

The benefits of open reinsurance markets

1. Introduction

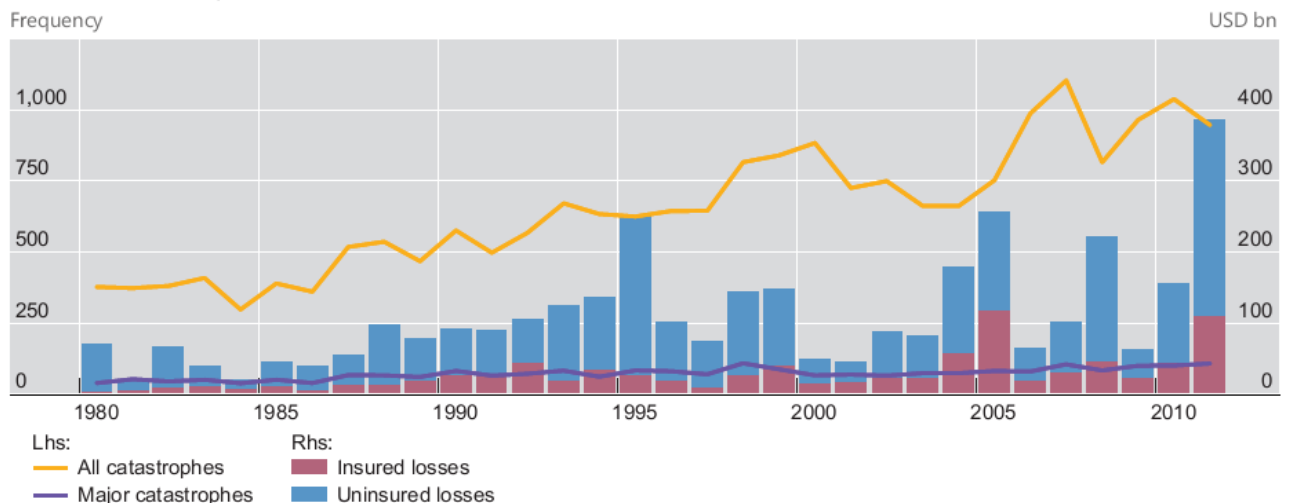
Open reinsurance markets are vital to enable reinsurance markets to operate efficiently, to diversify risk globally and to promote continued growth and recovery of global and national economies. Barriers to trade in reinsurance undermine the efficiency of reinsurance markets. They lead to higher reinsurance costs and less capacity in the long term.

Reinsurance provides a mechanism for insurers to reduce their underwriting risk across a broad range of non-life and life business classes. It thereby enables insurers to strengthen their own solvency and expand their capacity to absorb different types of business and customer risk, both catastrophic and non-catastrophic. In addition, reinsurance helps insurers to reduce the volatility of their earnings, accompanied by positive effects on capital costs, which insurers can pass on to policyholders, for example in the form of lower prices.

The value of global reinsurer support to countries that experience catastrophic losses has been proved time and again. In a recent example, 2011 witnessed the greatest natural catastrophe-related losses in history, reaching \$386bn (see chart 1 below)¹. The global reinsurance market paid out billions of dollars of claims under reinsurance contracts, which enormously helped post-disaster recovery in the countries most affected, which included Australia, Chile, Japan, New Zealand and Thailand.

