

A Framework for an International Supervisory System for Reinsurance Companies Article

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By its very nature, reinsurance is an international business. The geographical spread and diversification of risks has always been an essential element of good risk management practice in reinsurance. By contrast, the benefits of such diversification have traditionally not been adequately reflected in national insurance supervisory regimes, which are primarily aimed at protecting the interests of policyholders.

Policyholder protection is, of course, an absolutely legitimate reason to supervise insurance companies. The question is, however, how this supervision should be executed and how (national) supervision needs can be aligned with more far-reaching requirements for an efficient supervisory system on international reinsurers. More and more, reinsurance supervision is also regarded as an element that could and should contribute to creating value for the reinsurance companies, the insurance industry and, in the last analysis, for the policyholders. Current reinsurance supervision does not sufficiently fulfil these functions. It does not take into account that supervision on the one hand and the quickly evolving internal risk management and capital models of the reinsurers on the other hand should run parallel in order to achieve an optimum result.

If, in an extremely simplified model calculation, it is assumed that the current system results in allocated capital which is 5% higher than economically necessary (= cost of capital), that the global reinsurance volume (premiums) totals US\$ 150bn and that the premium-to-capital ratio remains constant, then the global welfare effect of centralised supervision by home state regulators would amount to US\$ 7.5bn p.a.

Reinsurance supervisory rules should therefore provide the right incentives for transparent and sustainable value creation whilst not neglecting the policyholder protection needs. This means that the supervisory system should not discourage the use of diversification benefits. On the contrary, it should not restrict the companies' freedom of trade and business needs more than absolutely necessary.

Let me explain this in more detail.

As I said, the main feature characterising the operations of all major reinsurance companies is that they operate beyond the national borders of their home countries and write risks in a large number of countries. They do so in order to acquire a portfolio that is as widely diversified as possible, since this has a balancing effect on loss performance and reduces the necessary risk capital. In certain lines of business, for instance in natural hazards reinsurance, such risks can only be written responsibly if the risks are spread globally. This requires that reinsurers have free market access in as many different countries as possible and that this access is not hampered more than necessary by the authorities supervising these companies.

Reinsurers organise their operations and conduct their business in the commonly known ways: They may underwrite their foreign business directly, i.e. from their home countries by making use of cross-border freedom of services. Reinsurance business can also be written by legally dependent, locally established branch offices. The treaties concluded in this way immediately establish rights and obligations for the company's main office. And finally, reinsurance covers can also be provided by local subsidiaries. In the latter case, from a purely legal point of view, only the subsidiaries are affected by the contractual relationship thus established, also as far as their (generally limited) financial capacity to cover claims is concerned. In practice, however, experience shows that parent companies come to the aid of their subsidiaries for economic reasons, if and when required.

At first sight, a reinsurer's organisation – direct business, business via branches and subsidiaries – does not differ from that of companies from other sectors of the economy. However, there is one important difference: reinsurers not only need to have the necessary ordinary share capital, they are also required by supervisory law to cover the risks they carry with solvency capital. This requirement can result in inefficiencies induced by national supervisory laws, which may lead to redundant guarantee capital in the various countries of activity and administrative costs for the reinsurer, and which have ultimately to be passed on to the company's clients and consequently to the policyholders. These inefficiencies should be kept to a strict minimum and can only be accepted insofar as they are deemed indispensable because of supervisory necessities.

In managing their global business, reinsurers have to take a holistic approach to risk monitoring and control. This consists above all in analysing, regulating and controlling globally the interdependencies between risks on the asset and liability sides and strategic and operational risks. For this purpose, they use instruments such as asset-liability management, active capital management and capital modelling. A central risk controlling unit coordinates regular risk assessments on the basis of centrally defined standards.

