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Rialtóir Airgeadais

Requirements for Reinsurance Undertakings carrying on Life Reinsurance, including transitional requirements

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Consultation Paper | CP20

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1 Introduction

1.1 Scope

On the 15th of July 2006, Statutory Instrument 380 of 2006 ("S.I. 380") transposed into Irish law Council Directive 2005/68/EC ("Reinsurance Directive"). The Irish Financial Services Regulatory Authority ("Financial Regulator") is issuing this paper further to its statutory powers under S.I. 380, as detailed below. The requirements in this paper apply to reinsurance undertakings established in the State carrying on life reinsurance business, hereinafter referred to as "life reinsurance undertakings".

The International Association of Insurance Supervisors (IAIS) has developed a set of standards relevant to both the supervision of insurance and reinsurance undertakings. The IAIS standard on reinsurance "Supervision of Reinsurers", issued in October 2003 (available at www.iaisweb.org), elaborates on their earlier publication on the principles of supervision "Minimum requirements for supervision of reinsurers", which focuses particularly on where reinsurers differ from primary insurers, hence requiring the supervisory framework to be adapted. The Financial Regulator has had regard to the IAIS standards in drafting this paper.

1.2 Implementation

The Financial Regulator wishes to establish the degree of compliance within existing life reinsurance undertakings to make an initial assessment of the extent to which life reinsurance undertakings meet the required standard. The compliance submissions described in sections 1.2.1 and 1.2.2, below, are without prejudice to a reinsurance undertaking's rights under Regulation 11(1) of S.I. 380.

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1.2.1 2006 Compliance Submission

Life reinsurance undertakings must confirm their compliance or otherwise with the provisions of the following regulations of S.I. 380 (by reference to the most recently audited financial statements):

1) Regulation 23 (1) (a), and
2) Regulation 26.

This submission must be lodged with the Financial Regulator by close of business on **29th of December 2006**, and must be clearly titled '2006 Compliance Submission'. It may be emailed to: **reinsurance@financialregulator.ie**.

1.2.2 2007 Compliance Submission

Life reinsurance undertakings must further confirm their compliance or otherwise with all of the provisions of S.I. 380 (by reference to the most recently audited financial statements), including without limitation:

1) Regulation 23 (1) (a), and
2) Regulation 26, and
3) Regulation 23 (1) (b) and (c).

This submission must be lodged with the Financial Regulator by close of business on **29th of June 2007**, and must be clearly titled '2007 Compliance Submission'. It may be emailed to: **reinsurance@financialregulator.ie**.

If a life reinsurance undertaking is not compliant with one or a number of the required areas at the time of the submission, it must include with the 2007 compliance submission a detailed plan as to how the undertaking intends to become compliant in the areas of non-compliance by **28th of September 2007**. A life reinsurance undertaking must clearly state the reasons for any areas of non-compliance by such a date. The Financial Regulator will discuss the plan for compliance with the life reinsurance undertaking with a view to reaching an acceptable schedule of actions.

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1.3 Legal Basis

Chapter 2 (Technical Provisions) contains rules of the Financial Regulator made under Regulation 23(2) of S.I. 380 with respect to the technical reserves that are to be established and maintained by a reinsurance undertaking established in the State.

Chapter 3 (Assets covering Technical Provisions) contains rules of the Financial Regulator prescribed under Regulation 26(5) of S.I. 380 as to how reinsurance undertakings must comply with Regulation 26 of S.I. 380.

Chapter 4 (Required Solvency Margin) provides, pursuant to paragraph 9(2) of Schedule 1 of S.I. 380, for the circumstances in which the required solvency margin may be determined in accordance with Article 28 of the Life Assurance Business Directive, as well as providing guidance on transfers of reserves and ceding allowances.

Chapter 5 (Systems and Controls) states the opinion of the Financial Regulator for the purposes of Regulation 20 of S.I. 380 as to its subject matter. Accordingly, Chapter 5 outlines the systems and controls that, in the opinion of the Financial Regulator, can be considered to be sound and adequate for the purposes of Regulation 20 with respect to the matters discussed in Chapter 5.

Chapter 6 (Regulatory Returns) requires authorised reinsurance undertakings established in the State to lodge certain returns with the Financial Regulator, pursuant to Regulation 21 of S.I. 380.

This paper may be amended or supplemented by the Financial Regulator from time to time. Failure by a reinsurance undertaking to comply with the above provisions of S.I. 380, or rules or other requirements laid down in this paper, may be the subject of an administrative sanction under Part IIIC of the Central Bank Act 1942 and shall, except where there is a reasonable excuse, constitute an offence, in accordance with S.I. 380.

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2 Technical Provisions

2.1 Introduction

Regulation 23 (1) of S.I. 380 requires that technical provisions be determined in accordance with Directive 91/674/EEC ("the Insurance Accounts Directive") and any rules of the Financial Regulator in force under Regulation 23(2). Statutory Instrument No. 23 of 1996 ("the Insurance Accounts Regulations"), which transposed the relevant provisions of the Insurance Accounts Directive into Irish law, states that the reserves must be determined:

"On the basis of recognised actuarial methods annually by a Fellow Member of the Society of Actuaries in Ireland, with due regard to the actuarial principles laid down in Council Directive 92/96/EEC[1]."[2]

Reinsurance undertakings must have technical provisions determined by a Fellow Member of the Society of Actuaries in Ireland with due regard to the principles of Article 20 of the Life Assurance Business Directive, as per Appendix 1, and in accordance with any rules of the Financial Regulator made under Regulation 23(2) of S.I. 380, including such rules in sections 2.2 and 2.3 of this Chapter. This is equivalent to their existing obligation under S.I. 23 of 1996.

For the avoidance of doubt, on the basis of their compliance with the above, the Financial Regulator does not intend to require life reinsurance undertakings to calculate their technical provisions in accordance with the more detailed requirements outlined in the European Communities (Life Assurance) Framework Regulations, 1994 (S.I. No 360 of 1994).

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[1] Since consolidated into Article 20 of the Life Assurance Business Directive (2002/83/EC).
[2] Paragraph 26(4) of Part II of the Schedule to the Insurance Accounts Regulations.

2.2 Gross and Net Technical Provisions

As a rule hereby made under Regulation 23(2) of S.I. 380, a reinsurance undertaking must calculate both gross and net technical provisions.

The above rule has been made in order to better establish the extent of a reinsurance undertaking's exposure to its retrocessionaires. Reinsurance undertakings must outline their retrocession strategy to the Financial Regulator as part of their transitional compliance submission.

To assist reinsurance undertakings, Appendix 2 contains Guidance on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers, which was published in May 2003. Further to the points of guidance in Appendix 2, reinsurance undertakings should consider their inward reinsurance and their retrocession as a whole programme, as this will be the basis upon which the Financial Regulator will examine an undertaking's compliance with the above rule.

Reinsurance undertakings should note that in the event that the Financial Regulator considers that their retrocession programme is partly or wholly unsuitable, some or all of the retrocessionaires' share of technical provisions may not be considered admissible as assets covering the technical provisions.

The Financial Regulator will allow technical reserves to be covered by claims against reinsurance undertakings that are not authorised in accordance with the Reinsurance Directive, on a basis equivalent to that applied to reinsurance undertakings that are authorised in accordance with the Reinsurance Directive.

2.3 Guaranteed Surrender Values

As a rule hereby made under Regulation 23(2) of S.I. 380, a reinsurance undertaking must hold technical reserves that are equal to the minimum guaranteed surrender values under the reinsurance contract.

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A life reinsurance undertaking must value any and all liabilities that may arise from the termination of a life reinsurance contract, whether projected or not, or irrespective of whether the reinsurance undertaking and/or the cession undertaking has the right of termination.

Where a termination of a reinsurance contract results in an increase in total net liabilities of a reinsurance undertaking (such as an elimination of negative reserves, or the payment of break-up penalties or fees), provisions in respect of the higher amount must be held.

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3 Assets Covering Technical Provisions

The provisions of this Chapter are hereby prescribed as rules under Regulation 26(5) of S.I. 380.

Life reinsurance undertakings must adopt a prudent person approach when determining the assets covering technical provisions. The Board of Directors of the reinsurance undertaking must demonstrate to the Financial Regulator that it is adopting a prudent person approach in accordance with the rules in this Chapter and S.I. 380. Such prudent person approach must include at a minimum the requirements of Sections 3.1 to 3.3 of this Chapter with respect to Funds Withheld, Deferred Acquisition Costs and Inter-Company Transactions.

Life reinsurance undertakings must consider their entire business from acceptance through to retrocession when deciding their asset mix (and investment) strategy. As part of this approach, consideration must be given to the claims payout patterns and the potential volatility of these patterns with a view to projecting liquidity requirements and ensuring that the assets selected provide the degree of liquidity required by this analysis.

Reinsurance undertakings must maintain an adequately diversified portfolio of assets to mitigate concentration risk including the risk that arises from excessive reliance on any one asset, issuer or group of undertakings.

A further area for consideration is the issue of settlement risk, which is considered to particularly impact on reinsurance undertakings that retrocede a significant proportion of their business. In the event that a reinsurance undertaking has a significant proportion of its assets as

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retrocession recoverables, it must establish whether this asset is indeed fully 'recoverable'. Reinsurance undertakings must hold an aged debtor analysis on all its retrocessionaire debtors. Furthermore, any debtor (not only retrocessionaires) over 90 days old may not be admitted as an asset covering technical provisions.

