GFIA
GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

To: IAIS Technical Committee

Date: 12 June 2015

Subject: Request for initiation of an IAIS study on the effects of restrictions on cross-border reinsurance

Dear Chair and Members,

The Global Federation of Insurance Associations (GFIA) represents approximately 87% of annual insurance premiums and more than $24 trillion in assets worldwide.

GFIA would like to draw the IAIS Technical Committee's attention to a growing trend amongst regulators to require localization of reinsurance risks. In recent years, six nations have introduced requirements forcing domestic retention of reinsurance risks, thus undermining the principle of global risk diversification, ultimately harming individual policyholders and businesses, and creating fragmentation of risks for their regions.

GFIA believes this trend is a threat to the G-20 priorities, Financial Stability Board (FSB) objectives, the IAIS' core objectives and the Insurance Core Principles (ICPs). In Annex I you will find an elaboration on how restrictions on cross-border reinsurance jeopardize said objectives. In Annex II you will find a summary of which ICPs are affected by such reinsurance restrictions.

Against this background, GFIA respectfully requests that the IAIS make a comprehensive analysis of the macro-prudential, financial stability, financial inclusion, and customer protection implications of the increasing trend of forcing localization of reinsurance. Such analysis could inform IAIS actions, but could also inform the policies of the FSB and G-20, whose objectives are equally affected.

GFIA would appreciate your early review of this request and would welcome the opportunity to discuss this issue further, or assist in any way the IAIS considers constructive.

Sincerely,

GOVERNOR DIRK KEMPTHORNE
Chair, Global Federation of Insurance Associations

GFIA contact
Brad Smith, chair GFIA Trade Working Group, BradSmith@acli.com

Global Federation of Insurance Associations (GFIA)
Secretariat: rue Montoyer 51, 1000 Brussels, Belgium
Tel: +32 2 894 30 81 E-mail: mihai@GFIAinsurance.org
www.GFIAinsurance.org

ANNEX I: Threats to the IAIS mission statement posed by restrictions on cross-border reinsurance

The IAIS Mission statement, as written in the *IAIS Mission and 2015-19 Strategic Goals* document (link), state that the IAIS intends to do the following:

- Collect and identify risks and developments in particular in the general economy and the financial sector.
- Analyze the relevance and impact of these risks and developments to the insurance sector, its business, regulation and supervision.
- To measure and monitor adherence to the Insurance Core Principles and Standards.
- Put in place and implement a process to address any gaps in Members' regulation and supervision.

GFIA would argue, in line with the IAIS' intentions noted above, and on the basis of the arguments presented below, that it would be valuable for the IAIS to do an analysis of the macro-prudential, financial stability, financial inclusion, and customer protection implications of the increasing trend of forcing localization of reinsurance.

Market development is adversely affected by limiting the use of cross-border reinsurance

- By excluding or severely limiting the participation of international reinsurers in their markets, countries forfeit the benefits of **international expertise, experience and innovative insurance products** for businesses and individuals that international reinsurers can provide. In particular complex lines of business that support economic growth – including export, business interruption, performance, construction, and liability insurance – are underused in markets that restrict foreign reinsurers, especially in small and medium developing economies.
- Access to international reinsurers also **helps smaller insurers compete with large insurers** for all risks, and thus provides more options for the public to address their insurance needs at a reasonable cost.
- Exclusion of international reinsurers results in **reduced local development of insurance for mortality and morbidity risks**. This development requires a major financial investment in the initial phase: training the sales force, underwriting the risk, medical examinations, etc. Life reinsurers around the world are willing, and have the expertise, to provide such capacity in exchange for long-term relationships. However, they now face the risk that sales or the quality of risk are insufficient to recoup the capital they invest. International life reinsurers are able to take on those risks based on their extensive experience and sophisticated assessment of the product, the market and the mortality or morbidity expectations.
- In life reinsurance, **longevity risk** requires sophisticated financial tools to be managed properly. Only those reinsurers with a global scope are able to provide adequate protection for the risk of living longer than expected. Such products are needed as part of retirement planning and should remain available.

Negative economic consequences of limiting the use of cross-border reinsurance

- **Reinsurance provides a global risk transfer mechanism.** Its fundamental purpose is to spread risk so that it is not concentrated in one jurisdiction or with just one company. Reinsurance improves cost efficiency where the reinsurer has a large portfolio of similar but uncorrelated risks and thus, lower fluctuation of claims and lower volatility costs.

  Under a regime requiring mandatory minimum cessions to local reinsurers, the size of the portfolios of similar uncorrelated risk is limited as a consequence of scale and by not providing geographic diversification. The exclusion of global reinsurers results in both concentration of risk and higher costs for the industry and consumers to manage these risks. Reinsurance is most effectively conducted as an international business transaction.

- Recent catastrophic experiences in Japan, Chile, Malaysia, New Zealand, Thailand, and the Philippines illustrate the **difference in terms of economic recovery** between markets that promote the spread of geographic risk and those that concentrate risks in the local market. Reports by leading economists show a net increase in economic activity in markets that allow cross-border reinsurance following extreme events because quick loss-payments that flow from outside the country speed up recovery and prevent economic stagnation[1].

