

EU Reinsurance Directive

■ **To those not working in reinsurance or involved in buying reinsurance the EU Reinsurance Directive probably seems of marginal interest at first glance. Reinsurance is the transfer of insurance risk from one insurance business to another and it occurs in both life assurance and general insurance sectors.**

At one level there is a specialist industry of pure reinsurers; many are global players who pool risks, provide risk assessment expertise, offer cost efficient structures for housing risk and in many cases provide financing to enable direct companies to continue to write new business.

However, reinsurance isn't limited to pure reinsurers; most UK insurance groups consist of a number of separate insurance companies, often the by-product of mergers. Reinsurance is also used as a tool within groups to pool risk or investments and provide efficient capital structures to operate under. This is reinsurance business as well.

Why is a directive needed?

The existing EU insurance directives do not cover reinsurance even as part of an insurance group. Within the EU very few countries regulate pure reinsurance business at all. The UK provides comprehensive prudential regulation equivalent to that of direct writing insurers via the FSA. Outside the EU the US provides a comprehensive regulation of reinsurers; elsewhere there are varying degrees of regulation.

For the EU this is unsatisfactory:

- It is not consistent with a single market in financial services. Reinsurance is one of the few remaining wholesale markets that are not regulated on a pan European basis.

- The EU is disadvantaged in World Trade Organisation negotiations relating to mutual recognition of reinsurers. For example the US currently requires the establishment of trust funds in respect of US business written.

What is proposed?

The main purpose of regulation is to ensure a company maintains adequate means to meet its liabilities. For insurance or reinsurance this is a combination of how the technical provisions (the liabilities established for claims payments) are calculated and the extent that solvency capital is held over and above provisions to provide a cushion for unexpected adverse events. These are very similar concepts to those faced by the banking sector. Reinsurance introduces a further issue of how to allow credit for these in respect of business reinsured to another party.

In simple terms the current proposals say that reinsurance should be treated in exactly the same way as insurance. They also force mutual recognition by regulators within the EU on the basis of home state regulation.

General critique of the directive

EU directives in general set minimum standards not universal standards; national governments can and often do 'gold plate' the rules.

The proposed directive will make things more equal and afford greater protection to insurers and ultimately their policyholders to the extent reinsurance is used; however, it will not create a completely level playing field in the EU. It would seem that regulatory arbitrage is here to stay at least until other developments come into play.

Specific concern in relation to life reinsurance business

However, the UK industry, through the Association of British Insurers, and the European industry, through the Comité Européen des Assurances, have a specific area of concern in respect of the life reinsurance sector.

Life reinsurers do not write the same business mix as the direct writing companies they serve. Their business is predominantly protection business that tends to be heavily impacted by solvency requirements that relate to the Sum At Risk (SAR – the face value of the risks being carried less technical provisions held in respect of them). In contrast most direct writers have a mix of protection business and investment business (bonds, pensions, savings plans, and mortgage endowment) where the face value tends to be lower and is often very close to the value of technical provisions so generating very little SAR. The table below contrasts the key proposals of the directive with those currently ruling in the UK, one of the most heavily regulated regimes for life reinsurance.

Current UK rules acknowledge that the nature of reinsurance business is to pool risks and thus reinsurers need to be able to pass a large part of the risk on to a group pool company or share risk with other reinsurers. To assist in this they allow a high level of credit to be taken for both technical provisions and solvency capital; more so than for a direct writer.

Theory suggests that the more diversified and the larger number of risks you pool the smaller the variation in expected outcome. Thus a reinsurer can typically justify a lower solvency capital margin on both grounds. Studies have shown that for most reinsurers a

David Rawlings discusses why the EU Reinsurance Directive is relevant to more than those working in reinsurance.

0.1% of SAR is an adequate buffer for any one year of variation around an expected outcome. The proposal is three times this.

The potential consequences for the life reinsurance sector are two fold if the current proposals materialise. In the short term there will be an immediate requirement for additional capital because these rules will apply to 'in force' business that is supported by lower capital requirements at present. Longer-term, rather than encouraging growth through opening up a single reinsurance market, it might well have the reverse effect. There is also a distinct threat of loss of business to competition from outside the EU. For direct writers and consumers, in the UK at least, it can only mean higher prices for life protection products.

An alternative approach

Prior to the current draft, discussion had taken place on alternative means of assessing the necessary solvency capital for life business. Solvency margins are primarily in place to absorb a one off unexpected hit while technical provisions are designed to reflect current best

knowledge of the risks involved. Thus should a company have under priced its products or find that claims experience on a long-term product is deteriorating unexpectedly, technical provisions should be adjusted, not additional solvency margin held. It is therefore reasonable to argue that a better way to assess solvency margins for life protection business would be to base the requirement around a percentage of premiums or claims as is proposed for non-life business.

What else does the future hold?

A lot of things are coming together in the world of insurance reporting and we should not look at the directive in isolation from the development of International Accounting Standards (IAS) and EU solvency II capital requirements.

IAS is slowly heading towards a fair value view of technical provisions along with the rest of a company's balance sheet. Much of what we currently have under UK Companies Act and UK regulatory reporting is far from 'best estimate' or 'fair value' and certainly not

derived from a basis consistent with other International Financial Reporting Standards. We should be looking to a world where a common set of principles underpins technical provisions across the main insurance and reinsurance markets for both published and regulatory reporting. The emphasis of solvency II is to explicitly relate solvency requirements to business risks in a consistent manner. The FSA is already heading in that direction with the concept of individual capital assessments that become mandatory at the end of 2004.

If both the above were combined it would be difficult to argue that the rules were unfair to any one sector. It would be helpful if interim reinsurance directive proposals were a step in that direction and did not disrupt the market. ■

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	EU Proposed	Current UK
Rules on technical provisions	Some minimum standards	Detailed prescribed rules, prudence in every assumption
Reinsurance credit for technical provisions	Max 50% as for insurers	Max 85%
Rules for minimum solvency requirements	Minimum 3m Euro. 0.3% Sum At Risk +4% technical provisions	Minimum 3m Euro. 0.1% SAR +4% technical provisions
Reinsurance credit for solvency requirements	Max 15% as for insurers	Max 50%