In formulating their approach in compliance with the rules in this Chapter, life reinsurance undertakings shall have regard to the following:

- the Insurance Accounts Regulations' rules on valuation of assets (mainly in Chapter 2 of Part II of the Schedule);
- the Guidance for Insurance Companies on Asset Management, issued by the Department of Enterprise, Trade and Employment to the insurance industry in July 2001 (attached in Appendix 3 of this paper); and
- Guidance Paper No.9, 'Guidance Paper on Investment Risk Management', issued in October 2004 by the International Association of Insurance Supervisors (available at www.iaisweb.org).

3.1 Funds Withheld

An asset that is withheld by a cession undertaking for the benefit of the reinsurance undertaking ("Funds Withheld") may be an allowed as an asset only to the extent that these funds withheld are available to the reinsurance undertaking in the event of an insolvency of the cession undertaking, whether by way of a legally enforceable offset or otherwise, and such fact is confirmed in a written legal opinion by competent external legal advisers, and approved by resolution of the Board of Directors of the reinsurance undertaking.

Funds Withheld may be considered an allowable asset in the context of the total assets of the life reinsurance undertaking being suitably diversified, liquid and secure. Therefore, having considered asset-liability matching issues, and the overall effect on the asset mix, the Board of

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Directors of the life reinsurance undertaking must then satisfy themselves with appropriateness of the security and liquidity of such funds, with a requirement to write down the assets to reflect any concerns.

3.2 Deferred Acquisition Costs

Deferred Acquisition Costs ("DAC") may be admitted as an asset for life reinsurance undertakings provided that such an asset is calculated on a prudent person basis and in accordance with the rules in this Chapter. The Board of Directors must also ensure that the assets of a reinsurance undertaking, including DAC, remain suitably diversified, liquid and secure. In addition, the basis and methodology used to determine the DAC asset must have been disclosed to the Financial Regulator in writing.

Principle 1 – A DAC asset may only be used when deferred acquisition costs can be expected to be recovered from future margins in the portfolio.

In particular:

- Only those acquisition costs which have been incurred and which have not already been recovered may be used to determine the DAC asset.
- The net present value of future margins on the contracts in question must be sufficient to cover the deferred acquisition costs.
- The reinsurance undertaking must be sufficiently certain that these future margins will be realised.

Principle 2 – The spreading of acquisition costs must take into account the nature and timing of the margins arising over the related contracts.

In spreading the acquisition costs to determine the DAC asset, consideration must be given to the nature and timing of the margins arising on the reinsurance contracts to which the acquisition costs relate. It is not necessary to spread the acquisition costs over all future margins if the reinsurance contract design is such that margins specifically

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earmarked for initial costs can be separately identified and can cover the acquisition costs deferred.

Principle 3 – The basis and methodology used to calculate the DAC asset must be prudent and consistent with that used to calculate the mathematical reserves on the policies to which the DAC asset relates.

As described above, a reinsurance undertaking needs to ensure that assets exceed liabilities on a prudent basis. Inconsistencies may arise if the DAC asset is not calculated on a prudent basis or if the basis or methodology used to calculate the DAC asset is not consistent with those used to calculate the liabilities.

Principle 4 – The DAC asset must be regularly reviewed.

A reinsurance undertaking holding a DAC asset must regularly check that it is still prudent to assume that incurred acquisition costs will be recovered out of future margins. At a minimum:

- The recoverability of the costs must be confirmed at least annually.
- If circumstances have changed and there is uncertainty over whether future margins will be sufficient to cover the deferred costs, the asset must be reduced appropriately or written off.
- In conducting the review, reinsurance undertakings must follow Principles 1,2,3 and 5, in determining the recoverability of the DAC asset.

Principle 5 – A reinsurance undertaking using a DAC asset for purposes other than to cover liabilities on the portfolio to which it relates must ensure that the DAC asset is recoverable in all reasonably foreseeable circumstances.

Companies holding a DAC asset face the risk that such an asset will be eroded by discontinuance. To mitigate this risk, a DAC asset may only be used to cover liabilities on reinsurance contracts to which the asset relates or to cover liabilities on other reinsurance contracts, or to cover solvency requirements, where, on the basis of a prudent consideration by the life reinsurance undertaking, the DAC asset is fully recoverable in all

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reasonably foreseeable circumstances. For the avoidance of doubt, the standard of prudence required herein is equivalent to that of Principle 3 above.

Consistent with the foregoing, a DAC asset cannot be higher than the minimum amount that would be realised by the reinsurance undertaking in the event of a termination of the reinsurance contract in question. Where contract wording is contained in the reinsurance contract to ensure no impact upon the provisions of the reinsurance undertaking in the event of a termination by the cession undertaking at its discretion, the reinsurance undertaking must be satisfied that such contractual terms are legally enforceable in order for Principle 5, above, to be satisfied.

3.3 Inter-company Transactions

In this section 3.3, a loan or receivable is "inter-company" where it occurs (in substance or in form) between a reinsurance undertaking and [a person with whom the undertaking has a 'close link' within the meaning of Regulation 3(1) of S.I. 380, or who is required to be included in consolidated accounts of the undertaking prepared in accordance with the Group Consolidated Accounts Directive.

3.3.1 Inter-company Loans

An inter-company loan, can only be used as an asset covering technical provisions where:

- under the terms of the loan (including any related security document) cash or another asset of at least the value of the sum repayable to the reinsurance undertaking is segregated from, and does not constitute, the assets of the borrower and is available to the reinsurance undertaking in order to satisfy the repayment of the loan, including in the event of the insolvency of the borrower or any other person holding such cash or other asset;
- the loan has been approved by the Board of Directors;

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- the validity and enforceability of the loan, and its compliance with the conditions above, has been confirmed in a written legal opinion by competent external legal advisers; and
- the inclusion of the loan as an asset has been approved in writing by the Financial Regulator prior to the reinsurance undertaking agreeing to the loan.

With regard to the first point, above, if loans or participation in the group treasury operation (i.e. essentially the "sweep" of funds excess to current requirements) are intended to be used as admissible assets to cover technical provisions they must be contractually framed so that the reinsurance undertaking retains ownership of the funds. The contract must also provide that, in the event of liquidation (or another insolvency trigger event), the funds are 'ring-fenced' beyond the reach of the liquidator (or other insolvency practitioner) and immediately payable in full to the reinsurance undertaking in repayment of the loan.

With regard to the last point, above, the approval process depends on whether the assets are to be used as admissible assets to cover technical provisions. For approval of inter-company loans intended to be used to cover technical provisions, the reinsurance undertaking must satisfy the Financial Regulator that assets supporting the loan (as described above) will be legally ring-fenced and that the level of the loan is appropriate to the undertaking's overall asset mix and consistent with its stated asset strategy.

3.3.2 Inter-company Receivables

In order for inter-company receivables to be admitted as assets covering technical provisions:

- balances must be settled at intervals equivalent to those commonly practised in the commercial market;
- gross amounts due must be paid and received, or net balances may be calculated and settled;

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- receivables included in the debtor assets aged more than 90 days may not be admitted as an asset covering technical provisions; and
- there must exist written contractual terms between the parties, and those terms must include settlement conditions equivalent to those commonly practised in the commercial market.

3.3.3 Inter-company transactions not covering Technical Provisions

Inter-company loans are permitted from surplus assets, provided however that a reinsurance undertaking shall, in accordance with Regulation 21 of S.I. 380, lodge with the Financial Regulator in advance of agreeing to provide such a loan a return notifying the Financial Regulator of the proposed loan and confirming that the loan is being made from free assets and will not be used to cover technical reserves. Such return must also include solvency margin calculations and extracts from the financial statements, showing both the current position (i.e. without the loan) and the proposed position (i.e. showing the effect of the proposed loan).

In the case of a sweeping arrangement, where the assets are not to be used to cover technical provisions, only the terms of the arrangement, and not every transaction under the arrangement, need be notified in advance to the Financial Regulator. Reinsurance undertakings must notify the Financial Regulator to any change of a previously agreed arrangement.

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4 Required Solvency Margin

4.1 Business to which life rules apply

Paragraph 9 of Schedule 1 of S.I. 380 gives the Financial Regulator the option to apply the rules as detailed in Article 28 of the Life Assurance Business Directive for certain classes of business. The Financial Regulator hereby exercises this option in the case of all business and operations coming within paragraph 9(2) of Schedule 1. This includes, therefore:

- life assurance linked to investment funds or participating contracts,
- annuities,
- capital redemption,
- management of group pension funds,
- management of group pension funds accompanied by insurance,
- operations carried out by assurance undertakings such as those referred to in Chapter 1, Title 4 of Book IV of the French "Code des assurances".

The Financial Regulator recognises that some of the life reinsurance business being written in the Irish market may not naturally fall into the EU classes of business as defined in the Life Assurance Business Directive. In order to assist reinsurance undertakings to determine the appropriate solvency margin for their business, the Financial Regulator endorses the methodology process as outlined in Appendix 4.

In accordance with Article 28 of the Life Assurance Business Directive, the solvency margin may in some instances be reduced to allow for retrocession, provided that the Financial Regulator has had sight of the reinsurance undertaking's retrocession programme in order to establish its quality. Should the Financial Regulator deem the retrocession programme to be partially or wholly unsuitable, it may reduce or remove the reduction factor applicable.

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4.2 Business to which non-life rules apply

For life reinsurance that does not fall into the categories listed in paragraph 9(2) of Schedule 1 of S.I. 380, reinsurance undertakings are required to use the rules outlined in Paragraph 5 of Schedule 1 of S.I. 380 in order to determine solvency requirements.

4.3 Mixed Business

For life reinsurance contracts that contain components of both the business referred to in 4.1 and 4.2 above, the reinsurance undertaking may separate such contracts for the purposes of determining the required solvency margin. Premiums, claims and reserves under such contracts may be separated into a component in respect of business to which life rules apply ("the investment component") and a component to which non-life rules apply ("the protection component").