- The expected **increase of extreme climate-related events** means effective risk diversification is crucial for the financial health of the risk carriers exposed to those events.

- The claim that restricting the use of cross-border reinsurance results in a short-term improvement in a country's balance of payments is difficult to substantiate. Reinsurance is used mainly to protect policyholders from severe events that are expected to occur only once every several years; as a result, proper calculation of potential foreign exchange gains is only possible over a long period of time during which insurance coverage remains constant. In this light, **any short-term assessment of the balance of payments implications of reinsurance will be not only tricky but inconclusive**.

Increased vulnerability in the insurance sector and negative financial stability consequences.

- Reinsurance transfers insurance risk into credit or counter-party risk, with the reinsurers assuming the risk. Thus, restricting reinsurance to local reinsurers results in **diminished financial strength of the available reinsurers**. As a result, the counter-party exposure in the local insurance industry increases. Forfeiting the international and extensive experience of professional reinsurers in favor of local (often nascent) reinsurers or politically selected domestic reinsurers creates vulnerabilities in the market.

- In the event of a large claim, the whole market, including local reinsurers, may be affected. In such a case, a fast claim payment protecting the liquidity of those reinsured may not be possible due to the financial stress on both the insurers and the local reinsurers. Disallowing or discouraging the use of international reinsurers creates **systemic vulnerability** in the country:

  - The risk remains in the country, lacking geographic diversification;
  - Any operational risks that may affect the national reinsurer will affect the whole industry, and not only those participants that are reinsured by the reinsurer subject to the risk.

[1] BIS Working Papers No 394: Unmitigated disasters? New evidence on the macroeconomic cost of natural catastrophes: http://www.bis.org/publ/work394.htm

- Large local claims, investment defaults, and any macroeconomic weakness will impact the entire industry, including the local reinsurers.

Impact on observance of IAIS ICPs

The restriction of cross-border reinsurance results in the **non-observance of several of the IAIS ICPs**. Fourteen of the 26 ICPs could be affected (***see Appendix II***). These include the following:

- Restrictions on reinsurance are inconsistent with the primary objective of supervision, which is to promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders.
- The ICP standard on portfolio transfers during a reinsurance transaction requires that the supervisor is satisfied that the interests of policyholders, of both the transferee and transferor, are protected before the supervisor approves the portfolio transfer. Given the vulnerability of some local reinsurers, this ICP standard cannot be fulfilled in jurisdictions where forced domestic retention applies.
- Another ICP standard states that, “the supervisor requires that cedents have reinsurance and risk transfer strategies appropriate to the nature, scale and complexity of their business, and which are part of their wider underwriting and risk and capital management strategies.” This standard will be very hard to observe in any environment that restricts reinsurers. A centralized decision on the level of reinsurance cessions and choice of reinsurers does not comport with the insurers’ key strategy goal to transfer risk.

Conclusion

Hopefully this elaboration of concerns can help inform the IAIS on the threats of requiring domestic retention of reinsurance risks, and can serve as a basis for analysis at IAIS level. These risks also jeopardize core objectives of the FSB and G-20, and GFIA believes that a convincing analysis of this topic by the IAIS could alert the FSB and G-20 to the significance of this negative trend.

ANNEX II: Summary of Impediments in the Observance of the Insurance Core Principles

Insurance Core Principle (ICP)	Violation
ICP1 - Objectives, Powers and Responsibilities of the Supervisor	1.3
ICP2 - Supervisor	2.4,2.5,2.7,2,12
ICP3 - Information Exchange and Confidentiality Requirements	3.3
ICP4 - Licensing	4.3, 4.7
ICP5 - Suitability of Persons	5.2, 5.5, 5.6
ICP6 - Changes in Control and Portfolio Transfers	6.2, 6.7, 6.10
ICP7 - Corporate Governance	7.0, 7.3,7.4,7.10
ICP8 - Risk Management and Internal Controls	8.0, 8.2
ICP9 - Supervisory Review and Reporting	9.0, 9.5
ICP10 - Preventive and Corrective Measures	10.2
ICP11 - Enforcement	11.0, 11.4, 11.5, 11.6, 11.10
ICP12 - Winding-up and Exit from the Market	
ICP13 - Reinsurance and Other Forms of Risk Transfer	13.0,13.1,13.5
ICP14 - Valuation	14.3,14.6,14.11
ICP15 - Investment	15.3,15.4,15.5
ICP16 - Enterprise Risk Management for Solvency Purposes	16.4,16.6,16.8,16.11
ICP17 - Capital Adequacy	
ICP18 - Intermediaries	
ICP19 - Conduct of Business	19.7
ICP20 - Public Disclosure	20.1,20.10
ICP21 - Countering Fraud in Insurance	
ICP22 - Anti-Money Laundering and Combating the Financing of Terrorism	
ICP23 - Group-wide Supervision	23.2,23.3,23.4,23.5
ICP24 - Macroprudential Surveillance and Insurance Supervision	24.0, 24.5, 24.7
ICP25 - Supervisory Cooperation and Coordination	
ICP26 - Cross-border Cooperation and Coordination on Crisis Management	26.0
Aggregate Level: Observed (O), largely observed (LO), partly observed (PO), not observed (NO), not applicable (N/A).	