Draft EU Directive

on

Reinsurance Company Supervision

- The Belt & Braces Approach -

Commissioner to reinsurer: of course you are risking and often loosing your shirt for madame, but I insist your trousers must always stay properly in place.

Final thesis presented by C.P.R. Thomas
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Æqui-£ibria Associates S.A.
3, rue des Roses
L 7335 Heisdorf / Luxembourg
tel. +352 335992 / +1 (718) 928-5539
fax. +352 337509
Philipp.Thomas@aequi-libria.com
mob. +352 91 634 098 / +61 410 628485

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0 Executive Summary

Following a period of crisis in the reinsurance industry caused by underpricing and reserving issues emerging around prior acceptances of US asbestos exposures, there is currently a perception that the European reinsurance industry could benefit from a standardised regulatory approach. Whereas as from 1973 the EU has been creating a level playing field for direct insurers, substantial differences in regulatory frameworks persist regarding reinsurers. Since 1964 an internal market for reinsurance exists, both regarding freedom of establishment and freedom of services, but the rules to which reinsurers are subjected at head office level vary from one Member State to another.

The EU Commission has presented a draft directive that aims to standardise the Member State supervisory approach. The question arises whether there is a genuine need for yet another piece of regulation, in particular since financial markets are now increasingly policed by rating agencies and as direct insurers, buyers of reinsurance are already tightly controlled.

This paper reaches the conclusion that

- Most of the volatility of the reinsurance industry is not caused by its own technical inability or undercapitalisation but by claims phenomena arising from the US insurance markets (such as asbestos, mould and the WTC event)
- Systemic risk in the reinsurance industry would thus best be reduced by forbidding the acceptance of any North America related risks
- There is no objective need for a directive and that in the interest of economic efficiency of the reinsurance industry it would be best if the draft directive were not adopted by the EU Commission.
- The EU Commission itself admits that the Directive is based on a "fast-track approach" and will initially make an obsolete solvency standard (mere %age of premiums and paid claims rather than a state-of-the-art risk based capital adequacy system) applicable. There appears to be little point in hastily introducing half-baked and scientifically unfounded principles and shortly afterwards again replacing them, at both time creating regulatory compliance costs for the industry.
- Should the directive be nonetheless adopted, there is a risk of legal challenge both by Member States with a substantial reinsurance industry and by individual reinsurers (national court procedure against national decisions possibly involving the need for the national court to seek a preliminary ruling as per Art. 234 par. 2).

1 Scope of this paper

This paper takes the following approach:

- Demonstrating the overall economic context and significance of the insurance and reinsurance industries
- Discussing major cases of insurer and reinsurer insolvency (trigger for the current draft directive)
- Describing the existing regulatory situation in major EU countries in respect of reinsurance
- Reviewing existing EU regulation of the direct insurance industry (model for what is to happen to the reinsurance industry)
- Presenting current projects for international regulation of the reinsurance industry
- Summarising the EU's draft reinsurance directive
- Weighing the pros and cons of standardised regulation of the reinsurance industry in the sense of a cost/benefit analysis, particular emphasis being placed on the alleged risk of systemic collapse
- Explaining potential avenues for legal challenge to the directive

Overall, the questions, which are being examined, are:

- Is there a serious problem of financial stability emanating from the European reinsurance industry?
- Is the current regulatory approach taken in the EU to direct insurance a suitable model for regulation of the reinsurance industry?
- Are there alternative regulating mechanisms which should be weighed against a coordinated EU regulatory approach (IAIS/rating agencies)

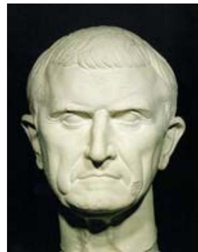
It is in this light that this paper attempts to verify whether the draft EU directive appears a suitable tool to address a problem the magnitude of which is not evident.

2 Introduction: The Economical Context

2.1 History of Insurance

The purpose of insurance is risk transfer from the original risk owner onto a specialist organisation. The consideration for the risk transfer is a premium. Sometimes insurance is also viewed as a sort of option which allows the policy-/optionholder in case of a loss to transfer that loss onto the insurer.

2.1.1 In Roman Days



Notorious was **Marcus Licinius Crassus,** b. 112 B.C., d. 53 B.C. a member of the 1st triumvirate with Caesar. He set up his own fire brigade of 500 men. They would only extinguish fires once Crassus had purchased the building at a bargain-basement price. Hence the suspicion he might have been involved in arson.

Crassus died in battle against the Parthians. His head was cut off & filled with liquid gold as belated punishment for his particular greed.

2.1.2 Lloyd's

Lloyd's is not actually an insurance company but a mere (less and less) self-regulating market place. It started in 1688 at the eponymous coffee house of Edward Lloyds in London. Lloyd's as an institution was incorporated by Act of Parliament in 1871. Underwriters initially only wrote marine insurance, the first non-marine insurance was written in1887. Lloyd's continues to occupy a vanguard market position in marine, aviation and a number of niche areas, e.g. kidnap & ransom, bankers' blanket.

Lloyd's does not distinguish between direct insurance and reinsurance (in fact nor does the regulatory agency Financial Services Authority). About half of the £14b in annual premiums going into Lloyd's are in respect of reinsurance.

2.1.3 United Kingdom (non-Lloyd's)

Whereas Lloyd's until late in the 19th century stayed out of non-marine insurance, fire insurance was the domain of insurance companies outside of Lloyd's. The need for insurance was demonstrated in 1666 when the Great Fire of London occurred. Subsequently a number of fire offices were established which often maintained their own fire brigades, amongst them:

- 1710 Sun Fire Office
- 1845 Royal

Fire marks on buildings were needed to identify insured buildings for fire brigades.

The 19th century saw the expansion to the US and the colonies.

2.1.4 Continental Europe

Milestones in the development of fire insurance were

- 1676 establishment of Hamburger Feuerkasse, oldest insurance company worldwide
- 1836 Provinzial Rheinland founded by charter signed by Prussian King Friedrich Wilhelm III

In about half of all continental European territories, fire insurance was not left to the private sector but underwritten by government entities working along the following principles:

- Compulsory insurance, in particular for buildings (less so for contents), hence very low marketing cost
- Regional monopoly
- Little premium differentiation according to risk characteristics
- Linkage via joint distribution channels to government sponsored savings banks

2.1.5 Health, pension, workers‘ compensation insurance

1878 saw the introduction of social insurance by German Chancellor Bismarck. A mixture of paternalism and a desire to weaken the socialist opposition motivated him. These insurances in most States became the preserve of the national government as ultimate risk carrier. These systems were flawed from the beginning by being essentially unfounded, present governments are now faced with the dilemma of having to find funds for the sins of the past.