This is the case provided that:

- the Board of Directors of the undertaking shall be responsible for the separation of these elements;
- the Board of Directors must take whatever actuarial and other professional advice it deems appropriate; and
- except to the extent that may be agreed otherwise in writing with the Financial Regulator, the principles in sections 4.3.1 to 4.3.3, below, are satisfied.

4.3.1 Separation of Premiums

The method of separation used by a reinsurance undertaking must be based on recognised actuarial methods. In particular, the reinsurance undertaking must calculate the premium in respect of the protection component on a basis consistent with the pricing basis that would apply if that component had been accepted on a stand-alone basis. The pricing basis used for this purpose must be set prior to the first regulatory returns in which a given reinsurance contract is included, and must then be

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applied unchanged for as long as the contract remains on the life reinsurance undertaking's books.

The pricing basis must include as a minimum:

- the mortality, morbidity and other biometric risk assumptions;
- expense assumptions in relation to the protection component (including commission);
- lapse assumptions; and
- allowance for required profit margins.

The pricing basis used for this purpose must be disclosed in full to the Financial Regulator (please note that this disclosure will be treated as confidential information in accordance with the Financial Regulator's statutory professional secrecy obligations). The reinsurance undertaking may take either of two approaches in calculating the premium in respect of the protection component:

(a) calculate a level annual premium applicable throughout the full term of the reinsurance contract, or

(b) calculate a premium that varies throughout the term of the reinsurance contract in a direct relationship with the pattern of the underlying biometric assumptions.

This choice may be made on a contract-by-contract basis. However, once one of the approaches has been chosen for a given contract and included in a regulatory return, the reinsurance undertaking may not switch thereafter to the other approach.

The premium in respect of the investment component will then be the balance of premium payable under the mixed contract.

4.3.2 Separation of Claims

Each reinsurance undertaking writing mixed business must identify separately claims in respect of the payment of protection benefits and claims in respect of the payment of other benefits under each mixed contract. Reinsurance undertakings must have in place with each relevant

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cession undertaking the administrative arrangements necessary for the Board of Directors to be able to satisfy itself that claims in respect of the protection component are accurately recorded. Claims thus identified must then be used as an input to calculating the solvency requirements to which the non-life rules apply.

4.3.3 Separation of Technical Provisions

Each reinsurance undertaking must calculate the technical provisions in respect of the protection components of mixed contracts on a basis consistent with that which would apply if that component had been accepted on a stand-alone basis. This reserving basis must be fully disclosed to the Financial Regulator, be consistent with the overall reserving basis for the mixed contract and must include as a minimum:

- the mortality, morbidity and other biometric risk assumptions;
- expense assumptions in relation to the protection component;
- lapse assumptions; and
- allowance for required profit margins.

The technical provisions in respect of the investment component will then be the balance of the total technical provisions held in respect of the mixed contract. This must be consistent with the value of the assets underlying the investment component of the contractual liabilities.

4.4 Transfers of Reserves

Irrespective of the accounting treatment that is applied to a reinsurance contract, a reinsurance contract that results in a direct transfer of existing insurance or reinsurance reserves from a cession undertaking to a reinsurance undertaking need not be counted as premium for the purpose of determining solvency requirements if it can be clearly demonstrated that the amount transferred is consistent with the existing reserves of the cession undertaking for the book of business that is being transferred. Any transfer of reserves or other payment in excess of the existing insurance reserves held by the cession undertaking in the reinsurance

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contract should be counted as a premium for solvency requirements or alternatively be discussed with the Financial Regulator.

4.5 Single Premium Business

For business to which the non-life solvency rules apply, Paragraph 6 of Schedule 1 of S.I. 380 states that the required solvency margin shall be determined based on the premiums or contributions due in respect of reinsurance business in the immediately preceding financial year.

4.6 Yearly changes in Solvency Margin

It should be noted that for business to which the non-life solvency rules apply, Paragraph 5 (3) of Schedule 1 of S.I. 380 states that there is a requirement that the percentage reduction in solvency margin from one year to the next can be no greater than the percentage reduction in technical reserve over the same period.

4.7 Ceding Allowances

Under a life reinsurance contract, a reinsurance undertaking may pay an allowance to the cession undertaking. These can include administrative expenses incurred by the cession undertaking in administering the business that the life reinsurance undertaking has committed to share under the terms of the reinsurance contract or are to reflect the expenses incurred by the cession undertaking in writing the underlying insurance contracts. The Financial Regulator considers that these allowances should be included as administrative expenses for the purpose of determining the solvency requirements for life reinsurance undertakings insofar as they relate to business linked to investment funds where the life reinsurance undertaking bears no investment risk and the allocation to cover management expenses is not fixed for a period exceeding five years. A ceding allowance that reflects commission payments or other acquisition related costs may be excluded.

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Any apportionment of expenses in a reinsurance contract between lines of business must be carried out according to principles and guidelines approved by resolution of the Board of Directors of the life reinsurance undertaking.

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5 Systems and Controls

The Financial Regulator developed its views in this chapter having considered the provisions of the Reinsurance Directive, international standards in this area (including Guidance Paper No. 11 of October 2005 of the IAIS, available at www.iaisweb.org), the results of a pre-consultation through the reinsurance industry's representative body and the results of consultation with the statutory consultative panels.

5.1 General

A robust internal controls system is critical to effective risk management and a foundation for the safe and sound operation of a reinsurance undertaking. It provides a systematic and disciplined approach to evaluating and improving the effectiveness of the operation and assuring compliance with laws and regulations. It is the responsibility of the Board of Directors to develop a strong internal control culture within its organisation, a central feature of which is the establishment of systems for adequate communication of information between levels of management.

Internal controls should be designed to ensure and demonstrate that the firm is being operated within the parameters set by the Board of Directors. These controls must be adequate for the nature and scale of the business and proportional to the size and complexity of the business. The oversight and reporting systems must be sufficient to allow the board and management to monitor and control the operations. The onus will be on the Board of Directors to ensure that such systems are applicable to the reinsurance undertaking and that such systems meet their ongoing corporate governance duties and responsibilities.

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6 Regulatory Returns

Pursuant to Regulation 21 of S.I. 380, the returns, documents and information specified in this Chapter 6 are hereby required to be lodged with the Financial Regulator by an authorised reinsurance undertaking established in the State that carries on life reinsurance.

6.1 Compliance Submissions

The submissions listed under sections 1.2.1 and 1.2.2 of this paper must be lodged with the Financial Regulator in the manner and timeframe specified in those sections.

6.2 Inter-company loans not covering Technical Provisions

The notification specified in section 3.3.3 of this paper must be lodged with the Financial Regulator in the manner and timeframe specified in that section.

6.3 Statement of Actuarial Opinion

A life reinsurance undertaking must lodge with the Financial Regulator, in respect of any financial year ending on or after the 30th of June 2007 and each such financial year thereafter, a return in writing containing a report by the undertaking on the adequacy of technical provisions and the calculation of the required solvency margin, together with a Statement of Actuarial Opinion ("SAO") prepared in the format prescribed by the Financial Regulator (see section 6.5, below). The actuary by whom the SAO is prepared must hold a current practising certificate to act as a signing actuary in respect of life reinsurance business, issued by the Society of Actuaries in Ireland. Such return must be submitted to the Financial Regulator within 6 months after the end of the financial year to which it relates.

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In respect of financial years ending before the 30th of June 2007, the life reinsurance undertaking must conduct an actuarial review of its technical provisions and solvency calculations. This review should be lodged with the Financial Regulator within 6 months after the end of the financial year to which it relates, and should be carried out by an appropriately qualified and experienced actuary. The review should address, as a minimum:

- a description of the methodology used to calculate technical provisions;
- the assumptions underlying the calculation of the technical provisions and full justification for the use of these assumptions;
- the quantitative impact of the retrocession program on the technical provisions and solvency margin;
- a verification of individual calculations for sample contracts/treaties;
- the extent of verification of the aggregate technical provision calculation;
- a description of the methodology and assumptions underlying any Deferred Acquisition Cost asset; and
- results of any stress tests carried out, and their appropriateness.

For avoidance of doubt, the actuarial review above is not a Statement of Actuarial Opinion. The purpose of this review is to ensure a smooth transition to the requirement to provide a Statement of Actuarial Opinion. The report on the review is expected to highlight any issues that exist in each of the areas covered, and to set out recommendations to the Board of Directors as to how these issues might be addressed.

6.4 Other Returns

The calculations under Chapter 4: Required Solvency Margin herein together with copies of latest policies and procedures required under Chapter 5: Systems and Controls must be submitted to the Financial Regulator within 6 months after the end of the life reinsurance undertaking's financial year. However, in an individual case or

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circumstance, the Financial Regulator may specify to a reinsurance undertaking more frequent intervals for such lodgment.

In view of the above, the Financial Regulator believes it is prudent for reinsurance undertakings to maintain capital cover at more than 100% of the solvency margin required by S.I. 380, to avoid unintentionally falling below the required solvency margin. It is for the Boards of Directors to establish a level of capitalisation above the required solvency margin that they believe is sufficient in the circumstances.

In order that the Financial Regulator can monitor solvency levels in the sector, if a life reinsurance undertaking's assets fall below 150% of the solvency margin required under S.I. 380, the undertaking must notify the Financial Regulator in writing of the details of this immediately. The Financial Regulator may require such a reinsurance undertaking to report its solvency status to the Financial Regulator on a more frequent basis thereafter. The frequency and extent of this reporting will depend on the exact circumstances of an individual reinsurance undertaking. Reinsurance undertakings that manage their solvency position in a deliberate and stable way to a level below 150% coverage will only be required to provide sufficient reporting to demonstrate that there is no material deterioration in their position. A more stringent level and frequency of reporting will be required for reinsurance undertakings whose solvency position falls below the Board of Directors strategic target or approaches the 100% level.

