Thus, the independence of brokers, which is the very essence of their profession, is not necessarily assured.

28. The image of the reinsurance broker has also suffered in recent years from the involvement of a number of brokers in practices that have cast some doubt on their observance of appropriate standards of ethics and professionalism and have been a cause for concern, particularly for insurers of developing countries.

29. The study prepared for the UNCTAD secretariat on the role of reinsurance brokers in developing countries (see annex below), while acknowledging the essential services rendered, also draws attention to the power wielded by them in the face of generally weak and inexperienced insurers. The relationship of dependence may tempt the broker to take undue advantage of the weakness of the ceding company. Among the dangers this implies is the fact that the reinsurance may be placed with questionable reinsurance companies. As brokers do not incur any legal liability in the case of default or insolvency of reinsurers selected by them, the consequences would have to be borne fully by the ceding company.

30. The study argues that in order to avoid pitfalls and draw maximum benefit from a broker's services, insurers from developing countries need to have a complete understanding of the different functions of the broker and the nature of his relationship with both the ceding company and the reinsurers. Insurers also have to be aware of the legal position of the broker and have an understanding of the extent to which he can be held liable for his acts. Equally important is their understanding of the nature of the fiduciary role of the broker and a reasonable assurance that the latter will fulfil the financial obligations which arise from the trusteeship relationship which he entertains with the ceding company.

31. Insurers therefore need to make a careful and judicious selection of their reinsurance brokers so as to ensure that the high standards of professionalism and ethical conduct which the latters' functions require are observed. Decision-making in this area is difficult, however, since, as is the case regarding the supply of reinsurance services, the international market for brokerage services is very complex and lacks transparency. Small insurance companies often do not have the necessary experience to identify the information that is required and to evaluate it once it is secured.

32. The study prepared for the UNCTAD secretariat argues that the choice of a broker should be made with full knowledge of certain information, with particular emphasis on the corporate, technical, financial and managerial aspects of the structure of the brokerage firm, as well as on the record of its past experience. The specialization of the broker should of course also be taken into account.
33. To assist in this, the study advocates a role for the authorities of the respective country. Specifically, it is proposed that the supervisory authority invite reinsurance brokers to make available to them certain information, and that the authorities inform their own insurers of the existence of this information. The information in question would include the act of incorporation and contain indications as to the amount of capital, major shareholders and partners, a list of managers and organizational chart, audited accounts for the last two years, and names and addresses of banks in which the brokers' funds and insurance funds are deposited.

34. On the basis of the information supplied to the relevant authority, insurance companies wishing to resort to the services of a reinsurance broker would be better able to appraise the reliability and suitability of various candidates. Small insurance companies which in view of the limited amount of business they provide would be in a weak position to ask different brokers to provide full information would particularly benefit from this. In this context it has to be emphasized that nothing prevents an insurance company from asking for further information from the respective brokers.

35. As is the case regarding the direct choice of its reinsurer by the ceding company, the latter would also have sole and final responsibility for the choice of its broker, being fully exposed to the caveat emptor principle. In this context the above observations regarding the possibility for the insurer to establish a long-term relationship based on mutual interest, trust and co-operation with his reinsurer also apply mutatis mutandis to his relationship with his broker.

Note

Annex

THE ROLE OF REINSURANCE BROKERS IN DEVELOPING COUNTRIES

Study prepared by Mr. M. Habib Makar at the request of the UNCTAD secretariat */

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*/ The views expressed in this study are those of the author and do not necessarily reflect those of the UNCTAD secretariat.
INTRODUCTION

1. Reinsurance brokers have always been an integral and important segment of the international reinsurance scene. In serving as intermediaries between insurers and reinsurers all over the world, they have occupied a foremost position in this field. The practice of relying on brokers to negotiate and place reinsurance has in fact existed practically since the emergence of reinsurance itself as a legal operation. However, the last 30 or 40 years have witnessed a sharp increase in the degree of reliance on reinsurance brokers. This development is due in particular to the ever-growing value and complexity of risks, requiring careful handling of the reinsurance protection. In this very field, reinsurance brokers have established an enviable reputation for technical knowledge and experience, as well as close relationships with world-wide markets, and both of these factors have enabled them to mobilize the necessary capacity to cover such risks in an appropriate manner.

2. Reinsurance brokerage remains marked by a high degree of concentration, with United Kingdom and United States brokers dominating the scene. The prevalence of British brokers is understandable, given the traditional and outstanding leadership of Lloyd's in the world of reinsurance. The same applies also to United States brokers, since the North American market provides more than half of the world's non-life insurance premiums.

3. Not so long ago, reinsurance brokers were viewed as middlemen whose main duty was to bring ceding companies and reinsurers together and, through their thorough knowledge of risks and familiarity with different markets, assist them in concluding reinsurance transactions, servicing them without themselves being involved in the transactions in any way.

4. The image of the reinsurance broker seems, however, to be undergoing some change. Some highly publicized episodes of fraud, malpractice and negligence involving a number of brokers have drawn the attention of ceding companies, reinsurers and regulators to the necessity of making the dealings of reinsurance brokers more transparent and more accountable to the reinsurance partners, as well as to the insurance regulatory authorities.

5. The reasons for this change in the image of reinsurance brokers are multiple. Perhaps the most obvious reason is that many new players have entered the reinsurance brokerage field recently, attracted by high amounts of cover and consequently higher brokerage earnings. It may also be due to the high interest rates, which have made the brokers' responsibility for transmitting cash between ceding companies and reinsurers a lucrative source of income for brokers.

6. The change of attitude towards reinsurance brokers can also be explained by the corporate links and partnerships which have been established between some brokerage firms and reinsurance companies and which have had the effect of compromising the brokers in terms of their duty to act in the best interest of their clients.
7. Also, many reinsurance brokers have misused the binding authority given to them by certain reinsurers to earn the maximum of brokerage regardless of the quality of business accepted and its claims experience. The huge losses assumed by such reinsurers have resulted in scepticism about the reliability of broker services.

8. As a result of all these developments, the attitudes towards reinsurance brokers are changing. Lawsuits against them are on the increase, and changes regarding the role of reinsurance brokers, their financial liabilities and their remuneration are expected to be the subject of discussion in the not too distant future.

9. For developing countries, the deteriorating image of the reinsurance broker is cause for alarm due to the fact that their insurance industry relies heavily upon the services of reinsurance brokers as risk distributors. In order to avoid pitfalls and draw the proper benefits from the services international reinsurance brokers can provide, both ceding companies and reinsurers from developing countries need to acquire a thorough understanding of the different functions reinsurance brokers can assume and the services they normally provide. This includes knowledge of the legal position of brokers, particularly their legal responsibilities towards their ceding companies and the reinsurers with whom they place their business. This report elaborates on these two matters in detail. It also examines the regulatory frameworks within which brokers operate. Finally, the report examines the criteria for the choice of brokers and the way in which the regulatory authorities in developing countries can help insurers and reinsurers select reliable and secure reinsurance brokers.
Chapter I

FUNCTIONS OF THE REINSURANCE BROKER

10. The functions of reinsurance brokers can be summarized in a three-stage sequence – the acquisition of business, its placement and its subsequent servicing.