2.1.6 Substitution by alternative products

Insurance risk is nowadays also absorbed by the bond markets (e.g. catastrophe bonds where the repayment of principal and/or interest is contingent upon the non-occurrence of a predefined catastrophic event. Also, there are derivative contracts under which payments are triggered in case specified claims events occur.

These contracts which serve a similar purpose as direct insurance are typically taken out via Special Purpose Vehicles in offshore locations. They are essentially unregulated. Reinsurers are often major participants. SCOR for instance compounded its problems by having been an active participant in this market.

2.1.7 Recent Major Losses

The insurance industry is subject to considerable fluctuations in claims frequency and severity, e.g.

- Hurricanes in the US
- European winter storms
- Earthquakes in Turkey
- Non-terrorism caused crashes of commercial airliners

However, in addition it also manages to pick up exposures, which at the time did not exist in the mind of the underwriter and for which typically no proper price has been charged. Such unforeseen losses usually appear to originate in the US:

2.1.7.1 WTC 11.9.2001

The economic loss is estimated between US$ 80 and 100 billion, thereof US$ 40.2 billion insured (territorial split between insurers: 50% in Europe, 40% in the USA and 10% in the Bermudas)[1].

Initially, it appeared that insurers might in many instances escape liability due to the exclusion of war risk. However, in spite of initially having labelled the attack one on the US and despite NATO having invoked Art. 5 of its Charter, US insurers were rapidly persuaded that as a matter of patriotism they were expected to pay up.[2]

2.1.7.2 US Asbestos Liability Claims[3]:

During the period 1940 to 1979 some 27 million US workers (only counting those working in typical at-risk industries) were exposed to asbestos. Until the year 2000 there were 600.000 claimants (but many simultaneously claimed from several defendants) facing 6,400 defendants (of whom already 67 bankrupt). The claims cost to date amounts to US$ 54 billion, thereof US$ 22 billion form US insurers, US$ 10 billion from non-US insurers and US$ 22 billion uninsured. However, claims cost still likely to surface is estimated at between US$ 145 and 210 billion. 65% of all payments currently are being made to claimants still without symptoms („nonmalignant“), typical for the often bizarre legal system in the US.

In particular US insurers appear to be tackling the resulting problems in respect of their own reserving and balance sheet position on a pay-as-you-go basis, i.e. by maintaining only claims reserves sufficient for a couple of future pay-out years.

However, some US insurers are now willing to face reality: During the 3rd quarter 2002 Allianz Insurance injected US$ 762 million into the reserves of its US

[1] http://www.swissre.com/, The Impact of a new large-scale Terrorism Attack on Insurance, Reinsurance and the Economy, Rede vor dem World Economic Forum in Davos Jan. 2003, Swiss Re's Chief Financial Officer, John H. Fitzpatrick

[2] INSURERS: WTC ATTACK NOT ACT OF WAR, http://www.sure-net.com/board/messages/480.html

[3] http://www.litigationfairness.org/pdf/asbestos_rand.pdf, Studie der Rand Corporation Jan. 2003 im Auftrag der U.S. Chamber of Commerce

subsidiary Fireman's Fund[4]. ACE during the 4th quarter of 2002 featured a claims reserve for net account amounting to US$ 354m which, however, for gross signified US$2.18 billion in additional claims reserves; of the US$ 1.86 million of reinsured claims 1/3 was borne by Berkshire Hathaway[5]. It appears that the more solvent US insurers are presently increasing their reserves to the technically indicated level, not least to force their less well capitalized competitors out of the market who face pressure to follow suit but are not able to do so.

Asbestos claims are not, however, limited to the US. The phenomenon appears to be manifesting itself in the UK as well.[6]

2.1.7.3 Mould

The highly creative US plaintiff's bar has discovered mould (which is prevalent in humid and badly ventilated spaces and which can cause allergies) as a new major class of litigation. In 2001, in Texas alone some 50,000 claims were filed, the pay-out was US$854m[7]. Frequently, the claims are further increased by "bad faith" claims against insurers who allegedly have dragged their heals over settlements. Famous is a Texas judgment where the owner of a mansion was awarded a total of US$32 million.

There are estimates that toxic mold might cost US insurers between US$ 10 and 60billion.

[4] http://www.allianz.com/Az_Cnt/az/_any/cma/contents/74000/urlObj_74491_allianz_3._Quartalsbericht_d.pdf, Bericht 3. Quartal S. 3
[5] http://www.businessinsurance.com/cgi-bin/news.pl?newsId=1912, Business Insurance 27.1.2003 ACE boosting asbestos reserves by nearly $2 billion
[6] Court case over asbestos insurance starts today, Financial Times 27.1.2003, p. 4
[7] Testimony By Gordon Stewart President Insurance Information Institute
New York, New York Before The House Financial Services Subcommittee On Oversight And Investigations And Subcommittee On Housing And Community Opportunity
http://financialservices.house.gov/media/pdf/071802st.pdf

2.2 Insurance as an Economic Factor

Global premium volume in 2002 amounted to USD 2 627 billion, of which USD 1 536 billion was attributable to life insurance and USD 1 091 billion to non-life insurance.[8] Non-life premium growth was 9.2%, only partially explained by expansion of the world economy but primarily by sharp price increases following a period of insufficient pricing.

Almost 40% of the world insurance market premium-wise are found in North America, 32.4% in Europe (all countries, not just EU), 23.8% in Asia (thereof 17% in Japan).

On a premiums-per-capita basis, Switzerland ranks No. 1 at US$ 1,822, the US No. 2 at US$ 1,799. The insurance market as compared to GDP stands at almost 5% in the US, similar levels are achieved by other highly sophisticated societies. Generally, there is a highly positive correlation between the size of the insurance industry of a country and its degree of development.