If it becomes clear that a life reinsurance undertaking's situation is unlikely to improve in the foreseeable future to a compliant level, the Financial Regulator will discuss options for an exit strategy with the reinsurance undertaking, so as to facilitate an orderly run-off of the reinsurance undertaking.

Consultation Closed

6.5 Prescribed Forms

The Financial Regulator will publish detailed forms required for the reporting of life reinsurance undertakings described in this Chapter in due course.

6.6 Compliance prior 12/12/07

In this Chapter and the returns referred to in this Chapter, in respect of the period on or before 12 December 2007, references to compliance of provisions of S.I. 380, where relevant, are to compliance with such provisions as they would apply to a reinsurance undertaking but for the application of Regulation 11(2) of S.I. 380 (but without prejudice to the rights of such reinsurance undertaking under Regulation 11(1) of S.I. 380).

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Appendix 1: Article 20 of Life Assurance Business Directive

Life Insurance Directive 2002/83/EC
Article 20. Establishment of technical provisions

Title III Conditions Governing the Business of Assurance

Chapter 2 Rules Relating to Technical Provisions and their Representation

The home Member State shall require every assurance undertaking to establish sufficient technical provisions, including mathematical provisions, in respect of its entire business.

The amount of such technical provisions shall be determined according to the following principles.

A. (i) the amount of the technical life-assurance provisions shall be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions for each existing contract, including:

- all guaranteed benefits, including guaranteed surrender values,
- bonuses to which policy holders are already either collectively or individually entitled, however those bonuses are described - vested, declared or allotted,
- all options available to the policy holder under the terms of the contract,
- expenses, including commissions,

taking credit for future premiums due;

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(ii) the use of a retrospective method is allowed, if it can be shown that the resulting technical provisions are not lower than would be required under a sufficiently prudent prospective calculation or if a prospective method cannot be used for the type of contract involved;

(iii) a prudent valuation is not a "best estimate" valuation, but shall include an appropriate margin for adverse deviation of the relevant factors;

(iv) the method of valuation for the technical provisions must not only be prudent in itself, but must also be so having regard to the method of valuation for the assets covering those provisions;

(v) technical provisions shall be calculated separately for each contract. The use of appropriate approximations or generalisations is allowed, however, where they are likely to give approximately the same result as individual calculations. The principle of separate calculation shall in no way prevent the establishment of additional provisions for general risks which are not individualised;

(vi) where the surrender value of a contract is guaranteed, the amount of the mathematical provisions for the contract at any time shall be at least as great as the value guaranteed at that time;

B. the rate of interest used shall be chosen prudently;

C. the statistical elements of the valuation and the allowance for expenses used shall be chosen prudently, having regard to the State of the commitment, the type of policy and the administrative costs and commissions expected to be incurred;

D. in the case of participating contracts, the method of calculation for technical provisions may take into account, either implicitly or

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explicitly, future bonuses of all kinds, in a manner consistent with the other assumptions on future experience and with the current method of distribution of bonuses;

E. allowance for future expenses may be made implicitly, for instance by the use of future premiums net of management charges. However, the overall allowance, implicit or explicit, shall be not less than a prudent estimate of the relevant future expenses;

F. the method of calculation of technical provisions shall not be subject to discontinuities from year to year arising from arbitrary changes to the method or the bases of calculation and shall be such as to recognise the distribution of profits in an appropriate way over the duration of each policy.

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GUIDELINES ON THE REINSURANCE COVER OF PRIMARY INSURERS AND THE SECURITY OF THEIR REINSURERS

Consultation Closed

Prudential Supervision - Insurance

Irish Financial Services Regulatory Authority

January2004

Guidelines on the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

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In July 2000, the Monetary and Exchange Affairs Department of the International Monetary Fund, in conjunction with the World Bank, completed an assessment of the regulation of the financial sector in Ireland. In relation to the insurance sector, the assessment was carried out by reference to standards and guidelines laid down by the IAIS (International Association of Insurance Supervisors).

They noted a number of areas not adequately addressed vis-a-vis the IAIS standards. The then supervisor (Department of Enterprise, Trade & Employment) subsequently, July 2001, issued guidelines to address the issues raised and to ensure full compliance with the existing IAIS standards and guidelines. In order to stay up to date with new IAIS standards the Authority[3] will periodically issue guidelines as required. Therefore the following guideline is based very closely on the 'Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers' as issued by the IAIS, January 2002. The level of documentation required for compliance with the guideline will be reflective of the complexity of the underlying policies issued and the consequential reinsurance purchased. It is considered vital that companies however small address the issues contained in this document, evaluate their compliance, and formalize policies and procedures.

If the self-evaluation reveals that the company is non-compliant with the requirements of this document then the company will need to develop a draft plan that will bring it into full compliance. This plan may be discussed with the Authority prior to finalisation.

The Authority would not expect every company to have a fully documented reinsurance strategy document during the early part of 2004. However, would expect this to be in place going into the January 1, 2005 renewal season.

Consultation Closed

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[3] "Authority" means the Irish Financial Services Regulatory Authority

Guidelines on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers

This document provides guidance to insurers on the policies and procedures that companies should have in place for evaluating the adequacy of each company's reinsurance cover.

In addition, in recent years reinsurance has evolved with the introduction of many new products. These are commonly known as alternative risk transfer (ART) products. Although this subject will be dealt with in the future by a separate paper, we believe that much of the guidance provided in this document will also apply in the case of ART products.

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1. Introduction

1. Insurance companies assume risk on behalf of policyholders. They mitigate these risks by acquiring insurance with reinsurers. Through the use of reinsurance, an insurer can reduce risk, stabilise its solvency, use available capital more efficiently and expand underwriting capacity. Reinsurance helps an insurer obtain a desired, prudent risk profile (i.e. relationship between the risks a company runs and its financial strengths). An insurer may purchase reinsurance direct, or with the assistance of an intermediary. However, irrespective of the reinsurance obtained, the primary insurer remains contractually responsible for paying the full claim amounts to policyholders.

Accordingly the quality of the reinsurers selected is pivotal to the financial stability of the ceding insurer.

The guideline is laid out in the following manner:

- Section 2 sets out to explore the general subject of managing reinsurance security (N.B. this is for background purposes only);
- Section 3 addresses the strict regulatory requirements, which represent the minimum acceptable legal standard;
- Section 4 outlines the Authority requirements for a ceding insurer's reinsurance strategy and related corporate governance; and,
- Section 5 describes how the Authority intends to administer this guideline.

Consultation Closed

2. Managing Reinsurance Security

Reinsurance purchased at the best terms and the lowest price means nothing if the reinsurance company is no longer in business when the claim payment for indemnification comes due.

Selection of Reinsurers

The four most important criteria used for selecting reinsurers are availability, price, security, (financial ability to meet its obligations), and service. These factors involve inverse relationships; e.g., the weakest reinsurers in terms of security and service may be most attractive with regard to availability and price. As selecting reinsurers involves tradeoffs among these four criteria the insurer needs to evaluate which tradeoffs are most suitable.

In practice it is understood that insurers need to tradeoff criteria and therefore some flexibility is required in the selection process. If the insurer sets the criteria for security too strictly, it may not be able to obtain adequate reinsurance, or the price may be too high. Similarly, if the insurer sets the criteria for price too strictly, adequate reinsurance may not be available; or the security may be imprudently weak. How these tradeoffs are handled is a reflection of the expertise and experience of the ceding insurer's management. It is usually beneficial to make several successive attempts to determine an optimal tradeoff. However, from a regulatory perspective security is of primary importance.

Role of Intermediaries

The role of the intermediary, if one is involved, is not to select reinsurers for the company, but merely to introduce them based on predefined quality criteria. Unless the intermediary accepts the responsibility for selection, it remains with the ceding insurer. If the company fails to define any criteria of its own and simply accepts whatever reinsurers the intermediary introduces, it has not delegated the responsibility for the selection of the reinsurers, and remains responsible for whatever

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reinsurers it accepts. This could potentially compromise the financial security of the company and would certainly not be in compliance with the requirements of this guideline.

Establishing Criteria for Evaluating Security of Reinsurers

The evaluation of a reinsurer's security can involve many complex considerations. To standardize this evaluation, insurer should establish certain initial criteria. Special circumstances may suggest some modifications of the initial criteria, but the more structured the process, the sounder the eva1uation. The most important and widely used initial criteria for security are size, rating, and ownership.

The influence of size on security is evidenced by the fact that the majority of insolvencies occur amongst the smaller reinsurers, rather than the larger reinsurers whose business is more diversified both geographically and across class of business.

The rating of a reinsurer by an independent source is a second security criterion that may be used in conjunction with size. A rating is a relative benchmark, based on rigorous, objective and independent analysis and opinions developed using a consistent and predictable methodology by experts in the complex field of global financial markets. However, a knowledge of how rating agencies rate reinsurers is useful in fully understanding the ratings and in evaluating the significance of changes in ratings. A significant limitation of ratings is the time lag in issuing reports.

An insurer that selects only premier reinsurers is likely to have fewer problems with uncollectible reinsurance and needs to spend less time and resources evaluating its reinsurers. This does not mean that this insurer is a better evaluator of reinsurers than other insurers or the rating agencies. It means that *this* insurer places a higher priority on security relative to price and availability.

Insurers often modify security criteria under two circumstances: (1.) for some kinds of reinsurance, especially long-tail lines; and, (2) for maintaining continuity of relationships with existing reinsurers.

