

# **OFFSHORE GROUP OF INSURANCE SUPERVISORS**



**GUIDELINES  
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**STANDARDS FOR REINSURANCE SECURITY**

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### **GUIDELINES ON STANDARDS FOR REINSURANCE SECURITY**

All the members of the OGIS will have a captive insurance industry of some size; on the domestic side most will have foreign insurers carrying on business through branches or agencies, and a few will have indigenous insurers in their jurisdictions. Not all of these insurers will purchase reinsurance protection, but for those that do the major considerations regarding the security of reinsurance will apply in all cases, captive or otherwise.

The insurance supervisors will require that through the insurer's use of reinsurance it will satisfactorily cope with the risk of capital and surplus impairment in adverse years and avoid severe fluctuation in annual occurrences.

This may be per risk capacity on an:

- excess of loss basis;
- annual aggregate excess (Stop Loss) protection;
- catastrophe (eg. Hurricane) protection for one event; and
- participating reinsurance where captive and reinsurer share in risks on a pre-agreed basis.

There are therefore only two types of reinsurance: 'Working' and 'Risk'.

A 'working' cover is one where the limits (capacity) are small relative to premium generated. In the 'risk' cover, limits demanded of the reinsurer are such that a significant loss will be beyond the acceptable time scope of the particular insurer.

Whilst long established rules of thumb for NP to surplus ratios (usually between 5 and 3:1) are still useful as one component of solvency assessment, for most insurers and captives in particular, a risk assessment is of greater value. Reinsurance will play a key role in limiting both individual and aggregate risks to manageable proportions.

When the insurer and reinsurer agree on intent, a total insurance programme is designed in two key segments plus possible per occurrence catastrophe or annual stop loss protection. The latter may assist in maximizing the ratio of net retention per risk to policyholder's surplus. The insurer will decide upon a basic retention or first loss relative to its capitalization of surplus and premium generated.

Having established therefore the necessity for reinsurance it can be seen that the supervisor must consider two aspects:

- a) the security to the company i.e. the captive, as a result of the proper reinsurance programme and
- b) the security provided by careful selection of the reinsurance carrier.

Enquiries should be made to ascertain the soundness of the fronting company and the reinsurers to form an opinion and to be satisfied as far as possible that claims made under these contracts can be met in full.

The insurer and the supervisor must obviously be concerned about the 'security' problem.

How to go about ensuring that the reinsurers are going to 'pay up' is not simple although most brokers and risk managers have their own methods of checking security, but in certain cases it may be necessary for the insurance supervisor to investigate more fully, including checks covering fit and proper considerations on the management (see separate OGIS standards paper).

The supervisor should ensure that the broker used for the insurer's reinsurance programme is fit and proper including having the capability to ensure that the markets used are of adequate stature.

For those captive reinsurers which use a fronting insurer, the selection and use can make an important contribution to the process.

The fronting insurer, which should be a well-established and authorized company in the particular country of operation, will be writing 100% of the risks.

This company has therefore a specific interest in the security of the captive and of the captive's reinsurers. As far as the first level of security, that of the captive before reinsurance, is concerned the fronting insurer should be fully aware of the financial standing of the captive, particularly regarding capital funds, the use of Letters of Credit or similar instruments and the possibility of loans back to the parent. At the second level, that of the captive's own reinsurance programme, the fronting insurer has a vested interest and should be able to confirm to the captive owner that the reinsurers used meet particular criteria.

It is equally important that the reinsurance treaty arrangements between the fronting insurer and the captive do ensure that in the event of a claim the fronting insurer pays this in full and then recovers subsequently from the captive which will in turn recover from the captive's reinsurer. It is important for the supervisor to be confident that the contract wordings will allow this process to occur (see later paragraph for further comments on contract wordings).

Supervisors should insist on seeing the reinsurance programme in detail and a full list of reinsurers with their percentages. It would also be useful to see the internal retrocession organized by the broker for the main reinsurer involved in the programme.

With this list the supervisor can vet the reinsurers involved and insist on additional information if required.

For peace of mind all fronting insurers and reinsurers should be highly rated by an acknowledged rating agency.

In certain instances, for instance financial reinsurance contracts, a supervisor may deem it prudent to review the relevant contract wordings. Should the supervisor not have the appropriate expertise to perform the review he may need to outsource the exercise, for a domestic insurer possibly to his legal department, or for a captive to the captive's own insurance manager. 'Cut-through Clauses' are sometimes useful tools to enable the captives to claim directly against retrocessionaires although they are commonly used to give comfort to front companies, enabling them to 'cut-through' the captive and to claim on the reinsurer. The insurance supervisors should be aware of the effect on the captive of these clauses.

Apart from the financial security of reinsurers one of the problems at present is the delay and in some cases repudiation of claims payments.

In a soft competitive market it is not unusual to use delay in claims payments or the 'small print' to improve profitability.

This problem should be considered as part of the vetting of the reinsurers used in a captive programme.