The relevance of the insurance industry in an overall economical context stems from the following:

- Mechanism for risk transfer within society. Only risk reduction at the level of the individual economic entity to an acceptable level make it possible for certain risky activities to be undertaken. As an example, in the absence of property insurance banks would be a great deal more hesitant to finance real estate via granting mortgages.
- Accumulation of a considerable part of the saving of a society and allocation thereof to the capital markets (in 2002 with disastrous results to insurers' solvency margins)
- An instrument through which substantial taxes can be levied. In many EU countries, insurance premium taxes are around the 20% of premiums mark. This allows for the highly effective levying of taxes on economic activities.
- Substantial employer

[8] World insurance in 2002: high premium growth in non-life insurance, Swiss Re Sigma, www.swissre.com

2.3 Function of Reinsurance

Reinsurance is a sort of surrogate capital which supplements the direct insurance industry's own capitalisation. The reinsurance industry consists of wholesalers behind the direct insurance industry.

The following table[9] compares the relative size of ceded reinsurance and gross premiums:

US$ b, 2001 numbers	**Life**	**Non-life**
Gross premiums	1,439.2	969.1
g.p. excluding savings element	214.4	952.1
Ceded premium	24.4	129.5
Ceded as % of g.p. excl. savings	11.4%	13.6%

However, these percentages are not indicative of the relevance of reinsurance to direct insurers. Reinsurers get involved in the following situations:

- To created reasonably homogenous net retained portfolios by accepting individual large risks
- To offlay exposure to natural catastrophes
- To finance the acquisition cost of new multi-year portfolios where initial high upfront commissions are contrasted by low following commissions to agents or brokers; this is prevalent in life insurance
- To supply specialist knowledge, typically regarding pricing, legal wording, loss control. Examples are engineering insurance and underwriting sub-standard (i.e. medically impaired) life insurance risks.
- Training for ceding companies, a service normally not yet unbundled and separately billed for

[9] SwissRe Sigma 5/2003, Reinsurance – a systemic risk? P. 11

2.4 History of Reinsurance[10]

The earliest record of a marine reinsurance contract relates to a part of a voyage from Genoa to Sluys at the end of the Middle Ages. In 1681 an Ordinance of Louis XIV specifically decreed it legal for an insurer to reinsure risks taken on for gross account. This principle had already been mentioned in the Guidon de la Mer published in Rouen before 1546. Between 1746 and 1864 reinsurance was actually forbidden in the UK.

Fire reinsurance as a practice started much later. In 1826 Guardian Assurance offered a risk to the Royal Exchange (the latter's Court of Directors declined the offer).

In 1846 the first continental reinsurer was established: Kölnische Rück (now part of General & Cologne Re, in turn owned by Berkshire Hathaway, a US conglomerate).

Reinsurance typically involved the acceptance of risks from other jurisdictions. This lead to particular problems whenever hostilities erupted between the country of domicile of the reinsurer and that of the reinsured. The 1919 Versailles Peace Treaty[11] specifically contained provisions dealing with the effective date of termination of reinsurance cessions. Similar problems again arose on the occasion of the World War II.

Reinsurance used to be the preserve of continental European and London based dedicated "professional" reinsurers. However, since about 1990 there has been a wave of liquidations and failures of these traditional reinsurers and simultaneously a wave of creation of new, much larger and much better capitalised reinsurers, mostly located in the Bermudas.

[10] Pfeiffer, Einführung in die Rückversicherung, p. 18ff, 4th edition, Wiesbaden 1994
[11] Annex 20 to Art. 303, quoted from http://www.lib.byu.edu/~rdh/wwi/versa/versa9.html

2.5 Differences between Direct and Reinsurance

Since the current EU directives applicable to the insurance industry specifically exempt pure reinsurers, the question arises what the differentiating factors between direct insurers and pure reinsurers may be. A secondary question will be whether differentiation in line with these criteria appears appropriate.

2.5.1 From a Legal Perspective

A reinsurance contract can by definition only be concluded by a licensed insurer as buyer. A non-insurer cannot have direct access to the reinsurance market. However, there are approaches, which subvert this principle:

- Fronting: there is a direct contact between the policyholder and the reinsurer and one of the parties arranges for an otherwise uninterested direct insurer to act as a mere conduit for a policy which he issues but reinsures 100%
- Cut-through clause: in spite of the principle of privet of contract, such a clause permits the policyholder to seek direct payment from the reinsurer. This is particularly relevant in situations where there is a fear that the interposed insurer might fail.

2.5.2 From an Economical Perspective

A distinction needs to be drawn between:

- Reinsurance of an individual risk by way of "facultative reinsurance": this is rather similar to direct insurance, i.e. risk transfer takes place in respect of a single risk
- Reinsurance of an entire portfolio of risks by way of proportional "treaty" reinsurance: here, the reinsurer is not particularly concerned with individual claims affecting individual reinsured policies. His focus rather is on
    - The pricing of the reinsured portfolio (net of the ceding commission going back to the ceding company
    - Risk selection by the ceding company (avoidance of anti-selection)
    - Likelihood of catastrophe scenarios, in particular due to conflagration fires and natural perils
- Reinsurance of an entire portfolio by way of non-proportional reinsurance: here, the reinsurer essentially distances himself from the original pricing practiced by the ceding insurer and applies his own pricing, a function of the estimated "pure" or risk premium, his own capital and administration cost and of the current phase of the overall market (be it "hard" or "soft").

2.5.3 No direct contact with policyholders, in particular under personal lines

Whereas direct insurers frequently have hundreds of thousands of customers (in particular in classes such as homeowners, householders, motor, health and life), reinsurers may be dealing with only a couple of hundred ceding companies.

Reinsurers are only indirectly exposed to claims arising out of direct policies. Normally by way of privity of contract, a direct policyholder may not claim against his insurer's reinsurer (the exception being the so called cut-through clause which is frequently found under industrial insurance policies).

2.5.4 More international than direct business

Direct business tends to be of a primarily local nature. This in particular applies to the bulk of personal lines (e.g. homeowners, householders and motor classes) but also to medium sized commercial risks. Only multi-national industrial risk covers are of an international nature.

By contrast, reinsurance usually involves an international mixing of risk exposures, not least in order to create a portfolio of hopefully uncorrelated risks and thus to ensure an efficient use of capital (the required capital relative to exposing risks reduces as non-correlating risks are added to the portfolio).

2.5.5 Greater exposure to vagaries of US tort law

A significant portion of reinsurers' premiums (most operate on a worldwide basis) and an even larger portion of their claims reserves stem from the United States. This greatly exposes them to the litigiousness of the US society. In respect of this type of account, past claims experience is of little value when predicting the ultimate cost of claims for which a reinsurer remains liable.

