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GUIDELINES ON REINSURANCE PRACTICES AND PROCEDURES

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One of the most important risk management tools available to an insurer is reinsurance. Reinsurance, however, exposes the insurer to other risks including operational, legal, counterparty and liquidity risks. An insurer's financial soundness and reputation can be severely affected if its reinsurance risk management practices and procedures are inadequate. To mitigate this risk the Financial Services Commission (the Commission) requires that every insurance company should have a formal **policies and procedures document** that is adopted by its Board of Directors and which clearly establishes a framework for the company's reinsurance practices.

This approach is in keeping with international standards on corporate governance, which require that the Board of Directors remain responsible for ensuring that the company follows sound business and financial practices. Board members should never be able to distance themselves from a critical area such as reinsurance, by claiming that they have relied on the advice of Senior Management without having carried out any due diligence in respect of the advice being acted upon.

The following principles are intended to assist an insurance company in developing prudent approaches to managing its reinsurance risk:

1. **Every insurer should have a reinsurance strategy, approved by its Board of Directors, which is appropriate to the company's overall risk profile.**

An insurer should have a sound and comprehensive reinsurance strategy that reflects the size, nature and complexity of its business taking into consideration its [1]risk appetite, [2]risk tolerance, peak exposures and seasonality in the insurance book, levels of diversification and appetite for credit risk. The reinsurance strategy should document the significant elements of the insurer's approach to managing risk through reinsurance, including the purpose and objectives of seeking reinsurance, risk diversification objectives, [3]risk concentration limits, [4]ceding limits, desired [5]net retention and the practices and procedures for managing and controlling its reinsurance.

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[1] In this guideline, Risk Appetite, often a qualitative assessment refers to the total level and type of risk exposure that an insurer is willing to undertake to achieve its objectives.

[2] Risk tolerance refers to specific parameters and or limits on the level and the amount of risk an insurer is willing to accept/retain, such as maximum net retentions.

[3] Appropriate concentration limits should be based on premiums, expected claims, amounts at risk and possible future exposures (at the time of inception or renewal of the policy) on a consolidated basis, to individual counterparties, group of individual counterparties or related entities and counterparties in a specific geography.

[4] An insurer should not in the normal course of its business cede 100% or substantially all of its risks in its main areas of business.

[5] The level of net retention is generally determined with reference to the insurer's capital and surplus and varies based on the line of business underwritten.

The reinsurance strategy or Reinsurance Risk Management Plan (RRMP) should define and document:

- The insurer's policy on the use of rated and unrated reinsurers and the procedures for identifying appropriate reinsurers that provide the acceptable level of security;
- Aggregate exposure limits, that is, the maximum aggregate exposure to any one reinsurer, a group of related reinsurers and to unrated reinsurers;
- The type of reinsurance to be purchased and how flexible the insurer is in considering different forms of reinsurance e.g. financial reinsurance, fronting;
- The management of potentially large risk exposure under catastrophe reinsurance arrangements;
- Appropriate criteria for the purchase of [6]facultative coverage and specific process to approve, monitor and confirm the placement of each facultative risk;
- The roles and responsibilities on those positions charged with implementing the reinsurance strategy;
- The methodologies and process for selecting, documenting, approving, implementing, monitoring and reporting on the reinsurance arrangements; and
- The process for ensuring that the reinsurance strategy is updated to reflect changing market conditions.

Appropriate liquidity management strategy to take account of the structure of the reinsurance contracts and likely payment patterns arising from these. The strategy should address how the insurer will meet urgent requirements for cash, from claims arising in a catastrophe.

The Commission recommends that the relevant factors included in the Minimum Capital Test (MCT) Regulations should be taken into consideration during the design and negotiation of the company's reinsurance programme. As

[6] Facultative reinsurance should be secured before the insurer accepts a risk that exceeds its treaty capacity and/or its risk appetite.

the quality of the reinsurance programme and the financial strength of the reinsurer are taken into consideration when calculating the entity's regulatory capital requirements.

Oversight

The RRMP should be overseen by the Board of Directors (the Board) and implemented by Senior Management. In light of this, the Board of Directors is responsible for establishing appropriate monitoring mechanisms to ensure that the reinsurance strategy is being delivered and complied with by the company's management.

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

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

Limits on the net risk to be retained should be set either per line of business or for the whole account. The insurer may also set limits per risk or per event. The limits must be based upon an evaluation of its risk profile. For each approved reinsurer the appropriate level of exposure should be specified taking into consideration the ability and willingness of the reinsurer to fulfil its contractual obligation as they fall due.

The Board should review and approve the RRMP at least annually (in the case of a life insurer, possibly less frequently). Additionally, it should ensure that Senior Management possess the appropriate knowledge and expertise to develop and establish internal controls and procedures to monitor the effectiveness of and operational compliance with, the RRMP on an on-going basis.