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Long-tail reinsurance, such as excess of loss liability involves a longer time frame and requires more expertise than property catastrophe and pro-rata reinsurance. Accordingly, many insurers use stricter security criteria for long-tail reinsurance or restrict the amount of reinsurance placed with each reinsurer.

Many ceding insurers modify their security criteria, within reasonable limits, to include reinsurers that have served the ceding insurer well in the past. Continuity is an important element of good service. This is especially true for reinsurers that accommodated the ceding insurer during periods when availability of reinsurance coverage was a problem. Continuing such relationships helps to assure the insurer of adequate capacity during future periods of capacity contraction.

Limiting the Amount of Reinsurance Exposure with Selected Reinsurers

Many insurers limit the amount of their reinsurance exposure with any one reinsurer according to the size of the reinsurer's shareholders' surplus. They do so in order to reduce the chance the reinsurer will retrocede part of its business. The greater the participation in relation to the reinsurer's surplus, the greater the reliance on retrocessionaires. If a reinsurer uses a large amount of retrocessions, the financial security of the retrocessionaires becomes as important to the primary reinsurers as the reinsurer's financial security. Generally, a reinsurer is more likely to retrocede substantial portions of a block of business it has assumed when that block is more than 1 percent of its own shareholders' surplus. The existence of retrocessions may, potentially, lead to delays on claim payments, while the failure of a retrocessionaire may cause the reinsurer to become insolvent. It is therefore important that ceding insurer recognizes that the quality of retrocessionaires is an essential component in the evaluation of the reinsurer.

Exceptions to the limit that insurers cede to a reinsurer in relation to the shareholders' surplus of the reinsurer may be merited when backup security is obtained.

Consultation Closed

Many insurers also limit the amount they cede to any one reinsurer on the basis of their own shareholders' surplus. This is especially true when ceding to other than premier reinsurers, where the risk of insolvency is more significant. The amount of exposure to any one reinsurer, especially non-premier reinsurers, in terms of both the amount of one risk and the accumulation of balances recoverable, should not exceed the largest amount that the insurer is willing to retain on any one primary risk or catastrophe.

Another way to reduce the credit risk is to insert a right of offset clause in the reinsurance contract. Then, to the extent that uncollectible recoverables are due to the insurer, the insurer can reduce any payment that may be due the reinsurer.

When the insurer uses an unrated reinsurer from the same group of companies a concentration risk is created. Cut-through and insolvency clauses to retrocessionaires are only effective if the reinsurer accepting the insurer's risk is in turn retroceding a significant portion of the risk it is accepting to rated reinsurers. Another consideration is the volume of other reinsurance business the unrated group reinsurer is assuming, and the extent to which claims from these other sources will exhaust limits and aggregate retrocession cover provides.

Backup security or collateral is sometimes used (1) to make acceptable a reinsurer that otherwise would not meet the security criteria of the ceding insurer or (2) to cede greater amounts to one reinsurer than the usual limitations of the insurer allow. Backup security can take several forms, including letters of credit, funds withheld, and trust funds.

Monitoring Reinsurers

A prudent insurer monitors its reinsurers during the life of the reinsurance agreements and for as long as any obligations remain outstanding. If a reinsurer's financial condition deteriorates during the term of the agreement, the insurer may consider a mid-term cancellation. If such trouble develops while balances remain outstanding, the insurer may wish to negotiate a commutation while the reinsurer is still trying to retain its status in the marketplace.

Consultation Closed

The insurer should follow a systematic program for monitoring changes in the ratings, surplus, assets, reserves, premium volume, ownership, and management, for monitoring news reports, the timeliness of claim payments, and other information from miscellaneous sources. This information helps prepare the insurer to take timely corrective action if unexpected financial problems arise with its reinsurers.

Documentation

In addition to substantive documentation of the reinsurance cover in the form of:

- copies of contracts and amendments;
- copies of slips and cover notes; and
- written contract descriptions and summaries;

the ceding company should be careful to document their compliance with those internal control procedures that it considers necessary and adequate to (a) evaluate the financial responsibility and stability of the assuming company, and (b) provide reasonable assurance of the accuracy and reliability of information reported to the reinsurer and amounts due to or from the reinsurer.

As the insurer increases its use of second and third-tier reinsurers, and especially unrated, new and little-known reinsurers, it increases its need for information and analysis. This is particularly true if the insurer does not obtain available backup security and does not use prudent limitations. The insurer will be subject to a greater potential for loss from uncollectible reinsurance.

Consultation Closed

3. Regulations and Guidelines for their Interpretation

Insurance Act 1989 [1989 No. 3] Part II Supervision of Insurers, Article 12.

The Minister (now the Authority) may make regulations for the proper exercise of his functions under the Insurance Acts in respect of the following -

e) reinsurance cessions of authorised undertakings including information which undertakings must supply in respect of their reinsurance arrangements,

Article 13 (4) of the European Communities (Non-Life Insurance) Framework Regulations, 1994 (S.I. No 359 of 1994) deals with the allowance of a reduction of technical reserves arising from reinsurance.

Technical reserves may, subject to sub-article (3) be established and maintained after the deduction of reinsurance cessions, ***provided such reinsurance arrangements are acceptable to the Minister (now the Authority)***. However, any reduction in technical reserves arising from reinsurance shall be restricted to the extent of the insurance risk transferred under the reinsurance arrangements. Where the reinsurance arrangements are not acceptable, the Minister (now the Authority) may require that, in respect of the insurance contracts covered by such arrangements, reserves be maintained before the deduction of reinsurance cessions.

To provide context to the italicised phrase in the above paragraph, it is the undertakings themselves which are primarily responsible for the appropriateness and security of their reinsurance arrangements.

Sub-article (3) provides that, if more than 90% of the gross premiums written in any accounting class of insurance business adopted for the purpose of the annual returns is ceded by the insurer, then the insurance undertaking will be require to maintain technical reserves representing a minimum 10% of gross premium income or 10% of gross

Consultation Closed

technical reserves relating to such business, whichever is the greater, in that class and to hold assets representing that amount accordingly.

Similarly, to the treatment of reinsurance on Non-Life insurers as noted above, the European Communities (Life Assurance) Framework Regulations, 1994 (S.I. No 360 of 1994), Article 12 (5) together Annex VII discusses the suitability of reinsurance cessions and the acceptability of reducing technical reserves by reinsurance. Again, the primarily responsible for the appropriateness and security of their reinsurance arrangements rests with the insurer and must acceptable to the Minister (now the Authority). The reduction, in the case of Life reinsurance, is limited to 75% of the gross premiums written.

Admissibility of Reinsurance Recoverables as support for Technical Reserves.

Annex III, Article 5, 1 & 4 (Non-Life), provides that the value of any debt due the insurance undertaking under any contract of reinsurance to which the insurance undertaking is a party shall be the amount which can reasonably be expected to be recovered in respect of that debt (valued net of all amounts owed to the same third party) provided that no account shall be taken of any debts arising out of reinsurance operations which are owed by intermediaries and which have been outstanding for more than three months.

Annex III, Schedule 2, Part 1 (Non-Life) limits the admissibility of reinsurance recoverable, on paid claims, to 50% of net technical reserves, based on the reasonable expectation that the debt will be recovered.

Annex V, Article 5, 1 & 4 (Life), contain the same provisions for the valuation of debt due the insurance undertaking under contracts of reinsurance as in the Non-Life Regulations. Schedule 7 (Life) limits the admissibility of reinsurance recoverable, on paid claims, to 1% of net technical reserves for each reinsurer, and 2.5% in aggregate, again, based on the reasonable expectation that the debt will be recovered.

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Impact of Reinsurance on Minimum Solvency

Annex II, Part A, 4 (a) (v) & 4 (b) (vii) (Non-Life), reduces the required solvency margins calculations based on the reinsurance recoverable in the last financial year, capped at a maximum of 50%. Similarly, Annex II, Part A, 3 (Life), limits the reinsurance reduction factor to a maximum of 15% for the solvency margin calculation based on mathematical reserves, and to a maximum of 50% for the solvency margin calculation based on the capital at risk.

Consultation Closed

4. Reinsurance strategy and corporate governance

Board of Directors

It is expected that every insurer should have a reinsurance strategy, approved by the company's Board of Directors, that is appropriate to the company's overall risk profile. The reinsurance strategy will be part of the company's overall underwriting strategy. The Board should review the reinsurance strategy annually. In addition, the reinsurance strategy should be reviewed when there have been changes in the company's circumstances, its underwriting strategy, or the status of its reinsurers.

The reinsurance strategy should define and document the insurer's strategy for reinsurance management, identifying the procedures for:

- the reinsurance to be purchased;
- how reinsurers will be selected, including how to assess their security;
- what collateral, if any, is required at any given time; and
- how the reinsurance programme will be monitored (i.e. the reporting and internal control systems).

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

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

Senior management

Senior management should document clear policies and procedures for implementing the reinsurance strategy set by the Board of Directors. This includes:

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- setting underwriting guidelines that specify the types of insurance to be underwritten, policy terms and conditions, and aggregate exposure by type of business;
- establishing limits on the amount and type of insurance that will be automatically covered by reinsurance (e.g. treaty reinsurance); and
- establishing criteria for acquiring facultative reinsurance cover.

In order to avoid uncovered risks, the terms and conditions of the reinsurance cover should be compatible with those of the underlying business.

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 (or a combination thereof). The limits must be based upon an evaluation of its risk profile and the cost of the reinsurance. In particular, the insurer should have adequate capital to support the risk retained. Some insurers may use the results of dynamic financial analysis techniques (using the reinsurance cover as one of the variables) as input into these operating decisions.