The current US administration is trying to introduce some form of tort reform [12](capping punitive damages, making class actions more difficult, channelling cases to particular courts etc.), but it is more than doubtful whether this will ultimately be successful. Underlying appears to be a political struggle between two factions of US society for power and influence:

- Big business (pro-Republican)
- Trial lawyers (pro-Democrats, and major campaign contributors to boot)

The insurance and reinsurance industries are mere pawns in this battle.

2.5.6 Larger risk of error

In many lines of direct insurance, there is a well-founded statistical experience, which makes pricing errors rather unlikely. However, reinsurers deal with considerably more exposed risks for which no secure pricing parameters exist. It is e.g. much easier to calculate the risk premium on a motor own damage portfolio (many well balanced risks, years of statistical experience) than to predict the return period and the insured loss under a say magnitude 7 earthquake affecting a particular region.

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[12] Ripe for change, The past year has seen the recovering re/insurance industry coping with both tort reform and reserving for past year losses. But will the coming year bring the necessary changes?, Simon Ross, The Review, WorldWide Insurance Dec/Jan. 2003/4, p. 6

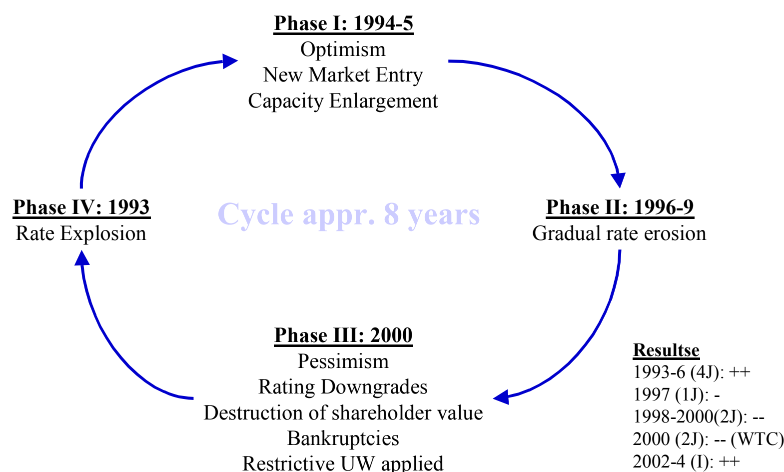
The much larger risk of pricing error should entail a much greater capital requirement, something that ought to be reflected by the pricing. Only now are reinsurers starting to plough most of their hard market profits into prior year reserving.[13]

2.5.7 Cyclicality more pronounced than in direct business

The insurance market remains exposed to irrational pricing cycles, in particular as regards commercial/industrial insurance and reinsurance. (personal lines are a great deal less volatile). What causes cycles:

- Perceived profitability attracting new capital to the industry (which has low barriers to entry)
- New entities competing for the same business, driving prices down
- Management having committed to deliver a particular business volume, desperately trying to stick to the business plan (no matter how ultimately ruinous) as they prefer to be sacked in 3 years because of lacking profitability rather than immediately because of insufficient top line growth)
- Camouflaging of the true level of profitability by releasing over-reserving from prior years and by under-reserving for the current year
- Finally, realisation of what has been going on
- Elimination of the weaker players, capacity crunch
- Back to the starting point

Cyclicality or
The Inability to Learn from the Past



Personal lines are a relatively stable account, in particular in countries where

- Multi-year policies are still the norm
- Intermediaries play an insignificant role (they typically ensure transparency of the market place, cause policyholders to shop around and encourage the "churning" of policies)

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[13] The haunted year: 2003 will be remembered not for strong growth in non-life premium levels but for the extra reserving for prior years business. It will take some sound decision-making in 2004 to stop investors becoming cynical about further announcements, The Review Dec/Jan 2003/4, p. 9

However, this does not apply to large industrial lines and to reinsurance.

2.5.8 Longer claims reserve gestation period

Reinsurance tends to involve cessions characterised by considerably delays between premium receipt and pay-out of claims. On one hand, this signifies a longer period during which investment income can be derived from insurance funds (premium- and claims reserves; alas at the prevailing 2 to 4% returns on invested funds investment income has become almost irrelevant compared to the situation during the late 1970s), but on the other hand, it means that the reinsurer remains exposed to the vagaries of business written decades ago. Examples would be:

- Liability (motor/operations/product)
- Aviation liability
- High layers of property excess of loss protections

Thus, a reinsurer runs the risk of writing business at what later turns out to be an uneconomic level of premium for years before the results under the first underwriting years are known and it is possible to increase future rates. Social phenomena (such as increasing longevity of accident victims, better health care) and legal developments (increasingly litigious society, introduction of contingency fees for plaintiffs' attorneys, class actions) might affect business written during the last 20 years.

2.5.9 When facing the brink temptation to decline liability on technical grounds

During times of most likely adequate tariff (=cartel) regulated original premiums, reinsurers were likely to honour all valid claims. However, during periods where they are fighting for naked survival, reinsurers will use a fine comb to go over claims which whilst they were still a going concern would have been paid as a matter of course. Often, they will even be tempted to refuse claims on spurious grounds.

Typically raised issues, which may justify declining a claim, are:

- Non-disclosure by the ceding company of material facts at the time of acceptance
- Different interpretation of the treaty wording
- Ceding company operated the cession in a fashion not covered by the wording
- Breach of warranty

Rating agencies are recognising this phenomenon by basing their counterparty ratings not only on "ability to pay claims" but also on an accompanying "willingness to pay".[14]

2.5.10 Increasing propensity to litigate

Reinsurers who have gone out of business are no longer interested to protect their reputation in the marketplace. They hence have no qualms to face their ceding company in front of either a civil court of an arbitration tribunal. Matters are often

[14] Syposium sets the tone, The ReBrief BadenBaden 2003, p.1, quoting Chris Klein, head of counterparty risk at Benfield Greig

further complicated by conflicts between different jurisdictions, which lead to anti-suit injunctions (seeking a court order preventing the adversary from filing a counter suit in a different jurisdiction).

Typically, reinsurers in run-off will only pay 70% of claims presented to them, and this only if they remain fully solvent.