Chart 1: Natural catastrophes: frequencies and losses

All natural catastrophes

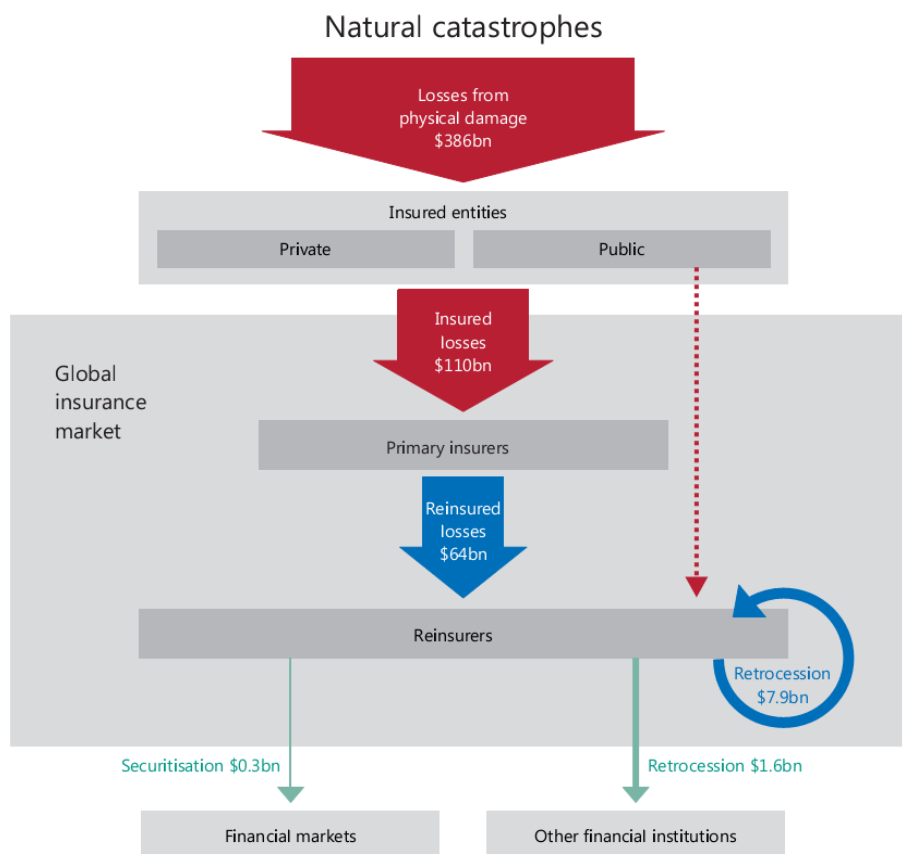


¹ Bank for International Settlements, 2012: Natural catastrophes and global reinsurance – exploring the linkages, http://www.bis.org/publ/qtrpdf/r_qt1212e.pdf

In more recent years, reinsurers have also met significant claims arising from floods in Canada, hurricanes in Mexico, floods in central Europe and storms in the US, as well as major marine and aviation claims.

Insured losses cascade down from insured policyholders to the ultimate bearers of risk (see chart 2 below, which shows the catastrophe risk transfer in 2011) – with reinsurers usually bearing 55–65% of insured losses when a large natural disaster occurs².

Chart 2: Catastrophe risk transfer in 2011



2. Importance of regulatory recognition of reinsurers' business models

It is crucial that there is appropriate recognition of the value of reinsurance and of reinsurers' business models, if reinsurers are to be able to continue to provide their key role in global commerce.

Reinsurers' key role in global commerce includes:

- providing capital relief to primary insurers by allowing them to reduce the level of their retained risks, thereby limiting the impact of adverse shocks on their financial positions and the volatility of their earnings
- facilitating the diversification of primary insurers' risk exposures

² Bank for International Settlements, 2012: Natural catastrophes and global reinsurance – exploring the linkages, http://www.bis.org/publ/qtrpdf/r_qt1212e.pdf

- providing a range of additional services to the primary industry, including consultancy, technical advice on underwriting, financial analysis of risks and portfolios, and operational capability in the claims process.

A Group of Thirty report on “Reinsurance and International Financial Markets” described the value of the reinsurance industry as follows:

“Through all [the above] channels, the reinsurance industry, insofar as it functions effectively, enables the risks of the personal, corporate and public sectors, as well as of the financial sector itself, to be covered more efficiently, cheaply and securely than would be possible by primary insurance alone.”

There are various ways in which appropriate regulatory treatment of reinsurers’ business models can be achieved.

One important way relates to the calculation of reinsurers’ regulatory capital requirement.

Reinsurers are engaged in B2B activities and provide reinsurance to cedants often in respect of large, complex and sometimes catastrophic risks. Obviously, it would not make sense for reinsurers to be required to calculate their regulatory capital on the basis of standard formulas predicated on a business model assuming the provision of cover for more routine, highly standardised, personal lines risks.

Solvency II thus permits, subject to regulatory approval, the use of internal models and undertaking-specific parameters (USPs) to calculate life, non-life and health underwriting modules.

It is important that supervisors, when assessing reinsurers’ internal models and USPs, do not apply markedly different criteria or assumptions that result in reinsurers being subject to an unlevel playing field in terms of regulatory capital requirements inappropriate to the nature and scale of their activities.

3. Freedom of reinsurance and access to markets

Professionally managed and well-capitalised reinsurance companies that are subject to solvency requirements should be able to operate in open markets worldwide to allow for an effective diversification of risks.

Reinsurance cover can either be sold cross-border, via branches or through subsidiaries. Global reinsurers’ business models are based on the widest possible distribution of risks (economies of scale) and the utilisation of diversification effects (economies of scope). They benefit from these economies by writing a large number of diversified risks in as many markets as possible.

It is therefore crucial for firms with adequate expertise, appropriate risk-management tools and capital commensurate with the risks they assume to enjoy unrestricted worldwide access to markets, freedom of contract and complete fungibility of capital.