Acquisition of business

11. The acquisition of business by reinsurance brokers involves becoming acquainted with ceding companies through repeated visits and exchanges of correspondence. During these contacts, the particulars of risks seeking cover are discussed in detail. The broker attempts to obtain all possible information or data which enables the reinsurer to reach a correct assessment of the risks in question and to quote appropriate terms for the cover. The broker, in his contacts with the ceding company, acts at this stage as a professional adviser, particularly as regards the type of cover, the risks to be included, and the hazards to be excluded. It is his responsibility to advise the ceding company on safe and adequate levels of retention, deductibles, and appropriate upper limits of cover, taking into due consideration what the ceding company is willing and able to pay.

12. Once the broker is given authority by the ceding company to negotiate reinsurance, he will have to prepare all the details of the reinsurance offer (general information, conditions and corresponding statistical data). Such information should be arranged in complete collaboration with the ceding company. He will have to prepare a summary of contract terms and provisions that is specifically designed to respond to the latter's financial and risk transfer needs.

13. The broker has thereafter to approach reinsurers who are prepared to take a share in the business offered. Needless to say, the placing of such business requires a great deal of contact with reinsurers on the part of the broker. In this respect, reinsurance brokers initiate and maintain extended and close relationships with reinsurers all over the world. Despite this, access to a given market differs from one broker to another, depending on the broker's specialization in certain regions, as well as in certain classes of business. The ability of the broker to place business also depends to a large extent on the market where he is domiciled. This explains, for example, why brokers acting from London are far better placed than brokers acting from other countries, simply because the London market is the biggest reinsurance market in the world. If the broker's own market does not allow the full placement of the risks involved, he can turn to other markets to complete the placing.

Negotiating the placement of business

14. In negotiating the placement of business entrusted to him, the broker must devote all his efforts to obtaining the optimum terms and conditions for his client, the ceding company. In this regard, the broker has to exercise his professional skills to assess the terms obtained from a given reinsurer. Such assessment is based not only on his own experience, but also on a comparison of terms with quotations which he obtains from other reinsurers.
As the broker is free to place the business with any reinsurer of his choice, he has a certain leverage to stir up competition amongst reinsurers who are interested in the business. This competition would ultimately allow him to obtain the most reasonable quotation for the type of risk he is placing.

15. In his endeavour to place business in reinsurance, a reinsurance broker generally turns to a well-known reinsurer, who would act as a "leader" as he is likely to be followed by other reinsurers because of his position in the market. He negotiates with him the definite terms of cover which are summarized in the "reinsurance slip". Once the slip is signed by the leader, it is offered to other reinsurers in the local market and abroad for underwriting of their own shares. The size of these shares usually depends more on the amount accepted by the leader than on a detailed analysis of the business offered.

16. In the choice of reinsurers to take part in the reinsurance cover, the broker is bound to pay particular attention to reinsurance security. He has to assure himself of the solvency and reliability of potential reinsurers. A well-established broker is generally in a good position to monitor what is going on in the reinsurance market, and for this very purpose many brokers maintain records of the reinsurers they do business with and often produce security lists. These lists are generally divided into three categories: reinsurers O.K. to reinsure with; reinsurers O.K. to reinsure with only after consulting with the ceding company; and reinsurers which should not be used at all. These lists are based principally on financial criteria, but other aspects of the activities and the performance of the reinsurers are often taken into consideration.

17. Once the reinsurance slip is signed by the reinsurers who accept certain shares in the cover, the slip itself becomes a contract and is binding for the contracting parties. Anything other than the standard conditions of reinsurance contracts which has not been incorporated in the slip is not considered as part of the contract. One of the reasons for this is that later reinsurers who will subscribe to the slip may, in part, do so out of good faith resulting from the subscription effected by the leader and earlier reinsurers. It is possible that the broker will prepare a cover note to inform the ceding company that the cover is concluded, but such a cover note is not considered a contract.

18. The broker may have to prepare the reinsurance document. He should be certain of incorporating in that document all clauses and conditions appearing in the slip; if the reinsurance document is inadvertently not in conformity with the slip, the contract wording will be subject to rectification.

Servicing the contract

19. After the placing of reinsurance is accomplished, the broker has to ensure the subsequent administration of the reinsurance transaction. This encompasses a wide range of administrative, technical and financial services. In his capacity as intermediary, all communications and correspondence between the ceding company and the reinsurers that concern the reinsurance transaction concluded by the broker are transmitted through the latter. This applies to periodic accounts, billing remittances and notices of every kind (changes in the risks, claim notices, notices of cancellation, etc.).
20. One of the main duties of the broker during the course of the reinsurance transaction is to establish periodic accounts on the basis of figures submitted by the ceding company. This includes processing all premium and loss transactions related to the reinsurance business handled by the broker, the distribution of premiums to all participating reinsurers, and the withholding and payment of applicable taxes.

21. The broker has also to assist the ceding company in preparing all necessary reports on losses incurred for the reinsurers. In this respect he has to provide professional guidance in identifying types of claims covered under the reinsurance contract. He has to distribute claim notices to reinsurers and to respond to their inquiries pertaining to the claims. Finally, he has to provide billings and collect losses from reinsurers to pay the ceding company.

22. In performing his duties, the broker has to maintain complete information on the experience of the reinsurance programmes he handles. This is essential for a review of the reinsurance arrangements at renewal dates, or for updating protection in the light of changes in the reinsurance requirements of the ceding company. The broker has also to continue vetting the reinsurers taking part in the transaction in an attempt to ensure that they continue to be solvent and reliable.

23. At the expiry of the term of the reinsurance transaction, the broker has to continue assuming the run-off administration of the business. In practice, reinsurance losses can take decades to develop, and it is the duty of the broker to see that his client is also duly indemnified after the reinsurance contract has expired. It is, however, possible for the ceding company and the broker to agree that the ceding company will deal directly with the reinsurer for the run-off business. If this is not possible (as in the case of Lloyd's underwriters), the broker who wants to discontinue handling the run-off has to find another broker who will assume this task on his behalf.

24. Reinsurance brokers are remunerated for their activities in the form of a brokerage fee which is paid by the reinsurers. This fee is calculated as a percentage of the reinsurance premiums paid to the reinsurer. It can vary from between 1.5 per cent and 15 per cent, depending on the nature of the business. It is obvious that such brokerage is reflected in the reinsurance price passed on to the ceding company.
Chapter II

THE LEGAL POSITION OF THE REINSURANCE BROKER

25. In examining the legal position of reinsurance brokers, we have to observe that nowhere are there specific rules of law that apply to reinsurance brokerage operations as such. In their absence, it is obvious that the general law of agency would apply, since a reinsurance broker is an agent of his principal. However, while the general law of agency applies, custom and usage have a certain bearing on the legal situation of the broker.