The senior management team has the responsibility for ensuring that the RRMP is operational through the dedication of adequate resources and is implemented by knowledgeable personnel. Senior Management should document clear policies and procedures for implementing the reinsurance strategy, this includes:

- **i.** Setting underwriting guidelines that specify the types of business to be underwritten and aggregate exposure by line of business;

ii. Establishing limits on the amount and type of reinsurance that will be automatically covered by reinsurance (e.g. treaty reinsurance);

iii. Establishing criteria for acquiring facultative reinsurance cover;

iv. Ensuring that the terms and condition of the reinsurance cover are compatible with those of the underlying business to avoid uncovered risk; and

v. Outlining the scope of authority and specification of matters reserved for Senior Management.

The insurer should have in place procedures for managing the reinsurance asset and to ensure that all reporting due to and from reinsurers is timely and settlements are made as required by the contract. The insurer should also have in place procedures for monitoring the aggregate net exposure to any one reinsurer to ensure that these limits are not breached, including procedures to ensure that [7]excess concentrations are brought back within limits or otherwise managed on an on-going basis.

2. **The insurer should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis.**

The insurer should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities on an on-going basis. Where possible, the insurer should conduct its own due diligence exercise on the financial health and capabilities of all current and prospective reinsurance counterparties. Consideration should be given to the reinsurer's balance sheet strength and regulatory standing. That is, whether the reinsurer is meeting its statutory capital requirements and is in good standing with its regulators.

The level of the due diligence carried out should be commensurate with the level of exposure to the counterparty. The insurer should develop a systematic program for monitoring changes in the ratings, surplus, assets, reserves, premium volume, ownership and management of its reinsurers. This exercise should be updated throughout the life of the reinsurance contract and beyond, in cases where there may be material exposures to incurred but not reported losses.

[7] The aggregate exposure limits might be breached in certain instances, for example by facultative placements and temporary inadequate capacity.

The Commission expects a higher level of due diligence by the insurer in respect of all current or prospective arrangements with unrated reinsurers. This assessment should include a review of the regulatory and supervisory regime and the legal and insolvency framework of the unrated reinsurer's home jurisdiction. The insurer should also consider how these reinsurers are likely to react during a period of extreme but plausible stress.

Outsourcing the due diligence function

The Commission recognises that there are situations where it may be necessary and appropriate for an insurer to utilise the services of a third party to conduct due diligence on its reinsurance counterparties. The evaluation of reinsurers, however, should not be based solely on rating agency assessments or reinsurance broker analysis and recommendation. The responsibility for selection of reinsurers remains with the insurer. Any abdication of this responsibility can potentially compromise the financial security of the insurer and would not be in compliance with the requirements of this guideline.

The Commission expects the insurer to retain ultimate accountability and take steps to mitigate against counterparty risks. Insurers should demonstrate sufficient knowledge of the due diligence exercise carried out by third parties during their own assessment of the financial health of respective reinsurers. The Commission recommends that where the due diligence function is carried out by a third party; the insurer should be guided by the following, in developing a prudent approach to managing risks involved:

i. Develop a process for selecting the third party, which is documented and board approved.

ii. Implement a program for managing and monitoring risks.

iii. Ensure that the Board of Directors receives information sufficient to enable them to discharge their oversight responsibilities.

iv. Ensure that the outsourcing agreement is documented by a written contract that addresses all elements of the arrangement.

v. Ensure regular update of information compiled on its panel of reinsurers and keeps abreast with developments in the international reinsurance markets especially developments relating to the reinsurers on its panel.

3. **<u>The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.</u>**

The insurer should have processes and procedures in place to ensure that comprehensive reinsurance contracts which are duly signed by both the insurer and reinsurer are in place prior to the effective date of the contract. Reinsurance contracts should be unambiguous and should represent the final arrangement of all material terms and conditions of the contract in writing. An actual transfer of risk must take place in the business reinsured (in the case of proportional contracts), or an actual risk must be covered (in the case of non-proportional contracts and facultative excess of loss reinsurance) between the insurer and the reinsurer. The reinsurer must assume "significant" risk; that is, it must be "reasonably possible" that the reinsurer can suffer a "significant loss".

There may be situations where a reinsurance contract is only duly executed by all parties after its effective date. Reinsurance coverage during this interim period is usually set out in a less formal document, for example, slip, cover note, letter of proposal, binding letter of intent, hereinafter referred to as the ***summary document***. If an event were to occur within this interim period the lack of certainty relating to the terms and conditions of the reinsurance coverage may result in actual operational and reputational risk for both the insurer and the reinsurer. In an effort to mitigate these risks the insurer should:

i. Obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, that set out:

a. the premium/consideration paid;

b. the percentage of risk assumed by each reinsurer;

c. the risk(s) reinsured;

d. the duration of coverage;

e. any exclusions to the terms of coverage; and

f. any standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract;

ii. address, within the summary document, any material issues most likely to arise, including all variable or unique agreement terms; and

iii. ensure that all comprehensive reinsurance contracts, including any amendments, are duly signed by both the insurer and reinsurer in a relatively short timeframe, having regard to the complexity and materiality of the agreement.