2.5.11 Parent entities will try to dissociate themselves from a failing reinsurer

In previous decades, even when a reinsurer failed, a ceding company often still had the hope that the reinsurer's parent entity would feel honour-bound to make good. Quite often the reinsurer's parent would in prior years have created the impression of there being an implicit parental guarantee, something often also taken into consideration by rating agencies. However, it is nowadays normal and quite accepted that parent entities will quietly walk away from their failing reinsurance subsidiaries. This has for instance occurred with

- Nederlandse Reasekurantie Groep, a subsidiary of banking/insurance giant ING
- Gerling Global, a subsidiary of direct insurance group Gerling Konzern Beteiligungen
- Copenhagen Re, a subsidiary of Danish insurance group Alm. Brand

2.5.12 Barriers to entry increasing

In previous decades, anyone with good relations to the broking fraternity (in particular over a liquid lunch) and able to raise a couple of £ million in capital was able to start a new reinsurer and write a sizeable account. These days are long bygone.

2.5.12.1 Rating de rigueur

Generally, a min. BBB rating is required for a reinsurer to be considered an appropriate contractual counterparty. The Russian Ministry of Finance has per 1.1.2004 adopted this criterion: only cessions to reinsurers rated at this level will be permitted.

Typically, newly created Bermudas domiciled reinsurers are capitalised at an initial US$500m to 1 b. At this level, rating agencies are willing to consider granting an ab initio rating of A, providing

- Management has an excellent prior track record
- The submitted business plan appears realistic
- The probability of ruin is contained

2.5.12.2 Need for advanced modelling, pricing and risk management ability

These talents are required in several contexts:

- Drafting of a credible business plan, probably also involving some stochastic modelling (Monte Carlo simulation approach)
- Appropriate pricing of risks to be taken on board (pure premium, loadings for fluctuation and to ensure remuneration of capital employed)

- Reserving

Whereas in the past reinsurers were run by charismatic globe-trotting bon-vivants, power has meanwhile shifted to actuaries and physicists. Assembling such talent is not only expensive, but the team will also only join an organisation perceived as making an impact in the marketplace and likely to be a future reference in someone's CV.

2.5.12.3 Speed of Market Entry

On the other hand, should e.g. a major broker or an investment bank be able to assemble both the talent and the capital, a new reinsurer can be up and running within about 6 months. This has been demonstrated on several occasions in the past. It is hence possible for nimble capital providers to enter the reinsurance market just after a cataclysmic event (such as WTC), which has caused rates to skyrocket. In principle, this should put a dampener on possible pricing upswings.

2.5.13 Different Development on the Insurance and on the Banking Sides

Whereas on the banking side there has never been a segregation of part of the industry into pure wholesale banking (apart perhaps from the German Landesbanken whose original intention it was to provide wholesale banking services to the Sparkassen of their area[15], but they later abandoned that principle), in particular on the European continent the 19th century has brought a development of pure wholesale reinsurers.

Whilst there are no pure wholesale banks, which might clamour to be exempted from banking regulations, the underlying market situation on the insurance side is different.

[15] for a description of WestLB's economical role:
http://www.westlb.de/index/1,1061,96538,00.html?fSelectedLanguage=2

2.6 Classification of Reinsurers

2.6.1 Major market players

A major player nowadays probably meets the following criteria

- Min. BBB rating by Standard & Poors or equivalent from another rating agency
- EUR 500m in annual premiums
- Capitalisation of min. EUR 250m but more likely 500m
- Specialist know-how

Players in this league include[16]:

Rank	Name	Country of HO	Net written premiums in US$b (non-life only)
1	Munich Re	D	19,814.1
2	Swiss Re	CH	13,502.9
3	Lloyd's	UK	6,842.1
4	Hannover Re (controlled by German mutual HDI)	D	6,278.6
5	GE Global Insurance	US	5,771.0
6	Berkshire Hathaway / General & Cologne Re (the sole AAA rated reinsurer left in the industry)	US	5,486.0
7	Gerling Global Re (meanwhile practically bankrupt)	D	4,563.9
8	Berkshire Hathaway	US	4,117.0
9	SCOR	F	3,964.1
10	Allianz	D	3,635.8
11	Converium (prior to its 2002 IPO: Zurich Re)	CH	3,154.2
12	Everest Re	Barbados	2,637.6
13	Axa Re	F	2,575.6
14	XL Re	Bermuda	2,564.3
15	Transatlantic Holdings (controlled by AIG)	US	2,500.2
16	Partner Re (incorporating the former Winterthur Re and SAFRE in Paris)	Bermuda	2,480.8
17	Tokio Marine & Fire	J	1,936.9
18	China Re	China	1,892.6
19	Odyssey Re	US	1,631.2
20	Sompo	J	1,488.0
21	Ace Tempest Re	Bermuda	1,298.6
22	Platinum Underwriters	Bermuda	1,210.0
23	Toa Re	J	1,077.2
24	Arch Re	Bermuda	1,066.0
25	Korean Re	S. Korea	995.0

In addition, there are niche players concentrating on particular market segments, e.g.

[16] Top 100 Reinsurers 2002, Reinsurance Volume 34, August 2003, page 9ff

- Renaissance Re (specialising in property catastrophe coverage)
- ManuLife (life retrocessions

It is possible for an adequately capitalised start-up to immediately move into this league, as occurs regularly with new Bermudan reinsurers.

2.6.2 Also-rans

A number of reinsurer do not meet these increasingly stringent requirements imposed by the marketplace. Whilst in the past they were still accepted security for minor shares on reinsurance cessions (in particular for non-liability classes the reserves under which have a shorter tail so that the future development of the reinsurer is of less relevance), they are currently finding it increasingly more difficult to attract business. Major handicap is the lack of a rating.

2.6.3 Captives

Captives are defined as reinsurers, which concentrate on writing business emanating from their parent organisation. Since it is considerably easier to have a reinsurer than a direct insurer licensed, most captives are operating as reinsurers and cause their parent group's direct insurance policies to be issued b licensed insurers via so called "fronting". They will then participate in these policies, which may be issued in a variety of territories.

Motivations underlying the creation of a captive may be:

- Retaining a significant part of a group's own risks in a coordinated fashion, in particular at times of relatively high premium levels (hard market)
- Using insurance policies to generate tax-deductible corporate expenses, such often essentially claims-free premiums being collected in a tax-free offshore environment.

Increasingly, captive are being submitted to various tests as to their real substance. These will include

- Whether there is local management (rather than just a management contract with an outside service provider)
- Whether policies are priced at arm's length (i.e. at terms and condition which would also be agreed between unrelated entities)
- Whether a significant part of premiums relates to non-group risks

Due to the need to comply with group home country tax authorities' criteria, the distinction between captive reinsurers and reinsurers operating in the open market is becoming increasingly blurred.