Legal definition

26. "A reinsurance broker may be said to be a person or a firm who negotiates and effects reinsurance contracts on behalf of and for the benefit of another with a third party." 1/ On the basis of such a definition, one can assert that the reinsurance broker is an agent of the ceding company because he acts on its behalf in negotiating and procuring cover. As such, the broker has certain duties vis-à-vis his principal, as well as the reinsurer.

A. Duties to ceding company

27. The broker must act strictly in accordance with the authority given to him by his principal, even if, in his opinion, the latter's instructions are not in the principal's own best interest. None the less, the broker is bound to advise and to warn the principal if the instructions he receives from the latter are not appropriate or adequate. The broker can refuse to follow the instructions of the principal only if they are unlawful or unfeasible. He must, however, inform the principal promptly of his refusal to enable the latter to avoid any prejudice resulting from his refusal to follow the instructions.

28. The broker must carry out the instructions of the ceding company with due diligence. This means also that he should carry out his duties within a reasonable time. If he fails to perform these duties in time, he may be held liable for the prejudice which could be caused to the principal.

29. The broker, in exercising the authority given to him by the ceding company, has to bring to bear proper skill in negotiating and placing reinsurance. As the broker is a professional, the standards by which his duties are judged are those of his profession. However, the standard of care to be met by the broker depends also on the circumstances of each case. Proper skill is particularly required in two specific fields: the obtention of the most appropriate terms of reinsurance, and the vetting of potential reinsurers to ensure their solvency and reliability.

Negotiating appropriate terms

30. Due skill is required from the reinsurance broker in negotiating reinsurance terms with underwriters to obtain reasonable protection at equitable cost. It is, however, extremely difficult to gauge the best terms and appropriate conditions for a given reinsurance cover. This is because the international reinsurance market is often volatile and lacks consistency, and different reinsurers may have different ideas and attitudes towards a given business.
Vetting reinsurers

31. The reinsurance broker is also required to use due skill in choosing the reinsurers to take part in the business he is placing on behalf of the ceding company. This implies that he inquires about the financial soundness of these reinsurers. Although financial collapse among reinsurers has so far been relatively rare, there is always a potential risk. There is also the problem of reinsurance collections which can be delayed because of lack of cash. Brokers, as an integral part of the reinsurance market, usually possess the means to effect a sound check on the solvency of reinsurers. This, however, does not absolve them from exercising care in choosing reinsurers, and any doubts about a reinsurer’s financial position should be communicated to the ceding company. The broker should not assume that the ceding company is already aware of the position of a particular reinsurer.

32. While they are expected to exercise sound judgement as to the financial security of the chosen reinsurer, brokers are usually not prepared to take full responsibility for the failure of a reinsurer to respond to his contractual obligations. There are currently very few precedents for holding a broker liable for placing a cover with an insolvent reinsurer. This situation is perhaps due to the fact that the ceding company is a professional and it should check the financial standing of the reinsurers by itself. However, the situation may result in a liability for the broker, if, by an act of the latter, the ceding company was denied the opportunity of identifying the reinsurer or if the ceding company was not given enough time to make reasonable inquiries.

Fiduciary duties

33. The broker owes fiduciary duties to his ceding company. It follows that whenever money is paid to the broker for transmission to the reinsurer, and likewise whenever money is paid to him by the reinsurer for transmission to the ceding company, a trusteeship relation is established between the broker and the ceding company. The significance of this is that in the event of a broker’s insolvency, the ceding company will be entitled to the full amount of money held for it on trust by the broker.

34. It is an established practice that the broker transmits the premium to the reinsurer. In the case of a Lloyd’s broker, the latter is personally liable to pay the premium to the Lloyd’s underwriter. There does not seem to exist a consensus in the relevant literature concerning the capacity in which the broker receives the premium from the ceding company. It cannot be said that he acts on behalf of the reinsurer, since this would come into conflict with his quality as agent of the cedent. Following this argument, if the broker becomes insolvent after receiving the premium, the ceding company will continue to be responsible for the premium to the reinsurer. In order to avoid this situation and take into account practical considerations, the parties to the reinsurance transaction may resort to a modification of the general rules of agency and agree that the payment of premium to the broker is considered payment to the reinsurance company.

35. The fiduciary duties which the reinsurance broker must accomplish vis-à-vis his ceding company imply the full disclosure by him of any transaction in which he has a personal interest and which may conflict with
the duties to his principal. Thus, if a broker places cover with a reinsurer in which he has a material interest, it is his duty to disclose that interest to his client before the reinsurance is placed. The point of this requirement is to enable the ceding company to check in time if the terms and conditions obtained by the broker have not been influenced by pressure from the reinsurer whom the broker controls or by whom he is controlled.

B. Duty of disclosure

36. The broker must also make full disclosure to his client of all material circumstances known to him relating to the reinsurance he is placing. This applies particularly to information concerning the reinsurer, on the availability of cover, on difficulties in procuring cover, on differences from cover required, on restrictions on cover, etc.

37. As mentioned above, the broker seeks his remuneration (the brokerage fee) not from his principal, i.e. the ceding company, but from the reinsurer. It would be a breach of the broker's fiduciary duties to the ceding company to refuse to disclose the amount of brokerage if asked for it. However, the broker is not obliged to make a disclosure if not asked.

38. It is not lawful for the reinsurance broker to accept a secret commission in relation to his dealings on behalf of the ceding company. Any payment by the reinsurer to the broker relating to the reinsurance transaction, other than the brokerage fee, which is disclosed to the cedent on its request is considered a secret commission, and here it will be presumed that the reinsured has suffered damages at least to the amount of the secret commission.

Claims handling

39. When a broker receives payment of a claim, the general rule is that in the absence of any authority from the reinsured, the broker's duty is to receive the claim in cash. The broker is not entitled to receive payment on account. However, if the parties to the reinsurance transaction agree to clearance of balances as the method of payment, the recording of the claim in the accounts constitutes an actual payment.

Accounts

40. The reinsurance broker is under obligation to transmit to the ceding company monies received by him on behalf of his client. For that purpose, the broker, in his capacity as agent of the reinsured, is under a general duty to keep proper accounts for the business he handles. Though the maintaining of such accounts looks simple, in practice brokers may encounter many difficulties in identifying within their overall accounting programme the account of individual contracts pertaining to a particular client. This is mainly caused by the fact that brokers often deal with both inward and outward business on a net balance basis. Despite these difficulties, the failure of a broker to maintain accounts in a way that allows him to produce a proper account for his client within a reasonable time is considered a breach of his legal obligation to his principal.
C. **Duties to the reinsurer**

41. As agent of the ceding company, the reinsurance broker is entitled to negotiate and effect reinsurance transactions on behalf of his principal. This implies that the broker, in place of his principal, has a duty to inform the reinsurer of all that the ceding company is required to disclose. There is, however, an overwhelming opinion which holds that the duty of disclosure by the broker should not be linked only to that of his principal. It is an independent duty, and thus the broker should disclose all facts known to him to the reinsurer. Should the broker not carry out this duty, the reinsurer is obviously entitled to annul the contract and to rescind it on grounds of fraud committed by the broker. To avoid the consequences which may result from erroneous or incomplete information, brokers usually insert the abbreviation "e. & o. e." (errors and omissions excepted) on their slips. As for statistical data presented by them, they stipulate "information not warranty". If the reinsurer signs a slip having these mentions on it, it implies that he waives his right to annul the contract in case of omission or misrepresentation by the broker.