To control their underwriting risks, reinsurers use tools such as underwriting guidelines, limits and clear underwriting authorities defining those who are authorised and responsible for concluding reinsurance treaties and at what conditions. Compliance with these guidelines is regularly monitored. Another preventive risk controlling measure consists in the agreement of accumulation budgets in reinsurance, particularly in property business, where reinsurance companies assume very large liabilities for natural catastrophe losses. It is therefore essential that the accumulation of natural hazard liabilities underwritten are permanently controlled and that accumulation budgets are fixed on a group-wide basis. An indispensable tool for risk prevention and controlling is the establishment of reserves for uncertain liabilities using actuarial methods. The adequacy of claims provisions for all classes of business and at all group companies has to be regularly checked by means of internal reviews and audits. Beyond this, the cession of a portion of the risks to third parties via external reinsurance and retrocession may limit the global exposure of the reinsurer.

It is a well-known fact that in reinsurance business both parties to the contract are professionals and, as such, they do not need the same protection private persons do. As a result, reinsurance transactions do not require the same close supervision as transactions with private consumers.

Another important feature of reinsurance business is the fact that the rights and obligations of a contractual relationship are typically established in tailor-made individual treaties. Of course, there are certain types of treaties that keep recurring in practice. Nevertheless, to provide optimal protection, treaty contents are typically designed to meet the ceding insurer's specific reinsurance needs. Recent isolated calls by regulators for the stipulation of standardised treaties in reinsurance are therefore to be rejected.

The current construction of the supervisory systems worldwide does not sufficiently meet these requirements. The various countries still have their own supervisory regimes and, based on the principles of national sovereignty, independently supervise the local operations of international reinsurers. Consequently, there are no globally applicable regulations stipulating roles, responsibilities and rules for supervision of a reinsurer's cross-border operations. And there is as yet no sign of an international consensus on whether a "home state regulator" or "lead supervisor" should be made (solely) responsible for supervising reinsurance groups that do business worldwide. It goes without saying that this kind of "disorder" does not exactly lead to friction-free coexistence between the various supervisory systems. Friction losses are especially evident where reinsurers transact business via (legally dependent) branch offices, and they are apparent in the multiple, occasionally conflicting reporting obligations towards supervisory authorities around the world. The above-mentioned obligations to provide collateral or LoCs lead to economic inefficiencies that could be avoided if there were adequate cooperation between the supervisory authorities. This impacts the cedants and their policyholders financially, which makes it clear why there is need for action.

To sum up, supervisory requirements that are not suitable for the business may ultimately lead to a situation in which the world market, on which reinsurers depend economically in order to diversify their risk, becomes so fragmented that reinsurance is seriously impeded or even no longer seems worthwhile. In the interest of an effective functioning of international reinsurance, it is therefore crucial to secure and/or to reinstall "freedom of reinsurance" in all its dimensions. This does not mean freedom from all supervisory rules. Rather, it means that the national supervisory systems and their application should be harmonised to the extent that international reinsurers are subject to only one set of supervisory regulations that are applied and implemented by – ideally – one authority responsible for the supervision of the reinsurer's global operations.

The above considerations clearly show that international coordination is indicated in the supervision of reinsurance companies. In my opinion, supervision should rest on two cornerstones:

- The supervision of a reinsurance company's international operations should be carried out by only one authority. Typically, this authority should be the home state supervisory authority.
- The supervisory authorities locally responsible for the various regions and countries in which the reinsurer operates should share their information with the home country's supervisory office in order to allow this office to exercise efficient supervision and to take appropriate measures if needed.

The home state regulator's supervision should cover both the reinsurer's foreign direct business and business written by its branch offices abroad. In a second step, it needs to be decided whether the foreign subsidiaries' operations should also be supervised by the home state regulator. The European Financial Services Round Table (EFR) has argued in favour of the latter in its "lead supervisor" concept. However, in its proposal, the EFR limits itself to the European Union member states whereas the present paper deals with a global supervisory system for reinsurers operating internationally.