2.6.4 Fly-by-night operators

The reinsurance industry has frequently attracted fly-by-night operators. What they found attractive was the ability to obtain substantial immediate cash flow (premiums)

by promising eventually (3 to perhaps even 20 years in the case of liability insurance) to pay claims. Particularly alarming cases were:

- Dai Ichi Kyoto Re in Brussels (run by fraudsters who created the impression of backing by major Japanese banks, out of business 1995)
- Merrion Re (an Irish reinsurer operating out of the offices of its accountant)
- Ardenia (a Luxembourg reinsurer whose assets were suddenly swapped against South American mining rights, valued at the directors' discretion, bankrupt 1993)

2.7 Finite/Financial Reinsurance

During the last 15 years, a new form of "diluted" reinsurance has become quite prevalent. Typically, such contracts

- Are written by a single reinsurer rather than by an entire panel
- Are of a multi-year nature
- Feature automatic price adjustment mechanisms, e.g. essentially a repayment of claims made via future premiums and a refund of excess profits to the ceding company
- Require the maintenance of an "experience account" which is monitors all cash flows between the parties, plus interest, the reinsurer de facto operating a "bank" for the ceding company.

The following definitions apply:

- Financial reinsurance: a contract which is labelled "reinsurance" but does not feature sufficient risk transfer for it to be treated as bona fide ceded reinsurance in the ceding company's accounts
- Finite reinsurance: a contract which includes less risk transfer than traditional reinsurance but which still meets the minimum risk transfer criteria.

It is not always clear where a particular contract is situated on the continuum of types of reinsurance:

From Full to Zero Risk Transfer

full risk transfer	reduced risk transfer by way of sliding scales, profit commission, loss participation etc. not exceeding 50%	**finite:** some risk transfer as only 50% to 90% profit/loss participation	**financial:** 100% profit/loss participation via experience account

interest part of the experience account calculation

Finite/financial reinsurance has been indicated as a culprit in several insurance company insolvency situations, e.g. Fortress Re and Independent Insurance (cf. below), not in the sense of having created the insolvency but having permitted management to continue in business at a stage when the insolvency should have been declared already.

3 Recent Failures

Failures of insurers are nothing new. In the past, unforeseen accumulation losses have repeatedly brought insurance organisations to the brink. This happened as a consequence of conflagration losses in mid 1800s European cities and again in the aftermath of the 1906 San Francisco Earthquake.

The 1980s saw e.g. the following failures:

- Hamburg International Re. This was a reinsurer controlled by the German Trade Union movement (via Volksfürsorge, their insurer). After a period of hectic expansion to e.g. the US, the London market and Malaysia the company stopped actively underwriting. It was sold to Chiltington, a run-off service manager, who has been able to keep it solvent so far.[17]
- NRG. This Dutch reinsurer had taken over UK reinsurer Victory, a company which turned out be insufficiently reserved, eventually dragging down the acquiring organisation as well.

However, the frequency of these industry mishaps has recently become rather disconcerting.

3.1 Reinsurers[18]

3.1.1 Gerling Global Re

This German reinsurer is the 100% subsidiary of the Gerling Group which was appr. 70% held by the Gerling family and 30% by Deutsche Bank. It appears that Gerling Global for many years was undercapitalised and underreserved, in particular on its book of US liability. Further problems arose out of the ill-conceived acquisition of Constitution Re, a US reinsurer owned by the Agnelli family of Italy. This acquisition occurred in undue haste and without proper due diligence.

On 26.10.2002 Gerling Global stopped underwriting. Apart from its life business which was transferred to a new subsidiary Revios Re (later sold to VHV Vermögensanlage AG) it is presently in voluntary liquidation, but whether it can remain solvent is more than questionable. It has e.g. stopped making payments on a €250m bond which was issued in 2001 via a Dutch subsidiary and which is guaranteed by the reinsurer.

The Gerling group is in the process of divesting itself of this subsidiary. The initially selected acquirer Lago Achte (run by Achim Kann, a former CEO of Frankona Re) is running into regulatory opposition and may need to be replaced by a Dubai based investor, Capital Union which is offering €250m. However, the net asset value of Gerling Global appears to be negative: EUR 50m of shareholders' funds (post reduction) vs. a loss carry forward of EUR 150.4m[19].

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[17] http://www.chiltington.co.uk/CWaboutusframeset.htm
[18] a table of bankruptcies can be found on p. 32 of SwissRe Sigma 5/2003, Reinsurance - a systemic risk
[19] press statement 29.12.2003, http://www.gerling.com/ggre/

One ceding company, DEVK (the railway workers' insurer) had placed 90% of its cessions with Gerling Global. Apparently, Gerling Global commuted its liabilities with DEVK of a face value of EUR 400m for a mere EUR 240m.[20]

3.1.2 London Market

The London market features dozens of reinsurers in run-off. Providing management or legal services to run-off reinsurers is a growth industry. There are established players such as Hampden and Chiltington. The UK courts and arbitration tribunals are clogged up with reinsurance related cases. Whole yearbooks are being published to allow accountants and solicitors to stay informed regarding the status of each individual one.[21] To cite some names: Dominion Insurance, English & American, Municipal Mutual etc.

3.1.3 Copenhagen Re

Copenhagen Re is a Danish reinsurer, which maintained a large London market presence (initially subsidiary, later branch). It is currently in run-off. Its reserves are believed to be very much on the low side. Substantial parts of its capital are blocked in particular jurisdictions (e.g. Australia) whose insurance regulators will only allow a release of capital to the main entity upon full and final discharge of local liabilities.

Parent company is Almenij Brand, a former mutual insurer that is now listed. Its 2003 half-yearly account clearly states that it will not be making further capital available to its subsidiary[22].

3.1.4 SCOR

SCOR is the only remaining significant French reinsurer, apart from Caisse Central de Réassurance, a government entity writing natural catastrophe exposures.

As a consequence of in particular investment write-downs (e.g. a shareholding in Swiss Life), adverse technical results at Commercial Risks, a Bermudan subsidiary which had been writing US workers' compensation business, in November 2002 SCOR required an initial emergency €381 capital infusion[23]. This, however, turned out not to suffice and currently (Dec. 2003) a further €750m rights issue is pending. It is hoped that following the 2nd tranche of capital raising the currently insufficient rating of BBB+ from Standard & Poors will move up a notch.

At the time of the first rights issue, there has also been a complete management revamp with Denis Kessler taking the helm.

Clearly without these two rights issues SCOR would, just like Gerling Global, also have gone into liquidation.

