Supervision of reinsurers

I. Summary

The reinsurer helps the direct insurer fulfil the obligations in the form of claims payments arising from the insurance contracts. The need of the direct insurer for this relief is a result of the specific nature of the actuarial risk it bears, which consists in unforeseeable fluctuations of the claims history, potential structural changes of the risk situation, and the threat of accumulations and catastrophic events.

About 70 reinsurance institutions are subject to supervision by FOPI, approximately a dozen of which are professional reinsurers; the rest are reinsurance captives. The gross reinsurance receipts in Switzerland in 2004 amounted to about 34.8 thousand million Swiss francs, i.e., about one third of the total premium volume generated in Switzerland.

Already under the old ISL, reinsurance companies were subject to supervision. However, some of the provisions differed considerably from those for direct insurers. Under the new ISL, reinsurers are subject to the same provisions shaped by the new supervision philosophy that also apply to direct insurers. With the new ISL and especially with the new Supervision Ordinance, reinsurers must fulfil new solvency requirements. These requirements are calculated according to two methods: First, the reinsurers must maintain available own funds in the amount of the required solvency margin, which depends on the business volume (Solvency 1). Second, the reinsurers must also conduct the Swiss Solvency Test, SST (Solvency 2).

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II. What is reinsurance?

1. Definition

The reinsurer helps the direct insurer fulfil the obligations in the form of claims payments arising from the insurance contracts. The need of the direct insurer for this relief is a result of the specific nature of the actuarial risk it bears, which consists in unforeseeable fluctuations of the claims history, potential structural changes of the risk situation, and the threat of accumulations and catastrophic events. The reinsurer is one of the possible options to relieve the balance sheet of the direct insurer.

2. Reinsurance techniques

In reinsurance, proportional and non-proportional business are distinguished:

- In the case of proportional reinsurance, the reinsurer assumes a percentage of the risk that remains the same over the term of the contract for all the policies of a certain sector or class of business; this percentage also applies to the distribution of premiums and claims between the contracting parties. The advantage of proportional reinsurance consists in its easy use and the numerical reduction of any technical losses of the direct insurer.
- In the case of non-proportional reinsurance, the reinsurer only assumes liability when the reinsured pool suffers a loss and this loss exceeds a certain threshold.

Reinsurers also balance portfolios among themselves. This is achieved by means of retrocessions (retro reinsurance: reinsurer A concludes a retro contract with reinsurer B). In this way, reinsurers aim for a worldwide balance of portfolios in addition to a balanced risk spread (mix of sectors).

3. Underwriters

For purposes of supervision law, we distinguish between direct insurers (leading underwriters) and reinsurers. As a rule, direct insurers conclude insurance contracts directly with the consumer. Professional reinsurers conclude their reinsurance contracts exclusively with direct insurers.

4. Captives

For some time, large industrial groups have established their own reinsurance companies (captives) that assume risks exclusively pertaining to the group, in part through reinsurance. In this way, well-run industrial groups with well-developed risk management participate directly in the good claims history of their own insurance policies. Captives are subject to simplified supervision. I.e.: As a rule, especially those captives that do not belong to an insurance group are not required to conduct the SST.

III. The significance of the reinsurance industry in Switzerland

Practically only one international reinsurance market exists, at the most divided according to sector. As a rule, this market is dominated by free competition among suppliers. In Switzerland, about 70 reinsurance institutions are subject to supervision by FOPI, approximately a dozen of which are professional reinsurers; the rest are reinsurance captives. The gross reinsurance receipts in Switzerland in 2004 amounted to about 34.8 thousand million Swiss francs, i.e., about one third of the total premium volume generated in Switzerland.

IV. Supervision

Already under the old ISL, reinsurance companies were subject to supervision. However, some of the provisions differed considerably from those for direct insurers. Reinsurers did also have to fulfil the licensing requirements and offer “the necessary guarantees in particular with respect to solvency, organization and business management” (article 10 of the ISL). But since these requirements were very general, FOPI developed a supervision practice, for instance concerning minimum capital and the organization fund. With respect to solvency, the practice was that own funds had to amount to at least 20% of the premiums for own account.

Under the new ISL, reinsurers are subject to the same provisions shaped by the new supervision philosophy that also apply to direct insurers:

- corporate governance rules
- internal risk management
- internal controlling
- designation of a responsible actuary, who reviews the numbers, compliance with the SST requirements, etc.

In contrast to the old rule, reinsurers must now provide more precise figures concerning technical reserves. With the new ISL and especially with the new Supervision Ordinance, reinsurers must fulfil new solvency requirements. These requirements are calculated according to two methods: First, the reinsurers must maintain available own funds in the amount of the required solvency margin, which depends on the business volume (Solvency 1). Second, the reinsurers must also conduct the Swiss Solvency Test (SST). For the SST, own funds are determined on the basis of the risks to which the insurance company is subject (Solvency 2).

V. Finite re

Finite re, or alternative risk transfer (ART), has become increasingly important in recent years. So far, there is no generally applicable definition of finite reinsurance. However, finite reinsurance contracts generally have one or more of the following characteristics:

- The contracts are tailored and as a rule more complex than traditional reinsurance contracts. For this reason, finite re is often called non-traditional reinsurance.
- The maximum indemnification of a reinsurer is limited. This is also sometimes true of traditional reinsurance. In traditional reinsurance, however, the limits are calculated so that they are only very rarely exhausted. In contrast, the limits for non-traditional reinsurance contracts are often exhausted even in the case of relatively small deviations from the expected claims payments. The risk of the reinsurer is therefore very heavily limited, which is why the term “finite reinsurance” is often used.
- The contracts extend over several classes of business and/or years. The fluctuation potential of the claims rate is thereby reduced.
- Experience estimates take the expected financial earnings into account. If the claims history is very favourable, the reinsurance client (ceding company) receives participation in the profits; if the claims history is very unfavourable, the reinsurer receives an additional premium. In extreme cases, this entails that the risk transfer is very small to non-existent. In such cases, the term “financing contract” is often used.
- Often, the assets/claims (balances) are not paid out during the term of the contract. The ceding company only pays a margin. At the end of the term, a final account is compiled and settled.

Recently, non-traditional reinsurance has come under increased pressure, because it can be used to illicitly gloss over results or misrepresent balance sheets. The abuse of this instrument cannot be tolerated. Abuse takes place primarily when the reinsurer falsely enters financing contracts as reinsurance contracts. In such as case, the reinsurer’s entry typically differs from the ceding company’s entry (not affecting net income in the case of the reinsurer, and affecting net income in the case of the ceding company).

VI. International supervision trends

Internationally, the realization is gaining ground that an insurance industry can only thrive in conjunction with financially strong reinsurers. Spectacular headlines have confirmed this realization. The trend is therefore for the state to more strictly regulate the reinsurance industry. The IAIS (international Association of Insurance Supervisory), to which Switzerland also belongs, drafts disclosure standards for the insurance industry and is also intended to guarantee more transparency among the various reinsurance providers worldwide.

In the EU region, the Solvency II project is being promoted alongside application of the existing Solvency I criteria; in addition to the existing approach, which considers the ratios between the balance sheet and the income statement, the Solvency II model also considers volatilities in the insurance balance sheet. A new EU directive on reinsurance is also being discussed. This directive is intended to define minimum supervision criteria within the EU. The pragmatic supervision criteria applied in Switzerland are considered very progressive worldwide. The new ISL already fulfils the minimum solvency criteria that the EU is beginning to discuss.