Access to reinsurance markets should apply equally to all markets globally. Europe must set an example by not creating inappropriate or disproportionate barriers to the transaction of European reinsurance business by non-European reinsurers.

The reinsurance industry has always promoted and continues to promote this concept of “freedom of reinsurance”.

4. Cross-border business

There should be no restrictions on or disincentives to cross-border business (either affiliated or unaffiliated transactions) such as retentions or limitations, or differential treatment of transactions, including the credit for reinsurance afforded to ceding undertakings, based merely on the geographic location of a reinsurer or its legal form.

Full access to international capital and cross-border reinsurance has tangible benefits for any local insurance industry, consumers and the wider economy.

Proposals in recent years in certain jurisdictions to restrict or penalise cross-border reinsurance can be seen as discriminatory trade barriers. Their effect will be to restrict access to international reinsurance capacity and services.

Some of these proposals strongly incentivise local insurers to place business with locally incorporated reinsurers or give those reinsurers rights of first refusal.

Discriminatory prudential provisions for cross-border reinsurers would fundamentally weaken the strength of any local insurance market by:

- reducing access to international reinsurance capacity and risk management expertise
- counteracting the goal of diversification of risks
- creating non-alignment with global regulatory standards and best practice
- potentially undermining equivalence discussions and ongoing negotiations with other international regulators and partners
- compromising financial stability in the face of major catastrophes, where losses may be concentrated with domestic insurers and reinsurers rather than globally distributed, forcing state intervention in some cases

The economic value of insurance and reinsurance lies in the spreading and diversification of risk, rather than the generation of premium within national borders. The concentration of risk within a single jurisdiction or region can also have negative consequences from a macroeconomic perspective in the event of major man-made or natural catastrophes.

Much of this effect is cumulative and built up over time, however the most significant impact will only become apparent following a catastrophic loss event. As such, the true economic cost of restrictions on cross-border reinsurance may not be readily apparent for many years, at which point the consequences may be difficult or impossible to avoid.

It is important that those countries leading the development of sound prudential supervision of insurers and their reinsurance risk profile develop approaches that are based on prudentially valid concepts (e.g. recognition of diversification benefits and risk mitigation, which is most accurately captured through internal capital models), remove disincentives, ensure equal treatment of foreign and local reinsurers and recognise robust regulatory frameworks. These countries will set the model for others in their region and around the world.

5. Branches

Branches play a key role for many reinsurers wishing to access and service cedants in foreign markets. They are not separately incorporated legal entities. Cedants trading with branches of reinsurers can thus benefit from the entire capital strength of the reinsurers and are not constrained by the extent of capital resources existing within the subsidiary. This provides obvious benefits for cedants.

Reinsurers often first enter into markets on a cross-border basis before setting up physical offices. If they choose, for commercial reasons, to maintain a physical presence in the form of a branch or a subsidiary, many reinsurers choose to establish branches in preference to subsidiaries as they are better able to leverage the benefits of the global reinsurance market, promote prudent diversification of risk assumed by the reinsurer and manage the efficient use of capital to cover risks to which otherwise they would not be able to allocate capital.

Host supervisors may also see great benefits in the establishment of branches without the need for a subsidiary operation in the host jurisdiction. On the international regulatory front, progress has been made on the exchange of information and cooperation between group-wide and home-country supervisors.

For example, the Multilateral Memorandum of Understanding (MMoU) of the International Association of Insurance Supervisors (IAIS) is a global framework for cooperation and information exchange between insurance supervisors. Further steps could be taken by insurance supervisors towards mutual recognition of reinsurance regulation, as discussed in the IAIS discussion paper of 2007 on the mutual recognition of reinsurance supervision.

Also, the IAIS common framework for the supervision of internationally active insurance groups (ComFrame) initiative will continue to foster greater harmonisation in the way internationally active groups, including the major reinsurers, are being supervised.

Moreover, a large majority of leading global reinsurers have developed strong enterprise risk management frameworks and are supervised from a group or a single entity perspective in their home countries.

Capital charges for branches lead to higher reinsurance costs

Additional solvency (and other capital) requirements at local level for branches of foreign reinsurance companies induce a competitive disadvantage, by increasing the overall solvency requirement of global reinsurers and by limiting their ability to move capital according to claims without improving policyholders' protection or creating more stability for the local insurance market.

Imposing a broad-brush solvency capital requirement on the branches of the global leading reinsurers would reduce their ability to manage liquidity, and would lead to higher costs and reduced reinsurance capacity for the insurance market, thus penalising insurers and policyholders.