The ceding insurer should ascertain whether the proposed reinsurer intends to retrocede any of the assumed business. If this is the situation it is then essential that the ceding insurer is equally satisfied as to the quality of the retrocessionaires used.

The insurer should maintain an up-to-date list of reinsurers that it has approved. For each approved reinsurer the appropriate level of exposure should be specified. To do this, the insurer should evaluate the ability and willingness of the reinsurer to fulfil its contractual obligations as they fall due (i.e. its security). Such assessment is required whether collateral is posted or not. The assessment should take into account the effects of any collateral the reinsurer has posted in favour of other insurers. The insurer's credit guidelines should describe the system for controlling exposures to each reinsurer.

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To improve the security of the overall reinsurance cover, insurers may choose to use a number of different reinsurers. Diversification by the insurer reduces the impact of counterparty credit risk; or withdrawal of capacity on reinsurance renewal in periods of capacity contraction.

Generally speaking, the fewer the number of reinsurers used, the more an insurer should pay importance to the security of its reinsurers. If a company takes advice on the strength and security of a reinsurer, then it should satisfy itself that the advice given is sound. Similarly, if reinsurance cover is acquired through an intermediary, the company should evaluate the operational risk associated with the transaction.

Senior management should ensure that the management information system in place meets all Board requirements with respect to reporting frequency and level of detail. In addition, there should be adequate systems of internal control to ensure that all underwriting is carried out in accordance with company policy and that the planned reinsurance cover is in place. The underwriting control systems should be able to identify and report on a timely basis where underwriters infringe authorised limits, breach company guidelines or otherwise assume risks exceeding the ability of the company's capital base and reinsurance cover to service.

If an insurer in Ireland is part of a global insurance group the reinsurance strategy should include information on the global reinsurance strategy. The information should identify the control mechanisms and detail the reporting arrangements for monitoring the reinsurance arrangements of the group, including where the responsibility resides for the monitoring; i.e. at the local insurer level; or, with the foreign parent. The strategy should also include the reporting arrangements between Irish and foreign operations, the monitoring of Irish insurer's operations by the foreign parent and the home regulator's supervisory arrangements regarding reinsurance. Where elements of the strategy are controlled by parent these should be identified and detailed.

Consultation Closed

The following mandatory contract terms should appear in all reinsurance policies:

- Insolvency Clause requiring the reinsurer to perform its contract obligations without diminution in the event of the ceding insurer becoming insolvent.
- A policy provision stating that the reinsurance agreement constitutes the entire contract between the parties.
- A policy provision requiring reinsurance recoveries to be paid to a cedent without delay and in a manner consistent with the orderly payment of claims by the ceding insurer.
- A policy provision providing for reports, no less than quarterly, regarding premiums and paid and incurred losses.

Internal control

There should be internal control systems in place to ensure that claims are reported to the appropriate reinsurer and that reinsurance claims payments are being promptly collected.

The underwriting control may include an actuarial assessment of the risk and whether it has been transferred as presumed. This assessment may also include a review of the reinsurance contracts. The Board of Directors should receive regular and comprehensive reports on the effectiveness and performance of the claims system and the reinsurance protection. Companies' internal control systems should be subject to regular audit examination.

Consultation Closed

5. Supervisory monitoring of compliance with the guideline

The supervisor may verify that the Board of Directors has established an overall strategy framework – addressing, *inter alia,* underwriting and reinsurance. This will include evaluation of reinsurance cover, reinsurer security and collateral that may be posted. The supervisor will take a risk-based approach – ensuring that the company has appropriate policies, systems and procedures in place and focusing more detailed examination work on areas posing specific and significant concern.

Before granting a license, the supervisor must be satisfied with the company's planned risk management and reinsurance strategies, and accompanying policies. When examining the business plan of an insurance company, the supervisor will evaluate if the proposed reinsurance covers maximum foreseeable loss. In the business plan the company must describe how, and to what extent, future policies will be reinsured.

Companies should maintain adequate reinsurance cover at all times based on their risk profile. While many reinsurance treaties operate on an annual basis, some treaties especially for life business and some ART contracts can operate for many years. In such cases, assurance that the reinsurer offers sufficient security to act as a long-term counterparty will be required. The supervisor should be made aware of the security and adequacy of the reinsurance or ART coverage for long-tail business (where claims development is slow) and the top layers of catastrophe programmes (where amounts involved can be large).

Sufficient and relevant information should be available on the reinsurers used and the reinsurance cover arranged. Relevant information may include:

- reports prepared by the ceding insurer describing the reinsurance cover, reinsurance programmes or treaties; and,

Consultation Closed

- the ceding insurer's financial statements, detailing the result of reinsurance, any amounts outstanding from reinsurers and the effect of the ART techniques, including financial reinsurance.

The company should have available on a timely basis:

- copies of contracts and amendments;
- copies of slips and cover notes;
- financial statements of reinsurers used; or
- written contract descriptions and summaries.

Using this information and other relevant information received during on-site inspection, the supervisor will evaluate:

- the prudence of the company risk profile including an evaluation of any risk concentration, i.e. an aggregate exposure with the potential to produce losses large enough to threaten the insurer's financial health or its ability to maintain core operations;
- compliance with the company's reinsurance strategy;
- the sufficiency of the reinsurance cover and the insurance company's financial strength, in particular under extreme, but plausible loss scenarios;
- the sufficiency of the reinsurance security, taking into consideration a wide range of factors including financial strength, whether reinsurers are properly supervised and whether or not collateral is posted; and,
- the appropriateness of any ART techniques, such as securitisation, used.

The choice of reinsurance cover is a business decision made by management within the overall reinsurance strategy of the insurer. However, where insufficient or inappropriate reinsurance cover affects the company's ability to pay policyholders' claims, the supervisor will enter into discussions with the management of the company.

Consultation Closed

The supervisor may disallow credit in whole or in part for reinsurance when calculating solvency requirements or technical provisions on a net basis or when determining the coverage of gross technical provisions by reinsurance recoverables. As well, the supervisor may require the insurer to:

- obtain additional reinsurance cover;
- provide additional capital;
- establish additional technical provisions; and,
- have additional collateral posted, if applicable.

Reinsurance recoveries in excess of 90 days overdue will generally not be admissible as assets; and in addition, for the reinsurers with balances that fall into this category, absent adequate collateral only 80% of the reinsurance recovery reserve from these reinsurer will be admissible. However, the Authority is cognisant of the fact that disputes/differences in interpretation do occur; as such it will extend the 90 days to 180 in the case of disputes on specifically referenced claims. The Authority will permit offsetting provided that the offsetting is with the same counterparty, there is provision in the reinsurance contract for offsetting, and that the offsetting actually occurs within a prescribed period of time. This is an important but necessary tightening of the position as laid out in the regulations.

Within a reasonable period after their finalisation, significant changes in reinsurance arrangements (including the panel) must be notified to the supervisor, who may request sight of all relevant documentation in assessing the appropriateness and adequacy of the changes.

Consultation Closed

GUIDELINES FOR INSURANCE COMPANIES ON ASSET MANAGEMENT

Consultation Closed

Insurance Financial Supervision Section

Department of Enterprise, Trade & Employment

July 2001

Guidelines for Insurance Companies on Asset Management

In July 2000, the Monetary and Exchange Affairs Department of the International Monetary Fund, in conjunction with the World Bank, completed an assessment of the regulation of the financial sector in Ireland. In relation to the insurance sector, the assessment was carried out by reference to standards and guidelines laid down by the IAIS (International Association of Insurance Supervisors).

With regard to the Insurance sector they noted that the safekeeping and the liquidity of assets were not explicitly addressed in the regulations. These issues can be either defined very narrowly, or, indeed very broadly. In attempting to rectify the situation it was considered preferable to adopt a broad approach and to provide all-inclusive guidelines for insurance companies on asset management rather than fill the specific gaps identified in a narrow way. Therefore the following is based very closely on the 'Supervisory Standard on Asset Management by Insurance Companies' as issued by the International Association of Insurance Supervisors. In an effort to provide a comprehensive view of the subject, the Guidelines include both current Regulations and previously issued guidance notes.

The implementation of the Guidelines needs to be tailored to the particular circumstances of the individual companies. For example, the Supervisor[1] does not expect that smaller insurance companies, such as captives, will have the same level of formalization as implied by the Note. Still, it is considered vital that companies however small address the issues contained in this document and formalize policies and procedures no matter how briefly.

Commencing with the financial year ended 31st December 2001, an expanded Directors' Certificate for Life Companies and a similar certificate for Non-Life Companies will be introduced. All insurance companies will be required to submit this Directors' Certificate with their Annual Returns. This Certificate will state, inter alia, that the company's practice in relation to the management of assets comply with this Guidelines Note.

1 At present, the Department of Enterprise, Trade & Employment. In future, the Irish Financial Services Regulatory Authority (IFSRA)

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1. Preamble

1. The nature of the insurance business implies the formation of technical provisions, and investment in and the holding of assets to cover these technical provisions and a solvency margin. In order to ensure that an insurer can meet its contractual liabilities to policyholders, such assets must be managed in a sound and prudent manner taking account of the profile of the liabilities held by the company and, indeed, the complete risk-return profile. The complete risk-return profile should result from a n integrated view on product and underwriting policy, reinsurance policy, investment policy and solvency level policy. The liabilities profile of a company with respect to term, and the predictability of the size and timing of claims payments, may differ significantly according to the nature of the insurance business conducted. It thus follows that the need, for example, to maintain a high degree of liquidity within the asset portfolio will similarly differ between insurers

2. The objective of this guidance document, in addition to detailing the relevant Regulations, is to describe the essential elements of a sound asset management system and reporting framework across the full range of investment activities. Given the wide variation in the nature of companies, it is acknowledged that the extent of the application of the practices described in this document by any given insurer may differ according to the size and structure of an insurance company and the type of business it conducts. However, the basic principles of Board of Directors' responsibility, the need for an investment policy, segregation of duties and control will be applicable to all insurance companies

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2. Introduction

2.1 Asset Liability Management

3. A key driver of the asset strategy adopted by an insurer will be its liabilities profile, and the need to ensure that it holds sufficient assets of appropriate nature, term and liquidity to enable it to meet those liabilities as they become due. Detailed analysis and management of this asset/liability relationship will therefore be a pre-requisite to the development and review of investment policies and procedures which seek to ensure that the insurer adequately manages the investment-related risks to its solvency. The analysis will involve, inter alia, the testing of the resilience of the asset portfolio to a range of market scenarios and investment conditions, and the impact on the insurer's solvency position.