The insurer should also have policies and procedures in place to identify the risk posed by a mismatch, intended or not, in the terms and conditions between the reinsurance contract and the underlying policies, which is, the risk that the insurer may bear a greater net exposure than it intended.

There should be sufficient copies of the document bearing the terms of reference and summary of the reinsurance contracts for use by individuals or departments involved in the day-to-day management of the reinsurance programmes.

4. The insurance company, its policyholders and its creditors should not be adversely affected by the terms and conditions of a reinsurance contract.

The terms and conditions of a reinsurance contract should not raise legal questions as to the availability of funds to cover policyholders' claims in the event of the insurer's insolvency. The insurer should ensure that all reinsurance contracts contain an insolvency clause clarifying that the reinsurer must continue to make full payments in the event the insurer goes insolvent without any reduction resulting from the insurer's insolvency.

Reinsurance contracts should not contain other terms, clauses or conditions that may limit, rather than enhance, a troubled or insolvent insurer's ability to enforce the contractual obligation of a reinsurer, including the coverage of policyholder's claims. The insurer should pay special attention to "off-set" and "cut-through clauses" which may run counter to the insolvency laws and may allow certain policyholders or creditors to have preferential treatment by diverting funds away from the insolvent insurer to a specific policyholder.

The Commission expects that all contracts related to reinsurance coverage, of a locally registered insurance company, be subject to Jamaican laws.

Guideline Administration

Supervisory information

An Insurer should file the following documents with the Commission annually:

- **i.** a copy of its RRMP or any material changes made to the RRMP;
- **ii.** a complete description of all its reinsurance arrangements, including levels of reinsurance, any alternative risk transfer (ART) mechanism and due diligence performed on reinsurance counterparties;
- **iii.** copies of all reinsurance contracts;
- **iv.** the proportion of cessions to rated and unrated reinsurers ***(Appendix 1)***; and
- **v.** amounts outstanding from reinsurers, including amounts in dispute.

The insurer should inform the Commission promptly if it anticipates that a problem is likely to arise, or has arisen, out of its reinsurance arrangements that may affect it or its reinsurers current or future capacity to meet their obligations. The insurer should have process and procedures in place to provide the Commission with information, on the appropriateness of its reinsurance protection, the company's financial position, the level of risk affected or any problems that might arise, after a major catastrophic event.

Alternative Risk Transfer (ART)

The Commission is aware that other legal forms of risk transfer exist which may seek to achieve the same objectives as traditional reinsurance for example; catastrophe bonds, industry loss warranties and [8]finite reinsurance. Such contracts should not be considered to mitigate insurance risk (underwriting risk and timing risk) unless there is a genuine and significant transfer of this risk. A genuine transfer of risk implies that the reinsurer assumes all the significant risk of the reinsured portions of the underlying insurance contracts and that these risks are not negated by

[8] Also called "financial reinsurance", "structured reinsurance", "non-traditional reinsurance" or "loss-mitigation reinsurance" is a generic term that is used to describe a wide spectrum of reinsurance arrangements that transfer limited risk relative to aggregate premiums that could be charged under a contract.

contract provisions. The insurer should be aware of any contractual features that may limit the amount of insurance risk to the reinsurer or delay the timely reimbursement of claims by the reinsurer.

It is essential that these transactions are accounted for appropriately. Only contracts that have transferred sufficient insurance risk as required by the relevant accounting standards should be accorded 'insurance accounting' treatment. If the reinsurance contract does not meet the insurance risk transfer requirement it should be accounted for as a financing agreement similar to that of a loan or a deposit.

Reinsurance declaration

A senior officer of the insurance company should make an annual declaration to the Board of Directors to confirm that the insurer's reinsurance risk management practices and procedures met, except as otherwise disclosed in such a declaration, the standards set out in these guidelines. The declaration should include an attestation that the reinsurance arrangements convey a true transfer of risk, the reinsurance arrangements are properly documented and binding and that all reinsurance arrangements with related parties are on terms and conditions at least favourable to the insurer.

When a deviation from these Guidelines has taken place, the nature and extent of the deviation and the proposed plans to address such deviations should be disclosed in full to the Board and the Commission.

Implementation

These Guidelines come into effect on **October 1, 2014.**

Appendix 1

Information Relating to the Financial Strength Rating of Reinsurance Companies						
	Current Year			Prior Year		
Break Down By Rating	Maximum Exposure	Premiums Ceded $000	As a % of Total Ceded	Maximum Exposure	Premiums Ceded $000	As a % of Total Ceded
*A+ or better						
*A to *A-						
*B++						
Worse than *B++ But not worse than *B						
Worse than *B						
Unrated						
Total						

*or equivalent financial strength rating