D. **Conflicting duties of the broker**

42. A broker serving as intermediary between the ceding company and the reinsurer may find himself acting on behalf of both contracting parties, particularly when he is entrusted with the collection of premiums, delivery of slips, and settlement of claims. In principle, no agent who has agreed to act on behalf of one principal can in law accept an engagement from a second principal that is inconsistent with his duty to his first principal, unless he fully discloses all material facts to both principals and obtains their express consent to that "dual role". Obviously this situation does not raise serious problems when the interests of both parties to the reinsurance transaction are not in conflict, but in case of conflict or peril of conflict, there is a considerable risk involved for the broker playing this "two-hat" role.

43. If the reinsurance broker is appointed by both the ceding company and the reinsurer as a paying agent, a situation which is often necessitated for considerations of expediency, the ceding company will discharge itself by paying the reinsurance premium to the broker. Should a delay in transmitting the premium to the reinsurer by the broker cause a loss to the reinsurer (loss of investment, devaluation), the ceding company cannot be held liable for such losses. The same rule applies to the reinsurer when he pays a claim to a broker.

E. **Direct contacts between the ceding company and the reinsurer**

44. For reinsurance transactions concluded through a reinsurance broker, direct contacts between the ceding company and the reinsurer are normally restricted by brokers' clauses which require that all notices, communications and settlements related to these transactions should be made through the broker. However, for any other business outside the scope of such transactions, the ceding company and the reinsurer are free to correspond and to conclude reinsurance transactions directly.
F. Termination of a reinsurance transaction concluded through a broker

45. At the termination of a reinsurance cover concluded through the intermediary of a broker, the question arises as to whether the two parties to this deal can effect the same cover without involving the broker. In principle, the broker does not have exclusive and permanent rights in the reinsurance deals of his clients, and he should have proper regard for the wishes of his clients in this respect. In practice, however, things do not happen this way. As brokers, insurers, and reinsurers operate in the rather small and interwoven world of reinsurance and unusually close and interdependent relationships exist between them, brokers, insurers and reinsurers frequently prefer to maintain established business relations and tend to avoid breaking such relationships.
Chapter III
SUPERVISION OF REINSURANCE BROKERS IN THE UNITED KINGDOM
AND THE UNITED STATES

46. The principal international reinsurance markets are to be found in the United Kingdom, other Western European countries, the United States and Japan. The markets of Western Europe (other than the United Kingdom) and Japan are mainly run by professional reinsurance companies, whereas in the United Kingdom market and to a lesser extent in the market of the United States, the international reinsurance brokers assume larger proportions of reinsurance business than professional reinsurers. In examining the types of reinsurance supervision the reinsurance brokers are subject to, we shall therefore limit our consideration to the United Kingdom and the United States markets.

A. Regulation of reinsurance brokers in the United Kingdom

47. In the United Kingdom, or more precisely the London market, Lloyd's Brokers occupy a unique position in the reinsurance field. This is because it is not possible to gain access to the reinsurance capacity provided by Lloyd's underwriters other than through the intermediary of Lloyd's brokers. These brokers have also the advantage that besides the possibility of placing business with Lloyd's they can place business anywhere else in the world. This explains why Lloyd's brokers are virtually international brokers.

48. Insurance brokers in the United Kingdom are subject to the application of the Insurance Brokers Registration Act 1977. This Act does not provide any distinction between direct writing and reinsurance brokers. In fact, reinsurance brokerage activity in the United Kingdom takes place within the framework of firms in which direct writing and reinsurance brokerage are integrated. Registered insurance brokers in the United Kingdom are subject to some degree of statutory control. They have to comply with several detailed requirements relating to registration, conduct, and compulsory professional indemnity insurance. The Act established the Insurance Brokers Registration Council, which carries out the functions of supervision and which reports to the Department of Trade and Industry. Although Lloyd's brokers are subject to the provisions of the 1977 Act, they enjoy a special status due to the self-regulation action taken by Lloyd's in recent years, which is embodied in the Lloyd's Act 1982 and the Lloyd's Brokers Byelaws 1988.

49. As the bulk of international reinsurance broking activity is assumed by Lloyd's brokers, consideration will be confined to regulations which are applicable to them. The Lloyd's Act of 1982 defines Lloyd's brokers as the only firms that in their own names and through their own slips can place business directly with Lloyd's underwriters. The 1982 Act has also defined the areas which brokers' byelaws should cover. The most recent byelaw for Lloyd's brokers is Byelaw No. 5 of 1988 passed in July 1988 after a series of scandals which involved members, underwriters and brokers. These scandals revealed regulatory inadequacies.
Pre-registration requirements

50. At the heart of the new rules is the requirement that all Lloyd's brokers should be registered. Certain requirements for registration were set up. One such requirement is that the broker should be adequately capitalized. The amount of capital required from the broker is assessed individually in the light of the nature and volume of the broker's business, his expense base, and any other obligations. Although there is no set formula to determine capital adequacy, less than 250,000 pounds sterling is unlikely to be considered adequate.

51. Lloyd's Act 1982 prohibits a Lloyd's managing agent from owning directly or indirectly an interest in Lloyd's brokerage (unless the interest is 5 per cent or less). Similarly, a Lloyd's broker is prohibited from owning an interest in a Lloyd's management agent. Otherwise there are no restrictions on the type of business that may be connected through shareholding with a Lloyd's broker. Reputation and suitability of partners are the sole criteria for assessing fitness for Lloyd's registration. This virtually means that anybody can buy or become a shareholder in a Lloyd's brokerage firm, provided he is considered suitable.

52. One of the conditions of registration of a broker is that he should have adequate and suitable resources in terms of directors and staff, and Lloyd's Council reserves the right to test the character and suitability of directors and members of staff.

53. Another condition for registering a Lloyd's broker is that he must not carry on any business other than insurance brokerage and activities directly ancillary to it. In addition, undue dependence of the brokers on a particular insurer or insurers, a particular source or sources of business, a particular type or types of business, and a particular class or classes of insuring will be taken into account when considering registration.