The EU directive for the supervision of reinsurance companies currently being prepared can serve as an example of a concerted system of coordinated supervisory regulations. This directive creates a European single market for reinsurance supervision, where

- the supervisory systems in the member states are brought closer together on the basis of the principle of minimum harmonisation of core elements for supervision that have to be applied in all EU member states. "Minimum harmonisation" does not mean that supervisory systems of minor quality should be installed but rather that Member States are free to go beyond the common supervisory standards under EU law in their national legislation;
- the member states recognise each other's supervisory systems;
- the financial supervision of reinsurance companies is assigned to the supervisory authorities in the reinsurer's home state (governing issues and general legal supervision remain with the host state regulator);
- the supervisory authority in the reinsurance company's home state is responsible for the latter's operations throughout the EU. This responsibility includes both direct business in other EU member states and business written by branch offices; however, it does not include business underwritten by subsidiaries in other member states;
- a system of information exchange between the supervisory authorities of the member states is introduced to ensure that the supervisory authorities in the host countries receive any information they may need about a reinsurer to examine the reinsurance programme of a primary insurer under their supervision.

As to the core elements of supervision that will be harmonised by the EU directive, there will be a stipulation that all reinsurers need to be licensed in order to carry on reinsurance business. This licence will cover all member states of the EU. The financial supervision exercised by the home state regulator will cover crucial areas for determining the financial security of reinsurers, namely the items reserves, solvency margin and investments.

The general legal supervision remaining with the host state regulator includes a fit-and-proper control of management, as well as shareholder and market conduct control. I have to admit that, in my eyes, host-state control for these issues does not seem to be in line with the general principle of mutual recognition and should be reconsidered.

With the exception of this aspect, the ideas behind this EU draft directive could also serve as a starting point for a globally coordinated supervisory system to which one can ascribe a number of advantages. Such a system is not only in the interest of the supervisory authorities' involved but also benefits the reinsurers under supervision as well as their clients, the cedants.

Advantages for the supervisory authorities are:

- Supervision of reinsurance companies on the basis of coordinated minimum standards leads to better global comparability of regulations and thus to greater transparency. At the same time, the data provided by reinsurance companies also become more comparable and make the business written by the industry more transparent.
- Comparable supervisory standards engender trust between supervisory authorities and consequently also promote administrative economy. They allow supervisory authorities to focus on the really critical issues.
- The quality of supervision improves when it is exercised at the headquarters of an international company. As described above, for reasons of good risk management practice, reinsurers must manage their business and the risks assumed centrally for their operations worldwide. Moreover, within reinsurance groups, management decisions are increasingly being taken by the ultimate parent company at the group's headquarters. This is particularly true for asset management, capital allocation, product development, the issuance of underwriting guidelines and last but not least the use of internal risk models for purposes of risk management. For this reason, supervision must occur where decisions are really taken and control is really exercised. Supervision should therefore be carried out by the home state regulator. It would then be more efficient and would also make crisis management – should it become necessary – more effective. This would also seem expedient for the European single market, as the Solvency II project is aimed at installing a supervisory system geared to the risks a company actually accepts.
- Centralised supervision by the home state supervisory authorities incidentally lends itself not only to financial supervision but also to fit and proper management. This should not remain with the host state regulator but should be assigned to the home state regulator. The supervisory authority in the reinsurer's home state has to acquire information about the personal reliability and professional suitability of the members of the Board of Management. If the supervisory authority of another country in which the reinsurer does business needs information about the company's management, this information could be passed on through information exchange. Such an arrangement would do away with multiple management reviews.
- The same applies to shareholder control. Here too the authorities' information requirements should be covered by an exchange of information between the supervisory authorities in the reinsurer's countries of operation.
- Centralised supervision also makes it easier for the authorities to keep track of all the relevant company data and information, for instance on (central) risk management. Short lines of communication between the home and host state regulator also benefit the supervisory authorities in the host state of a group of companies and ensure that the required information is provided fully and promptly.
- By enhancing the stability of the entire reinsurance group, centralised supervision indirectly protects policyholders' claims against primary insurers as well.

- Mention should also be made of the fact that central supervision based on mutually recognised supervisory standards prevents supervisory arbitrage that could otherwise be induced by supervisory law.