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[20] Rückversicherer unter Druck, *Von Herbert Fromme*
Die Kunden der Rückversicherer verlangen zusätzliche Sicherheiten für den Fall finanzieller Schwächung. Das sind auch Nachwehen der Gerling-Krise. FTD 3.4.2003, http://www.ftd.de/ub/fi/1048931522601.html?nv=rs
[21] http://www.biro.co.uk/7459/8762/?*session*id*key*=*session*id*val*
[22] http://www.almbrand.dk/abweb/files/almbrand/pdfEnglishAnnualRep/interimReport2003.pdf, p. 11
[23] http://www.scor.com/us/1_histoire.asp

3.1.5 Australians (ReAC[24], NewCapRe, GIO Re)

During the mid 1990s, a number of Australian reinsurance organisations were created. They initially benefited from the last years of a hard market but then continued expanding into a rapidly softening market. Their problems were exacerbated by full reliance on reinsurance brokers as business producers who tended to view Australian reinsurers as naïve capacity.

3.1.6 Fortress Re

Fortress Re was not itself a reinsurer but a mere underwriting agency specialising in aviation reinsurance. It was based in Burlington, N.C. and run out of an inconspicuous office building by its founders Maurice D. Sabah (73) & Kenneth H. Kornfeld (55)[25]. The security behind it consisted of three Japanese non-life insurers: Taisei (which over this matter went bankrupt), Nissan (now part of Sompo), Aioi one of which subsequently was dragged under by its losses from inwards reinsurance.

Fortress Re specialised in aviation reinsurance layers covering US$50m to 100m per any one event. In this particular niche, it held a 60% market share. Much of the business was broked by Benfield Greig, London reinsurance brokers. The IT systems were unsophisticated.

Annual premiums amounted to appr. US$ 500m. The total loss to the three represented Japanese insurers came to US$2b range, mostly due to the WTC event 11.9.2001. On the other hand, the agency itself over 20 years raked in US$ 528m in profit commissions and further profit sharing via Carolina Re, a Bermudan affiliate of Fortress Re (which also went bankrupt).

It appears that for years the true result of business written for the Japanese insurers had been masked by reinsurance arbitrage (buying cheap retrocessions) and later by financial reinsurance (without accounting for reinstatement premiums already due) from AIG, Hannover Re and Swiss Re.

This case is symptomatic for the aviation reinsurance sub-market, which is

- Highly cyclical
- Long-tail in nature
- Frequented by underwriting agents who often act on behalf of "innocent capacity" and purchase retrocessions on their behalf.

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[24] This author has been on the board of still publicly listed Reinsurance Australia Corporation since mid 2000

[25] Who Is Chico Sabbah? How last year's terror attacks uncovered--and imperiled--a long-secret fortune. Edward Cone, Forbes Magazine, http://www.forbes.com/forbes/2002/0930/400086_print.html

3.2 Direct Insurers

3.2.1 Lloyds in 1993

Lloyd's has in the past been generating some 50% of its premium volume from the United States. Therefore, Lloyd's had its fair share of US asbestos reserving problems which emerged during the late 1980s/early 1990s in respect of business written in prior decades.

In a tour de force, Lloyd's divested all claims reserves in respect of underwriting years prior to 1993 into a newly created dedicated run-off reinsurer called Equitas Ltd. Some 36,000 names were required to pay around £ 100,000 each by way of reinsurance to close.

Equitas is apparently doing a good job collecting inuring reinsurances and streamlining administration. However, he underlying problem of a run-away US asbestos claims situation persists. [26] An insolvency of this UK reinsurer remains a realistic possibility.

3.2.2 Independent Insurance

Independent was a maverick UK based and regulated direct insurer. It had been founded in 1986 by charismatic Michael Bright and was placed in provisional liquidation by the UK's FSA on 29.6.2001.

Publicly listed Independent had been growing exponentially over years (also into France, Spain and Malta) and been the darling of the insurance broking fraternity. It continued expanding during period of insufficient pricing, addressing its reserving insufficiency by both not recording claims and purchasing somewhat dubious financial reinsurance.

There was a limited contribution of reinsurance to Independent's failure:

- Independent itself was an active underwriter of often disastrous reinsurance (and e.g. caused substantial losses to Lloyd's marine syndicate 535 via uncollectible reinsured claims)
- Towards its end, Independent appears to have purchase financial reinsurance which it accounted for inappropriately (a matter still being investigated by the UK's Serious Fraud Office).

However, Independent itself did not suffer from uncollectible reinsurance.

[26] Equitas may again boost asbestos reserves
by Sarah Veysey, Business Insurance Daily News 4.12.2003, http://www.businessinsurance.com/cgi-bin/news.pl?newsId=3219

3.2.3 HIH UK Branch

HIH was an Australian reinsurer, which during the 1990s had rapidly evolved out of a former London broker owned underwriting agency. After a 1992 initial public offering, during the period 1995 to 1998 HIH was controlled by Swiss insurer Winterthur that as a consequence of its merger with Credit Suisse as well as due to uneasiness with hih's accounting practices decided to sell out. In 1998 HIH merged with another Australian insurer, FAI.

Both HIH and FAI were characterised by weak management controls, compliant external auditors and actuaries as well as a gung-ho volume oriented approach. The Australian regulators allowed the situation to deteriorate. Eventually, in March 2002 HIH collapsed, an A$5b bankruptcy.[27]

HIH had significant involvement in the London insurance market, both by way of a branch operation and as controller of Lloyd's managing agents Cotesworth. The London account was underwritten in a particular haphazard fashion and included a large portfolio of film indemnity policies.

3.2.4 Mannheimer Life Insurance

This medium-sized German life insurer pursued a particularly risky equities focussed investment strategy just as the German stock market collapsed from about 8,200 index points to a low of 2,200.

In addition, in order to maintain top line growth, it appears that Mannheimer acquired large pieces of business at uneconomical prices and continued to be overly exposed to the equity market.

As a consequence, Mannheimer Leben had to be propped up by Protektor, a German insurance industry rescue vehicle. The holding company lost its independence to Austrian insurance group Uniqa[28].

[27] Post Mortem of Two Australian Insurers
HIH and FAI before a Royal Commission, Versicherungswirtschaft Heft 13/2002, S. 1042, English translation downloadable from www.aequi-libria.com
[28] Various press statements under http://www.mannheimer.de/

4 National Regulation (or Lack Thereof) of Reinsurers

So far, the regulatory approach taken by EU member states in respect of reinsurers is far from uniform. Three major attitudes can be distinguished:

4.1 Regulation as for direct insurers

The UK has never attempted to properly distinguish between direct and reinsurance business. For example, Lloyd's write a 50% direct/50% reinsurance account. Consequently, reinsurers are subject to the same regulations as direct insurers. A similar concept underlies the Danish regulatory approach.