54. Certain other factors are taken into account when considering the registration of a broker. Among these factors are the ability and presumed willingness of the broker to adequately supervise the operations of his firm, to provide the customary services to his clients and to account for his activities, the adequacy and suitability of his location, organizational structure, staff training, the location of accounting, adequacy of records and internal control systems.

Post-registration requirements

55. Current regulation applicable to Lloyd's brokers also takes the form of post-registration requirements. There are stipulations which require that all appointments of directors and partners require the approval of Lloyd's Council. Also, any change in the shareholding of a broker requires notification to be made to the Council of Lloyd's, which has to remove the broker from the register if it is not satisfied with the reputation and suitability of the shareholders.
Records

56. Lloyd's brokers are under obligation to keep records of the contracts negotiated by them, claims resulting from them, and binding authorities under which they act. For international insurance and reinsurance business handled by them, corresponding records have to be kept for 80 years.

Accounts and funds

57. Lloyd's brokers are required to maintain insurance broking accounts with approved banks for all monies paid or received by them related to insurance and reinsurance transactions. They are also required to invest insurance broking funds in specified short-term assets which have to be approved by the Council of Lloyd's.

Solvency margins

58. Lloyd's brokers have to comply with certain solvency requirements under Lloyd's Brokers' Byelaws. The required solvency margins are operated on three levels, namely the insurance broking assets, the net current assets and the overall net assets. The main purpose of these solvency margins is to guarantee that insurance and reinsurance monies received by the broker are sufficient to meet all liabilities to insurance and reinsurance creditors and to provide a buffer against possible unidentified bad debts.

Protection of insurance and reinsurance creditors

59. For the purpose of ensuring that the interests of creditors of Lloyd's brokers, whose claims arise out of or in connection with insurance and reinsurance transactions, are protected, the Council of Lloyd's may require brokers to execute certain deeds or other instruments in favour of such persons.

Disclosure

60. Lloyd's brokers have to prepare yearly accounts and submit them to the Brokers Department of Lloyd's. These accounts should contain information equivalent to that required from insurance companies. Supplementary financial statements may also be required from the brokers, as well as a declaration which attests compliance with certain financial and other requirements. The broker is also under an obligation to make a statement about his insurance connections and trading arrangements.

Audit

61. Lloyd's brokers are required to have all their accounts, statements, declarations and returns, examined by an auditor, and the auditor has to prepare a report on the results of his verifications.

Professional indemnity insurance

62. Lloyd's brokers have to obtain a professional indemnity insurance policy. The provisions of such a policy should be in compliance with the Council of Lloyd's requirements. The limit of liability under this policy for
reinsurance transactions handled by the broker should be four times the amount of brokerage, with a minimum of 2 million pounds sterling and a maximum of 20 million pounds sterling. The uninsured excess should not exceed the greater of 5,000 pounds or 2 per cent of the brokerage plus 30 per cent of all additional tangible assets held by the broker in excess of this figure. Seventy-five per cent of the professional indemnity cover must be placed with licensed insurers in the United Kingdom or in EEC countries.

Run-off costs in case of failure of Lloyd's broker

63. In order to guarantee the continuing discharge of the functions of a Lloyd's broker after his failure, in connection with insurance and reinsurance contracts and binding authorities, a provision in the 1988 Act confers to the Council of Lloyd's the power to establish a scheme to provide run-off costs. Such a scheme does not provide compensation payments to those who suffer from the failure of the broker, ensuring only the run-off costs of the business after such failure.

Code of practice for Lloyd's brokers

64. A code of practice for Lloyd's brokers has been issued by the Council of Lloyd's. While the Lloyd's Act and Byelaws are mandatory for all Lloyd's brokers, such a code of practice provides a more flexible approach to certain areas of broker regulation, and thus departure from it remains possible. The code is aimed at establishing certain standards of professional conduct and to serve as a guide to Lloyd's brokers as to how they should conduct their business. The code affirms in a clear manner that Lloyd's brokers are principally the agents of their clients, and as such their obligations are based on the Law of Agency. It would be of great relevance for those who resort to Lloyd's brokers to acquaint themselves with the most salient recommendations contained in this code.

Disclosure of brokerage

65. A Lloyd's broker should, if requested by a client, disclose the amount of brokerage he is receiving from the underwriter.

Confidentiality of client's information

66. Any information acquired by a Lloyd's broker from his client must not be used or disclosed unless the consent of the client is obtained or the information is required by a court.

Choice of reinsurers

67. Brokers must ensure the use of a sufficient number of reinsurers to satisfy the requirements of their clients. They must also use their skill in the choice of such reinsurers, taking into consideration the best interests of their clients and the security of these reinsurers. Moreover, the Lloyd's broker should not allow any shareholding or other connections with the underwriter to prejudice the performance of his duties to his clients.
Disclosure to reinsurers

68. It is the duty of both the broker and his client to disclose to the underwriters all material circumstances within their knowledge and to give them a fair presentation of the risk.

Documentation

69. Lloyd's brokers have to inform their clients of the names of reinsurers with whom the reinsurance cover is placed. This information is to be given at the inception of the cover, and any change thereafter has to be advised to the client at the earliest opportunity. The broker should also provide the client with prompt written confirmation that the cover has been effected and with information on the terms thereof. If the full wording of the contract is not included with the confirmation, the broker should forward it as soon as possible.

Accounting

70. Any reinsurance monies handled by a Lloyd's broker have to be kept in Insurance Broking Accounts. The operation of these accounts is the responsibility of the broker, and he receives and retains any interest or investment income earned on them. The Lloyd's broker should remit money received and due to the clients promptly.

Binding authorities

71. If a Lloyd's broker has a binding authority to underwrite business on behalf of an underwriter, he should not accept business from a client under such binding authority if it is not in the best interest of this client. If the broker accepts his own client's risk under a binding authority, he should disclose this to the client. Where the client so requests, the Lloyd's broker should inform him of all financial advantages he received from the use of the binding authority.

Settlement of claims

72. Without the consent of both his client and the underwriter, a Lloyd's broker should not act for both during the claims settling process. By doing so, he would be undertaking duties for one principal which are inconsistent with those owed to the other. If he cannot reconcile the client's best interests with the obligations to the reinsurer, he should refer the claim to the latter for instructions.

Servicing

73. A Lloyd's broker should provide any relevant service requested by his client in relation to any cover placed for that client. This applies notwithstanding the expiry of the cover, unless the Lloyd's broker is properly satisfied that the client has instructed a new broker to assume all such obligations and that the new broker has accepted such instruction.
74. It goes without saying that it is too early to judge the impact of the new Byelaws and Code of Conduct on the behaviour and performance of Lloyd's brokers. At this point one can, however, assert that the wide powers given to the Council of Lloyd's to regulate brokers' conduct is a step forward in the right direction.