Capital charges lower diversification

The reinsurance industry's business model relies on strong geographic and risk diversification. In order for reinsurance companies to achieve geographic diversification, most reinsurance companies operate in many countries, often through branches. Global reinsurers have diversified businesses and as a result of this, diversification can lower their solvency risk overall, which benefits their ceding companies.

Imposing extra capital charges on branches undermines effective diversification. For cedants, the consequence will be increased costs likely resulting in higher premiums for consumers without increasing financial stability. For the reinsurance industry, the consequence will be a reduction in overall capacity as capital is scattered and resources devoted to meeting local capital requirements become unavailable to stand against the overall diversified risk portfolio.

6. Cedant responsibility

We believe that a greater focus and reliance should be put on the principles of “cedant responsibility”.

Reinsurance is a business-to-business transaction, carried out by sophisticated commercial reinsurance industry participants operating in a global market. These international reinsurers can assume the most complex and severe risks because they can underwrite internationally diversified portfolios and capitalise these risks in their domestic jurisdictions under globally diversified capital models.

Regulatory regimes should enable efficient and prudent access to global reinsurance capacity. Regulatory regimes should incentivise cedants to manage and justify their reinsurance strategy in a prudent risk-based manner and should not discriminate between financially strong reinsurers from well-regulated regimes and reinsurers in their own jurisdictions.

Indeed, IAIS principles set out that supervision of the purchase of reinsurance assets should not take the form of restrictions on the activities of foreign reinsurers, but rather should be a central part of the supervision of the cedant itself, with the regulator focusing on the cedant’s prudent approach to reinsurance purchasing and risk management³.

7. Impact on local (re)insurance industry

Restrictions on cross-border reinsurance and the branches of foreign reinsurers can, counter-intuitively, undermine rather than strengthen both local insurers and reinsurers.

Where domestic insurers are forced or incentivised to cede more of their risks to local reinsurers the consequences include:

- greater concentration of risk in those particular jurisdictions and companies
- increased impact of major loss events on the regional or local economies
- reduced reinsurance capacity available to domestic insurers
- higher prices and less certainty for insureds
- ultimately, reduced competitiveness of local insurers

Although increasing the cost of cross-border reinsurance and reinsurance from the branches of foreign reinsurers relative to domestic provision can seem an attractive measure by which to support the development of local reinsurance capacity it can unfortunately have the opposite effect. Larger cedants with a multinational presence may simply seek to purchase their reinsurance in a jurisdiction that does not apply such penalties.

Imposition of discriminatory requirements can lead to reciprocal barriers being imposed by other jurisdictions, which reduce the ability of the domestic reinsurers to access business from outside their own territory. This, in turn, can severely limit the ability of those reinsurers to themselves build a geographically diversified portfolio and to develop expertise, and consequently may impair their ability to offer competitive rates outside their own jurisdiction.

³ ICP13.1.3 “Responsibility for developing and agreeing upon the [reinsurance] strategy should rest with the Board and Senior management of the cedant”

8. Conclusions

Barriers or disincentives to domestic insurers accessing reinsurance from foreign reinsurers either cross-border or via branches are increasing in some markets, despite global trends towards more risk-based regulation.

Such barriers can limit economic growth potential, impose greater costs and increase risks for local insurers and ultimately reduce the availability and affordability of insurance for consumers.

Counter-intuitively, they can also undermine financial stability, introduce non-prudential incentives to purchasing decisions and hinder rather than boost development of local reinsurance capacity.

With losses from catastrophes worldwide on a trajectory of significant increase, as a consequence of economic development, climate change and globalised production and distribution chains, it is more important than ever that efficient international risk pooling is preserved and that leading reinsurers make the case for open markets and the absence of discriminatory barriers to cross-border reinsurance.

Governments and public bodies, as well as the private sector, will benefit from unconstrained access to cross-border reinsurance and the industry's expertise in loss mitigation as they continue to seek innovative and cost-effective ways to manage financial shocks from catastrophic events.

It is also vital that regulatory rules recognise reinsurers' business models, their global operations, their B2B nature and the characteristics of the risks that they underwrite.

Insurance Europe's Reinsurance Advisory Board (RAB) is a specialist representative body for the European reinsurance industry. It is represented at Chief Executive Officer (CEO) level by the seven largest European reinsurance firms: General Reinsurance Corporation, Hannover Rück SE, Lloyd's of London, Münchener Rück AG, Partner Re, SCOR and Swiss Reinsurance Company Ltd, with Insurance Europe providing the secretariat.

Through its member bodies the RAB represents around 60% of total worldwide reinsurance premium income. The RAB promotes a stable, innovative and competitive market environment. It further promotes a regulatory and trading framework that facilitates global risk transfer through reinsurance and other insurance-linked capital solutions.