2.2 The Investment Process

4. Depending upon the nature of their liabilities insurers will typically hold, in varying proportions, four main types of financial assets either directly, via other investment vehicles (such as UCITS [Undertakings for Collective Investments in Transferable Securities]), or through third party investment managers:

a. Bonds and other fixed income instruments;
b. Equities and equity type investments;
c. Debts, deposits and other rights;
d. Property.

5. The holding of a given asset portfolio carries a range of investment-related risks to technical provisions and solvency which insurers need to monitor, measure, report and control. The main risks are market risk (adverse movements in, for example, stocks, bonds and exchange rates), credit risk (counterparty failure), liquidity risk (inability to unwind a position at or near market price), operational risk (system/internal control failure), and legal risk.

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6. The actual composition of an asset portfolio at any given moment should be the product of a well structured investment process itself, which for the purposes of this document is regarded as a circular movement characterised by the following steps:

a. Formulation and development of a strategic and tactical investment policy;
b. Implementation of the investment policy, in a suitably equipped investment organisation, and on the basis of a clear and precise investment mandate(s);
c. Control, measurement and analysis of the investment results which have been achieved and the risks taken;
d. Feedback to the appropriate level of authority on points a, b and c.

7. Regulations impose restraints on the investment policies and procedures of insurers by placing restrictions on the type of, and extent to which, certain asset classes may be used to cover technical provisions, and specific requirements on the matching of assets and liabilities vis-à-vis currency. Nevertheless, insurers should develop and operate overall asset management strategies, which take account of the need to ensure the existence of:

a. The definition of a strategic investment policy by the Board of Directors, based on an assessment of the risks incurred by the company and its risk appetite;
b. On-going Board and senior management oversight of, and clear management accountability for, investment activities;
c. Comprehensive, accurate and flexible systems which allow the identification, measurement and assessment of investment risks, and the aggregation of those risks at various levels, for example for any separate portfolios held, for the insurance company and, as appropriate, at group level, at any given time. Such systems will vary from company to company, but should be:
    - sufficiently robust to reflect the scale of the risks and the investment activity undertaken;
    - capable of accurately capturing and measuring all significant risks in a timely manner;

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- understood by all relevant personnel at all levels of the insurer;

d. Key control structures, such as the segregation of duties, approvals, verifications, reconciliations;
e. Adequate procedures for the measurement and assessment of investment performance;
f. Adequate and timely communication of information on investment activities between all levels within the insurance company;
g. Internal procedures to review the appropriateness of the investment policies and procedures in place;
h. Rigorous and effective audit procedures and monitoring activities to identify and report weaknesses in investment controls and compliance.
i. Procedures to identify and control the dependence on and vulnerability of the insurer to key personnel and systems.

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3. Regulations and Guidelines for their Interpretation

8. Annex III of the European Communities (N on-Life Insurance) Framework Regulations 1994 (S.I. N o. 359 0f 1994), and Annex V of the European Communities (Life Assurance) Framework Regulations 1994 (S.I. No. 360 0f 1994) aim to set standards for the valuation of assets appropriate to compliance with statutory solvency requirements , based essentially on realisable value.

9. Also, Annex III, together with Schedule 2 (Non-Life); and, Annex V, together with Schedule 7 (Life), are intended to encourage a prudent spread of insurance/assurance business assets without imposing undue restraints upon investment selection and management which might be disadvantageous to the company, or its policyholders. Regulations of this kind can be expected to achieve such a purpose only in a fairly broad manner. The mere fact that investments are within the permissible limits is no guarantee as to their suitability. The companies' management are responsible for their investment decisions which must be presumed to be dictated by, in addition to sound asset allocation policy, commercial profitability and, the policyholders' interests. It remains the duty of management, at all times, to satisfy themselves and, if required, to satisfy the Supervisor as to the suitability of a company's investment portfolio.

10. Schedules 2 (Non-Life Regulations) & 7 (Life Regulations) specify maximum percentage limits, on both individual and aggregate base s, on the admissibility of different categories of assets for representing technical reserves. The purpose of these limitations is to restrict the amounts acceptable as cover for technical reserves where there is considered to be too great a concentration of investment, either individually or in aggregate, in a particular asset or type of asset. It is important to note that the holding of amounts in excess of these limits is by no mea ns prohibited but excess amounts must be left out of account for the purpose

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of covering technical reserves. However, such “excess ” assets may be readmitted for solvency purposes.

11. Where, in the case of a particular asset, a valuation rule is not explicitly given in the Regulations a nil value must be assigned to it. Accordingly, such items such as advance commission and goodwill must be excluded.

12. Life assurance linked assets are not required to be valued in accordance with Annex V (Life Regulations). Linked assets, including approved derivative instruments held in linked funds, are required to be valued in accordance with generally accepted accounting concepts, bases and policies appropriate for life assurance companies and in practice would be valued on the same basis as that adopted for the calculation of the corresponding property linked benefits. The definition of linked assets refers only to life assurance business as sets which are identified in a company’s records as being as sets by reference to the value of which property linked benefits are to be determined - it should be noted that the definition of property linked benefits does not comprehend benefits linked to an index of the value of assets not so held and identified with the consequence that such index linked assets are
treated as non-linked as sets.

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4. Definition of the Investment Policy and Procedures

4.1 Board of Directors

13. The Board of Directors should be responsible for the formulation and approval of the strategic investment policy, taking account of the analysis of the asset/liability relationship, the insurer's overall risk tolerance, its long-term risk-return requirements, its liquidity requirements and its solvency position.

14. The investment policy, which should be communicated to all staff involved in investment activities,
should in principle address the following main elements:

a. The determination of the strategic asset allocation, that is, the long-term asset mix over the main investment categories;
b. The establishment of limits for the allocation of assets by geographical area, markets, sectors, counterparties and currency;
c. The formulation of an overall policy on the selection of individual securities and other investment titles;
d. The adoption of passive or more active investment management in relation to each level of decision making;
e. In the case of active management, definition of the scope for investment flexibility, usually through the setting of quantitative asset exposure limits
f. The extent to which the holding of some types of assets is ruled out or restricted where, for example, the disposal of the asset could be difficult due to the illiquidity of the market or where independent (i.e. external) verification of pricing is not available;
g. An overall policy on the use of financial derivatives as part of the general portfolio management process or of structured products that have the economic effect of derivatives ;
h. The framework of accountability for all asset transactions. refer to 'Guidelines for Insurance Companies on the Risk Management of Derivatives' issued by the Supervisor

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15. The Board of Directors should also be responsible for establishing policies on related issues of a more operational nature, including:

a. The choice between internal or external investment management, and, for the latter, the criteria for selection of the manager(s). Also, in case of external management, a choice usually needs to be made between having a segregated (discretionary) portfolio managed, or participating in a collective or pooled fund, or other indirect investment vehicles;
b. The selection and use of brokers;
c. The nature of custodial arrangements;
d. The methodology and frequency of the performance measurement and analysis.

16. The Board of Directors should authorise senior management to implement the overall investment
policy. The Board of Directors must, however, always retain ultimate responsibility for the company's
investment policy and procedures, regardless of the extent to which associated activities and functions are delegated or, indeed, outsourced.

17. As part of the development of the asset management strategy the Board of Directors must also ensure that adequate reporting and internal control systems are in place, designed to monitor that assets are being managed in accordance with the investment policy and mandate(s), and legal and regulatory requirements.

The Board of Directors must ensure that:

a. They receive regular information, including feedback from the company's risk management function, on asset exposures, and the associated risks, in a form which is understood by them and which permits them to make an informed judgement as to the level of risk on a mark-to-market basis;
b. The systems provide accurate and timely information on asset risk exposure and are capable of responding to ad hoc requests;

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c. The internal controls include an adequate segregation of the functions responsible for measuring, monitoring and controlling investment activities from those conducting day to day asset transactions;
d. Remuneration policies are structured to avoid potential incentives for unauthorised risk taking.

18. Where external asset managers are used, the Board of Directors must ensure that senior management is in a position to monitor the performance of the external managers against Board approved policies and procedures. External managers should be engaged under a contract that, inter alia, sets out the policies, procedures and quantitative limits of the investment mandate. The insurer must retain appropriate expertise and ensure that, under the terms of the contract, it regularly receives sufficient information to evaluate the compliance of the external asset manager with the investment mandate.

19. The Board of Directors should collectively have sufficient expertise to understand the important issues related to investment policy and should ensure that all individuals conducting and monitoring investment activities have sufficient levels of knowledge and experience.

20. At least annually, the Board of Directors should review the adequacy of its overall investment policy in the light of the insurance company's activities, and its overall risk tolerance, long-term risk-return requirements and solvency position.