B. Regulation of reinsurance brokers in the United States

75. The State of New York in the United States has regulated the activities of reinsurance brokers (reinsurance intermediaries). This regulation was provoked by the collapse in 1975 of a leading United States broker who was part of a group of companies declared bankrupt. A considerable amount of money received from ceding companies and reinsurers had been diverted for the group's own use. As a result of this situation, the State of New York enacted legislation which provides for the licensing of reinsurance intermediaries and subjects them to examination by the Superintendent of Insurance. The regulation also provides that every reinsurance intermediary is responsible in a fiduciary capacity for all funds received or collected in such capacity and must not, without the express consent of his principal or principals, mingle any such funds with his own funds.

76. The regulation in force requires, among other things, written evidence every time the reinsurance intermediary acts in procuring reinsurance for a licensed ceding insurer or accepts reinsurance for a licensed reinsurer. Such written evidence should include authorization to procure or accept reinsurance and should specify the type of reinsurance sought or accepted, the scope of such authorization, the limits of cover, and the date of effect and expiration. Other aspects of current regulations are summarized below.

Case of unauthorized reinsurer

77. If the reinsurance intermediary places reinsurance on behalf of a licensed ceding insurer with an unauthorized reinsurer (a reinsurer not accredited in the State of New York), the intermediary has to inquire into the financial condition of the reinsurer and to disclose his findings to his ceding company. The latter may, however, release the intermediary from his obligation in this respect, if, for example, the ceding insurer carries out such an inquiry by himself.

Placing reinsurance with unauthorized reinsurers

78. According to the regulations in force, no reinsurance intermediary can procure a reinsurance contract with unauthorized reinsurers unless there is a provision in the contract for the appointment by the reinsurers of an attorney in the State of New York before whom all proceedings and lawsuits arising out of the reinsurance contract can be brought by the ceding insurer or on its behalf.
Disclosure by intermediary

79. At the time of negotiating a reinsurance transaction, the intermediary should make full written disclosure to the two parties of the transaction. A written disclosure should provide information on:

(a) Any control over such intermediary, or any control by such intermediary over any of the parties or any other intermediary involved in the transaction or any retrocessions placed by the intermediary affecting the said transaction. The word "control" means the possession of the power to direct such party through ownership, by contract or otherwise;

(b) Any retrocessions placed by the intermediary directly or indirectly in connection with the said transaction, including the identity of such retrocessionaries;

(c) The commissions earned or effected to be earned by the reinsurance intermediary both directly and in connection with retrocession connected with the original reinsurance transaction.

Books and records of reinsurance intermediaries

80. Reinsurance intermediaries have to keep records for each reinsurance contract placed by them for at least 10 years after the expiration of the contract. These records include the type of contract, limits, restrictions, classes of risks, territory, period of coverage, rates on which reinsurance premiums are calculated, names and addresses of reinsurers, rates of commissions, including commissions on retrocessions if handled by the intermediary, details regarding retrocessions if handled by the intermediary, and financial records, including premiums and losses.

Fiduciary responsibilities of the reinsurance intermediaries

81. Reinsurance intermediaries are responsible for funds received by them in that capacity. Such funds have to be deposited in identified accounts in banks duly licensed in the State. No withdrawal from such accounts is permissible except for payment of premiums, return premiums, losses to insurers or other parties, commissions due to others, commissions due to the intermediary, and voluntary deposits. The intermediary is also obliged not to commingle any premium and loss funds received by him in his capacity as intermediary with his own funds held by him as an insurance agent, insurance broker or in any other capacity.

82. If a ceding company obtains a reinsurance cover through a reinsurance intermediary from a reinsurer who is not licensed in the State of New York, the reinsurance agreement will not be allowed credit unless it includes a provision whereby the reinsurer assumes all credit risks of the intermediary related to the payment to the intermediary. This would mean that the payment of premium to the intermediary would be considered as payment to the reinsurer, thus virtually making the intermediary the agent of the reinsurer with regard to payment of premiums and claims.
83. If the reinsurance intermediary is not licensed in New York, the ceding company must obtain a written agreement from the intermediary that he will comply with the requirements applicable to reinsurance intermediaries in New York (Regulation No. 98). An unlicensed intermediary must agree to submit himself to the examination of the Superintendent of Insurance in New York as often as the latter may deem it necessary.

84. It is to be observed that New York is the only State in the United States which requires reinsurance intermediaries to be licensed. It appears unlikely that other States will follow the New York example. The reluctance of other States to provide a system of licensing and supervision of intermediaries stems from their apprehension that licensing might be considered by these States as a guarantee of trustworthiness, merit or reputation. They feel that it would be both unfair and possibly harmful if such trustworthiness was based solely on a simple licensing process.
Chapter IV

OPERATION OF REINSURANCE BROKERS IN DEVELOPING COUNTRIES

85. It is no secret that one of the aspects of contemporary insurance markets in most developing countries is their extensive reliance on the services of international reinsurance brokers. It is rather rare to find an insurance or reinsurance company in third world countries which is not assisted by one or more reinsurance brokers in negotiating the whole or part of its reinsurance or retrocession requirements.

86. This situation can be attributed to a multitude of factors, some of which are historical. This applies, for example, to brokers who were operating in developing countries in the direct business before being obliged to cede their place to local insurance entities and who then continued their activities in the reinsurance field. Also, some larger brokers were instrumental in helping local insurance companies to evolve by participating in their equity and by providing technical support.

87. The extensive reliance on reinsurance brokers can, however, largely be explained by the stage of development which characterizes insurance markets in developing countries. The very considerable move towards the localization of insurance and policies designed to keep insurance business within the country of origin has resulted in a sharp increase in risks requiring more reinsurance protection, as opposed to the previous situation where direct insurance was carried out by foreign carriers. The emergence of many small companies with little capitalization, a low degree of expertise and a small premium base have led these companies to rely extensively on international brokers not only to plan and place their reinsurance but also for assistance in performing some of their everyday duties such as risk inspection, claim services, documentation, staff education, etc. These brokers generally agree to go beyond assistance in reinsurance matters by providing advisory services in such matters as underwriting, loss settlement, staff development and training.

88. Another factor enhancing the role played by reinsurance brokers in developing countries is the nature of the insurance business transacted. Analysing the distribution of such business, one cannot fail to notice that apart from a relatively small volume of conventional risks such as motor, fire, and cargo, the bulk of the premiums written are derived from risks of above-average sums or exposures such as industrial fire, storage risks, hull, aviation, engineering, etc. Such risks, by their limited number and large diversity, do not lend themselves to cover under automatic coverages. Thus, they have to be reinsured facultatively. Obviously, for such cover, reinsurance brokers are best placed to obtain both competitive terms and sizeable capacity.

89. A third factor increasing the role played by reinsurance brokers in developing countries is the strain which substantial outflows of foreign reinsurance premiums exert on the foreign currency resources of a country. As much of the business written in these countries has to be reinsured abroad, insurers tend to curtail reinsurance costs by switching from proportional to non-proportional covers whenever this is feasible and possible. It is in this very field that international reinsurance brokers' strength comes fully into play.
90. In an endeavour to widen the scope of their activities or to curb their reinsurance expenses, many insurers and reinsurers in developing countries attempt to obtain business from other insurers or reinsurers on a reciprocal and non-reciprocal basis. As their means and outside connections are generally limited, they resort to international reinsurance brokers who have both the contacts and the skills to promote the two-way flow of business.