From the supervised reinsurance companies' point of view, centralised supervision by a home state regulator also provides considerable efficiency gains:

- A uniform reporting system applying to all group members when reporting to the company's headquarters and from there to the home state regulator is more economical administratively. It would remedy the current situation with its costly, multiple – and occasionally contradictory – reporting requirements in the various jurisdictions.
- A reinsurance group could derive far greater economic advantages from the allocation of the necessary operating equity. Centralised supervision would provide for capital management and allocation on the basis of economic criteria and independent of today's supervisory and company law structures. Capital could be held where this is economically sensible and, what is more, could be concentrated in one place. This would enable the diversification effects of risks written internationally to be fully realised and reduce capital requirements. The legal supervision of reinsurance companies would thus more closely match the economic perspective, a perspective that is currently also being increasingly applied by the rating agencies for instance.
- At the same time there would no longer be any need for the collateral required under various supervisory systems. The need to maintain these funds locally ties down the capital available in certain jurisdictions and thus leads to the division of a reinsurer's assets and risk capital. Since these funds only serve to satisfy a specific group of creditors, diversification effects can only be utilised to a very limited degree, a fact that consequently leads to capital requirements which, from an economic point of view, are unnecessarily high. In an internationally coordinated system of national supervision such inefficiencies could be avoided.
- It should also be mentioned that with the fragmented supervisory systems, the integration of IT systems is often not possible or only possible at excessive cost.

Finally, the reinsurers' cedants would also benefit from gains in efficiency.

- The direct supervision of reinsurance companies on the basis of mutually recognised supervisory rules would eliminate the need for cedants to obtain information about the quality and standing of the supervision exercised over a given reinsurer. Conversely, the supervisory authorities would no longer need to examine via the primary insurers the "security" of their reinsurers. In other words, the "indirect" supervision (i.e. of the reinsurers through the primary insurers) would be done away with. Indirect supervision is superfluous when direct supervision of the reinsurers is sufficient and globally coordinated. If this comprises financial supervision (reserves, solvency, investments), the supervisory authorities concerned could share their information about the respective parameters. The more internationally coordinated supervision is extended, the more indirect supervision becomes unnecessary in this respect. This would also apply, say, to fit-and-proper management or shareholder control.

- For risk management reasons, a reinsurer's clients, i.e. cedants, are generally interested in establishing business relations with the reinsurer's headquarters whenever possible and not with its local subsidiaries. Legally, this is done either by transacting business directly with the group's head office or by concluding a treaty with the reinsurer's branch office in the host country. In this regard, the relationship between the reinsurance company and primary insurance company differs from the relationship between the primary insurer and its clients, the policyholders. The first-mentioned relationship is characterised by the fact that the primary insurer is interested in contracting with a partner who, due to its size and financial power, can provide outstanding security. The primary insurer's client, however, is guided, either consciously or subconsciously, by the principle of "all business is local". A supervisory landscape that distinguishes clearly between primary insurance and reinsurance and provides for centralised control and risk management would appear much more important in reinsurance than in primary insurance.

Economically speaking, central supervision by a home state regulator would involve considerable welfare gains overall. The advantages of more efficient supervision that would allow the tools of risk diversification to be put to better use are likely to have a lowering effect on the cost element of reinsurance covers, as risk capital could be employed more efficiently, thus reducing the cost of capital. The benefits could in part even trickle down to the policyholder. It is naturally difficult to quantify these welfare effects.

How can such a global supervisory system be achieved? It could be established gradually through the conclusion of bilateral agreements between states and their supervisory authorities in which reinsurers are domiciled and operate. It would first be necessary to define certain minimum standards as a basis for mutual recognition. Such standards could be found in the draft European directive; however, worldwide standards agreed upon in the IAIS – the IAIS Principles and Standards – are suitable as well, or even better. These IAIS standards are now internationally acknowledged; they form, for example, the basis for the examinations carried out by the IMF on the "Financial Sector Assessment Programs" in a considerable number of countries. Mutual recognition of the supervisory systems would then become possible and enable the respective home state regulator to be made the lead supervisor.

It is not least the significant efficiency gains to be achieved that speak for a rapid and worldwide implementation of central supervision through a home state regulator. The more countries that participate in such a system, the better it would work and the more benefits it would bring.