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4.2 Senior Management

21. The responsibility for the preparation of a written investment mandate(s) setting out the operational policies and procedures for implementing the overall investment policy established by the Board of Directors will frequently be delegated to senior management. The precise content of the mandate will be different for each insurance company but the level of detail should be consistent with the nature of the current regulatory constraint and complexity and volume of investment activity, and should specify as appropriate:

a. The investment objective, and the relevant limits for asset allocation, and the currency allocation and policy; any relevant investment benchmarks should also be specified;
b. An exhaustive list of permissible investments and, as appropriate, derivative instruments, including details of any restrictions as to markets (e.g. only securities listed at specified stock exchanges), minimum rating requirements or minimum market capitalisation, minimum sizes of issues to be invested in, diversification limits and related quantitative or qualitative limits;
c. Details of whom is authorised to undertake asset transactions;
d. Any other restrictions with which portfolio managers have to comply, for example maximum risk limits within the overall investment policy (or in terms of limits on the duration of the portfolio in the case of a fixed-income portfolio), authorized counterparties;
e. The agreed form and frequency of reporting and accountability.

22. Supporting internal management procedures should be documented and include:

a. Procedures for seeking approval for the usage of new types of investment instruments: the desirability of retaining the flexibility to utilise new investment instruments should be balanced with the need to identify the risks inherent in them and ensure that they will be subject to adequate controls before approval is given for their acquisition. The principles for measuring such risk, and the methods

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of accounting for the new investments should be clarified in detail prior to approval being given for their acquisition;

b. Procedures for the selection and approval of new counterparties and brokers;
c. Procedures covering front office, back office, measurement of compliance with quantitative limits, control and reporting;
d. Details of the action which will be taken by senior management in cases of noncompliance;
e. Valuation procedures for risk management purposes;
f. Identification of who should be responsible for the valuation. Valuations should be carried out by individuals independent of those responsible for trade execution or, if this is not possible, valuations should be independently checked or audited on a timely basis. Accounting and taxation rules should be taken into consideration in developing the above operational policies and procedures.

23. Senior management should ensure that all individuals conducting, monitoring and controlling investment activities are suitably qualified and have appropriate levels of knowledge and experience.

24. At least annually, senior management should review the adequacy of its written operational procedures and allocated resources in the light of the insurance company's activities and market conditions.

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5. Monitoring and Control

5.1 Risk Management Function

25. Insurers should be capable of identifying, monitoring, measuring, reporting and controlling the risks connected with investment activities. This process should be performed by a risk management function with responsibility for:

   a. Monitoring compliance with the approved investment policy;
   b. Formally noting and promptly reporting breaches;
   c. Reviewing asset risk management activity and results over the past period;
   d. Reviewing the asset/liability and liquidity position

26. The risk management function should also assess the appropriateness of the asset allocation limits. To do this, regular resilience testing should be undertaken for a wide range of market scenarios and changing investment and operating conditions. Once an insurer has identified those situations to which it is most at risk, it should ensure that it feeds back appropriate amendments to the policies and procedures defined in its investment mandate in order to manage those risk situations effectively.

27. The risk management function should regularly report to appropriate levels of senior management and, as appropriate, to the Board of Directors. The reports should provide aggregate information as well as sufficient detail to enable management to assess the sensitivity of the company to changes in market conditions and other risk factors. The frequency of reporting should provide these individuals with adequate information to judge the changing nature of the insurer's asset profile, the risks that stem from it and the consequences for the company's solvency.

5.2 Internal Controls

28. Adequate systems of internal control must be present to ensure that investment activities are properly supervised and that transactions have been entered into only in accordance with the insurer's approved policies

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and procedures. Internal control procedures should be documented. The extent and nature of internal controls adopted by each insurer will be different, but procedures to be considered should include:

a. Reconciliations between front office and back office and accounting systems;
b. Procedures to ensure that any restrictions on the power of all parties to enter into any particular asset transaction are observed. This will require close and regular communication with those responsible for compliance, legal and documentation issues in the insurer;
c. Procedures to ensure all parties to the asset transaction agree with the terms of the deal. Procedures for promptly sending, receiving and matching confirmations should be independent of the front office function;
d. Procedures to ensure that formal documentation is completed promptly;
e. Procedures to ensure reconciliation of positions reported by brokers;
f. Procedures to ensure that positions are properly settled and reported, and that late payments or late receipts are identified;
g. Procedures to ensure asset transactions are carried out in conformity with prevailing market terms and conditions;
h. Procedures to ensure that all authority and dealing limits are not exceeded and all breaches can be immediately identified;
i. Procedures to ensure the independent checking of rates or prices: the systems should not solely rely on dealers for rate/price information.

29. The functions responsible for measuring, monitoring, settling and controlling asset transactions should be distinct from the front office functions. These functions should be adequately resourced.

30. Regular and timely reports of investment activity should be produced which describe the company's exposure in clearly understandable terms and include quantitative and qualitative information. The reports should,

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in principle, be produced on a daily basis for senior management purposes; less frequent reporting may be acceptable depending on the nature and extent of asset transactions. Upward reporting by senior management is recommended on at least a monthly basis. Reports should at least include the following areas:

a. Details of, and commentary on, investment activity in the period and the relevant period end position;
b. Details of positions by asset type;
c. An analysis of credit exposures by counterparty;
d. Details of any regulatory or internal limits breached in the period and the actions taken thereto;
e. Planned future activity;
f. Details of the relative position of assets and liabilities.

5.3 Audit

31. Auditors should be expected to evaluate the independence and overall effectiveness of the insurer's asset management functions. In this regard, they should thoroughly evaluate the effectiveness of the internal controls relevant to measuring, reporting and limiting risks. Auditors should evaluate compliance with risk limits and the reliability and timeliness of information reported to senior management and the Board of Directors.

32. Auditors should also periodically review the insurer's asset portfolio and written investment policies and procedures to ensure compliance with the insurance company's regulatory obligations.

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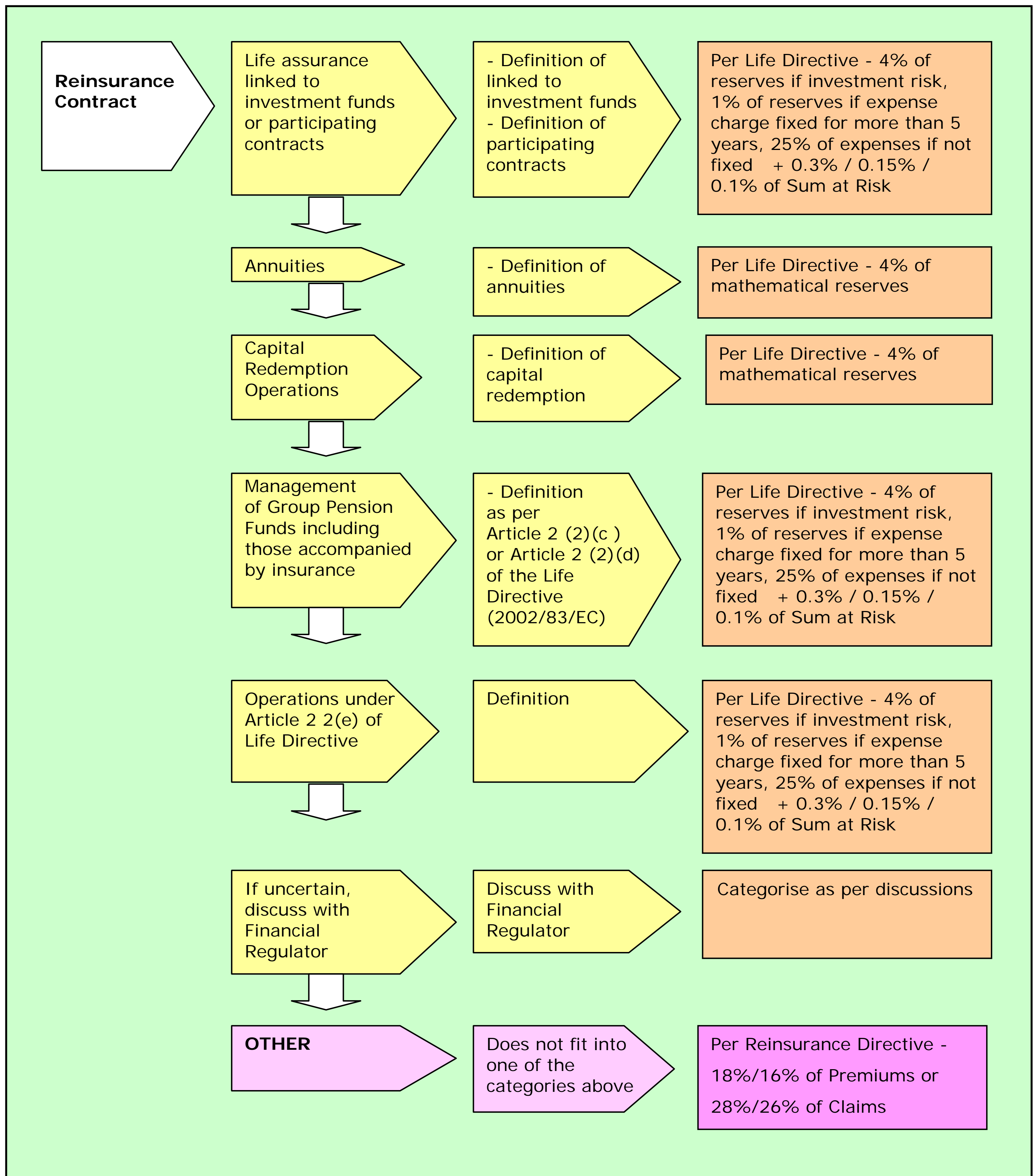
Appendix 4: Methodology for determining solvency



Source: Watson Wyatt report "Solvency margin and reserving requirements for life reinsurance business", February 2006, commissioned by Financial Regulator.

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