91. No one can deny the vital and useful services which international reinsurance brokers have offered to insurers and reinsurers of developing countries, particularly in their formative stages. The proof of this is that, despite the fact that professional reinsurers are very active in developing countries, the role played by reinsurance brokers in these markets is on the increase rather than on the decrease. It is obviously of great importance that brokers' services be performed with a high degree of professionalism and integrity. Such requirements are of particular importance for insurers in developing countries in view of the following considerations:

(a) The major part of the business they write has to be reinsured in view of their limited retention capacity;

(b) They have to count more upon reinsurance terms rather than on risk carrying for their survival;

(c) They lack the necessary know-how and experience in planning and administering their reinsurance programmes;

(d) Because of their limited financial resources, they are more vulnerable to the failure of a reinsurer or to delays in collecting their dues.

92. In the light of the above considerations, it is of the utmost importance to developing countries that international reinsurance brokers fulfil certain functions. These include:

(a) Obtaining, for the ceding companies, the most appropriate types of reinsurance cover on optimum terms;

(b) Paying maximum attention to the security and solvency of reinsurers and not reinsuring with a company unless there is a reasonable certainty that it can fulfil its obligations in the long run;

(c) Offering the ceding company efficient subsequent servicing, including prompt collection of claims, as well as appropriate handling of accounts;

(d) Offering the ceding companies sound ideas for the improvement of their performance, including direct underwriting, settlement of claims, etc.;

(e) Ensuring that the legal requirements of the country where the ceding company is domiciled are entirely met and complying with the general directions governing the insurance industry in that country.

93. Taking into consideration the serious responsibilities which the reinsurance broker has to assume in the context of a developing insurance market, and due to the fact that many insurers in developing countries may not
be in a position to evaluate objectively the professional performance of a broker, the selection of the reinsurance broker becomes a crucial decision. Even though he has no involvement in the risk carrying element of the reinsurance transaction, his selection has to be made with the utmost care.

94. In the choice of a reinsurance broker one should realize that no two brokers are alike, and that each displays characteristics that differ in detail from the other. Although in principle most reinsurance brokers handle all classes of business and all types of cover anywhere in the world, in practice a considerable specialization exists among them, with some brokers specializing in handling business from a given area, while others specialize in certain types of risk or certain types of cover. Other brokers may specialize in negotiating reciprocal exchanges. Obviously the choice of the broker depends on the nature of the requirements of the ceding company. More generally this choice has to be made in the light of certain criteria in application of the principle of "caveat emptor". Such criteria relate to the credibility of the broker, his technical expertise and his financial soundness.

Criteria for the choice of reinsurance brokers

The quality and skills of management and staff

95. There is no doubt that the overall personality of a brokerage firm stems from the reputation of the management of the firm and the skill of the staff. Obviously insurers and reinsurers would prefer to resort to skilled and well-reputed brokers who can give them independent advice and ensure them of sound services once the risk is placed.

Contacts with markets

96. Reinsurance brokers cannot exist without close links to the markets in which they can place their reinsurance business. It is therefore of extreme importance to look at the overall relationship that exists between the broker and the reinsurance markets of the world. The more contacts the broker has with the important reinsurance markets of the world, the more he will be able to secure optimum terms, to mobilize sufficient capacity and to satisfy the requirements of his clients.

Ownership and inter-company relationship

97. As it is the duty of the broker to obtain optimum terms for his ceding company, he must be in a position of complete independence towards possible reinsurers and be free from the pressure of corporate and other links with reinsurers (partnership, subsidiaries, affiliates, management pools, etc.). It should not be expected that a broker will take the same stand or attitude to the business if he comes under the control of reinsurers, or if reinsurers come under the control of the broker.

Premium growth

98. A good indication of the performance of the reinsurance broker is the volume of premium income passing through his hands. Obviously the scale of operations of a particular broker is a straightforward test of his ability and strength, and also a proof of the confidence which both ceding companies and reinsurers place in him.
Broker's financial standing

99. Despite the fact that the broker is in no way a risk carrier, his fiduciary duties towards ceding companies and reinsurers often oblige him to finance remittances to either party from his own account pending receipt of amounts due. Hence a basic requirement for the successful operation of the broker is that he has a good financial standing. The adequacy of funds and resources to service the business that has produced brokerage is also extremely important; they have to meet the requirements of the broker's clients, particularly when their business has stopped producing brokerage fees.

Errors and omission liability coverage

100. Reinsurance broking is a hazardous business, considering that much of the work is done orally and documentary evidence of transactions is often produced late. There are also cases of professional negligence, in which brokers may be sued by their clients. This is why it is necessary for a broker to carry a large amount of error and omission insurance cover. It would be very risky for a ceding company or a reinsurer to deal with a broker not well protected by such cover.

Supervision of the broker's activity in country of origin

101. Any assessment of the suitability of a reinsurance broker would be incomplete if it does not take into account the laws and regulations of the country where the reinsurance broker is chartered. If brokers are regulated (State regulation or self-regulation recognized by the State), they are likely to meet certain requirements regarding their establishment and operational standards. The existence of such regulation and supervision undoubtedly creates additional elements which reinforce the reliability and credibility of the broker subject to them, and such a broker will compare favourably with another who is not subject to any type of control.

Sources of information for the choice of reinsurance brokers

102. For the choice of a reinsurance broker, ceding companies and reinsurers should collect all relevant material concerning brokerage firms which they intend to use. Brokers can be asked to dispatch such material. It may be possible to obtain additional information from the supervisory authorities of the broker's country of origin if brokers' activities are regulated in that country. Brokerage trade associations could also be solicited to furnish information regarding their activities. Finally, market gossip can be an important source of information about brokers.

103. It may, however, be more practical for the ceding companies and for reinsurers selecting a broker to elicit information from the broker himself in the form of a questionnaire in which the major issues related to the scrutiny of the brokerage firm are brought in. Examples of these issues are:

(1) Identity of owners of the brokerage firm, names of partners and percentages of their participants in the share capital;

(2) The legal form of the brokerage firm, where it is chartered, and whether it is subject to some form of technical and financial control;
(3) The corporate links the firm has (subsidiaries, affiliates, pools, etc.);

(4) The countries where the brokerage firm operates;

(5) Names of senior and technical managers - number of staff, etc.;

(6) Names of staff having authority to negotiate on behalf of the brokerage firm;

(7) Assets of the brokerage firm (share capital and other funds);

(8) Methods of keeping fiduciary funds (funds of ceding companies/reinsurers);

(9) Methods of investing fiduciary funds;

(10) Procedure adopted by the broker for remittances;

(11) The name and address of the insurer covering the professional liability of the broker;

(12) Sum insured and the deductible under the professional liability policy.

Regulation of reinsurance broker's activities in developing countries

104. As most insurance laws in developing countries are geared to the protection of policy holders and the general public at large, very few provisions related to reinsurance are contained in these laws. Even if some countries regulate reinsurance in some way or another, there are usually no specific provisions regulating the activities of reinsurance brokers. The reasons for this situation are obvious, since the great majority of these brokers are foreign firms which operate from their head office abroad and normally do not have a local institutional presence in the countries where they acquire business for placing. In some countries, however, international brokers are locally licensed in their capacity as direct insurance brokers, while exercising reinsurance activities as well.

105. Under the present conditions of developing countries' insurance markets, attention must be drawn to the power wielded by reinsurance brokers in the face of generally weak and inexperienced insurers. The extensive dependence of ceding companies on brokers in the planning, placement and servicing of their reinsurances requires that the former closely monitor the performance of their respective brokers, if only to prevent them from taking advantage of their weaknesses. It has to be admitted that insurers in developing countries are unable individually to undertake such control. It is, therefore, reasonable to assume that in principle the insurance regulatory authorities have a role to play to help protect their insurers and consequently to help safeguard the interests of policy holders and the public at large. The problem which poses itself, however, is how far the regulatory authorities in many developing countries are equipped to carry out such a task, which requires above all extensive familiarity with the international reinsurance
scene. In this context it has to be remembered that some developing countries have only recently established insurance supervisory offices. It may be too early to expect them already to be fully knowledgeable in respect of the international broker scene.

106. To be pragmatic, the action of the regulatory authority should at present be confined to identifying reputable reinsurance brokers and ensuring that minimal adequate information on each of them is available to national ceding companies so that these companies can base their actions on factual and solid information about the brokers' technical and financial qualities. The intervention of the regulatory authority in this field should be confined to providing this factual information and should avoid being restrictive, because reinsurance brokers have a crucial and beneficial role to play in arranging reinsurance programmes for young insurance companies, particularly for those which lack the technical ability and experience to negotiate reinsurance cover by themselves.

107. A system of registration of reinsurance brokers could be introduced by the national regulatory authority. Such a system should confine the broking of reinsurance business in the local market to those firms which have been registered.

108. In order to be registered, a reinsurance broker should submit an application form to the insurance supervisory authority, together with a copy of the act of incorporation, with indications as to amount of capital, major shareholders and partners, particularly those engaged in insurance and reinsurance business, list of managers and organizational chart, audited accounts for the last two years, and list and addresses of banks in which the broker's funds and insurance funds are deposited. Brokerage firms applying for registration should also submit evidence that they are operating in conformity with laws and regulations in their countries of origin.

109. Brokerage firms seeking registration should submit evidence that they maintain a professional indemnity insurance policy for an important amount of money to cover their liabilities in case of errors and omissions. For any uninsured excess of this policy, the brokers should maintain in the country an adequate security such as a letter of credit from a local bank.

110. It is also suggested that brokers seeking registration should submit, with their application for registration, an undertaking that in all their activities with locally licensed insurance companies, they would adhere to the standards of professionalism that is expected from them (see paras. 100 and 101).

111. Consideration may be given to the possibility of brokerage firms which have already been registered in a developing country for the transaction of direct insurance business being registered also as reinsurance brokers. Such registration would be subject to the provision that the brokers in question should not be allowed to act as reinsurer intermediaries for any business which they handle on the direct side. This provision seems necessary in order to avoid a conflict of interests between the insured and the insurer, and to discourage any temptation by the broker to take advantage of his position when arranging the original cover.
112. Once the brokerage firm seeking registration submits its credentials fulfilling the information requirements, it should be automatically registered and its name should be added to the list of admitted reinsurance brokers to whom local ceding companies resort for the placing of their risk in reinsurance. Such registration should be reviewed periodically to oblige registered brokers to submit full and up-to-date information about their performance to the insurance supervisory authority. In such a way, information would be available to enable local ceding companies to select their brokers in full application of the principle of "caveat emptor", keeping them fully responsible for the choice they made.
SUMMARY AND CONCLUSIONS

113. International brokers play a dominant role in the placing of reinsurance worldwide. This role is particularly important in the context of developing countries. The intensive reliance of insurers in these countries on international brokerage services can be explained by a variety of factors related to the nature of the risks to be reinsured and the reduced technical abilities of insurers to plan and administer sound reinsurance programmes.

114. The association between international reinsurance brokers and insurers in developing countries has benefited the latter not only during their early stages of development but also more recently due to the ever-growing value and complexity of risks which require careful handling of reinsurance protection.

115. The image of the reinsurance broker seems, however, to have been questioned in the recent past - marked deterioration in morality and performance have caused scandals and cases of litigation. This is of particular concern for many insurers from developing countries, since they may lack the necessary technical and financial sophistication to be immune from the problems caused by brokers failing to live up to their duties.

116. To avoid pitfalls in this field, insurers need first of all to have a complete understanding of the different functions of the broker and the nature of his relations with both the ceding company and the reinsurers. They have also to be aware of the legal position of the broker, and of the areas where he can be held liable for his acts. These issues are examined in the first two chapters of the study.

117. Insurers also need to make a careful and judicious selection of their reinsurance brokers. The choice of which broker to use should be made on the basis of certain criteria, but with particular emphasis on corporate, technical, financial and managerial aspects. The specialization of the broker also has to be taken into account.

118. Chapter III examines the types of supervision which reinsurance brokers are subject to in two of the principal international reinsurance markets, i.e. the United Kingdom and the United States. It illustrates how international reinsurance brokers have to comply with certain registration requirements.

119. In order to examine the position of the reinsurance broker, the ceding company obviously needs information and data on the broker. Contrary to insurers in international insurance markets, who benefit from the existence of a wealth of publications, the insurance press, market gossip, etc., which shed light on the performance of brokers, insurers in developing countries are most of the time deprived of such sources of information. Hence the necessity for each ceding company in these countries to carry out by itself the task of vetting the brokers which it intends to use.

120. As such an exercise is difficult due to the lack of sufficient information, the choice of brokers is often made haphazardly or on the basis of incomplete information. Chapter IV explores the criteria for the choice of reinsurance brokers by insurance companies in developing countries, bearing in mind the importance of the role of the reinsurance broker in these countries.
121. In this context, a certain degree of regulatory intervention would seem appropriate to enable insurers to choose their brokers in an objective manner. A system of listing brokers who wish to operate in a market should be established. Once a reinsurance broker has complied with the information requirements of the insurance supervisory authority, it should be included in the list of admitted reinsurance brokers. In such a way, the insurance companies which would like to resort to the services of a reinsurance broker would be able to appraise and select the broker with full responsibility.

Notes


2/ Inversely, a broker could serve as intermediary for a reinsurance transaction which was previously concluded directly between the contracting parties.
REFERENCES