It is rather questionable whether the UK's present attitude is in line with the still valid 1964 Reinsurance Directive, which lays down, that EU reinsurers shall enjoy full freedom of service and also of establishment. It appears that the UK's FSA is denying EU based reinsurers freedom of establishment by demanding that their UK branches be subject to supervision.[29]

4.2 Lack of any regulation

The other extreme is what occurs in Belgium. Reinsurers so far are not subject to supervision. This also used to be the case in Ireland until about 2 years ago. Only those reinsurers operating under special licences out of the Irish Financial Services Centre were subject to authorisation and supervision (in return, they were entitled to pay corporate tax at only 10%), reinsurers outside of the IFSC were not subject to any supervision. However, Ireland has started tightening up its controls, so far only as a matter of administrative practice; proper supervisory rules governing reinsurers do not yet exist.

4.3 Limited scope of regulation

4.3.1 Germany

Furthermore, a middle-of-the-road position exists: regulation of reduced intensity compared to that which direct insurers are submitted to. In particular, the regulatory approach taken by Germany falls under this category.

The confusion which can be created by such a lukewarm regulatory attitude is exemplarised by the recent skirmish between Gerling Gobal Reinsurance and BaFin (the German regulator) re sale of Gerling Global Re. On 13.6.2003 the Hessen Higher Administrative Court in Kassel confirmed an earlier decision by the Frankfurt administrative court overruling a ban by the German supervisors BaFin against the sale of Gerling Global to Lago Achte, a vehicle controlled by Dr. Achim Kann.[30] BaFin appears to be under increasing criticism from regulators in other countries regarding the demise of Gerling Global Re. Given the delay in having an EU directive

[29] The Regulation of Reinsurance, Andrew Pincott, Kluwers Insurance and Reinsurance Law Briefings 12.3.2001, http://www.elbornes.com/articles/regsrein.htm
[30] Press Statement at http://www.gerling.com/ggre/

on reinsurance passed, BaFin is currently working on a tightening of national laws governing the supervision of reinsurers.[31]

4.3.2 Ireland

Ireland is fast becoming the choice EU location for new reinsurers, both for captives and for the subsidiaries of major Bermudan entities. This is due to

- Proximity to the London market
- The English language
- The still easy to deal with regulatory regime
- 12.5% corporate taxation (replacing the expiring IFSC special corporate tax rate)

Despite the closeness to the UK, historically Ireland has not regulated reinsurance at all, apart from reinsurers availing themselves of the special tax rate in the Irish Financial Services Centre IFSC. However, Ireland is currently devising its own regulatory system for reinsurers and is in the meantime cracking down on reinsurers who fail to submit periodic returns.[32]

4.3.3 Luxembourg

Luxembourg boasts the presence of 267 reinsurers[33], most of them captives. The country has for many years had special legislation dealing with reinsurers and in particular setting out

- Solvency standards (a mere 10%, much less than as per the EU non-life directives applies to direct non-life insurers): Art 3 of the Règlement Grand-Ducal[34]
- Fluctuation reserves ("provisions pour fluctuations") essentially contain tax-deferred profits, the key attraction of Luxembourg as a base for a reinsurer: Art. 6ff.

4.4 Collateral Requirements, the US Approach to "aliens"

In the US, non-admitted foreign reinsurers are somewhat strangely referred to as "alien reinsurers". US ceding companies can only take balance sheet credit in respect of ceded technical reserves if these are collateralised by way of letter of credit or a trust fund. This requirement was brought in at the eve of WW2 to allow Lloyd's to continue doing business in the US despite the fear of a German invasion.

The numbers are staggering:

- 2002 premiums ceded to alien reinsurers amounted to US$ 46b

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[31] BaFin to tighten its rein over reinsurers, EU Delay on Reinsurance Supervision Forces Germany to Act Now, Reactions, Baden-Baden Reporter 27.10.2003, p. 4

[32] Statement by the Irish Financial Services Regulatory Authority, http://www.ifsra.ie/frame_main.asp?pg=/industry/in_ins_intr.asp&nv=/industry/in_nav.asp

[33] www.commassu.lu, legislation down-loadable from here

[34] Règlement grand-ducal pris en exécution de la loi modifiée du 6 décembre 1991 sur le secteur des assurances précisant les modalités d'agrément et d'exercice des entreprises de réassurances (revised text applicable from 1.1.2002)

- recoverables simultaneously amounted to US$ 94b
- these recoverables represented 32% of US property/casualty insurance industry surplus (=shareholders' funds)[35]

This collateralisation requirement goes a long way to protect US ceding companies from failures of "alien" reinsurers. However, it does not protect them in respect of sudden increases in reserve requirement post failure of an alien reinsurer.

The flip side of the coin is that whenever a European reinsurer has covered both US and non-US risks, US ceding companies thanks to collateralisation stand a good chance to be paid in full whereas other non-collateralised creditors will have to be content with whatever remains of the assets.

For years, there have been attempts by European insurers, in particular Lloyd's to have the US collateralisation requirements waived. However, they appear to be faced with a "Fortress America".[36]

[35] Reinsurance facts, Frank Nutter, RAA president says that the RAA Report is based on solid facts …, The Review Dec. 2003/Jan. 2004, p. 13
[36] term coined by Commentary: Suddenly, Europe Fears Fortress America,Washington preached about protectionism for years but now is practicing what it pleases, Business Week 24.6.2002, http://www.businessweek.com/magazine/content/02_25/b3788072.htm

5 Super-/Transnational Regulation

5.1 EU Directives[37]

A paper "Progress report on implementation of EU legislation in Accession Countries"38 in the context of the May 2004 accession of new Member States lists the main directives. A summary is also contained in a EU Parliament fact-sheet[39]:

5.1.1 Non-Life Insurance (Directives 73/239, 88/357, 92/49)

These involved:
- Introduction of a classification of types of non-life insurance
- Standardized regulatory approach, in particular as regards the solvency margin
- Freedom of establishment (granted already in 1993)
- Freedom to act as a co-insurer, providing the leading insurer was locally licensed (as from 1988)
- Freedom of services (without establishing an établissement stable) in respect of large commercial risks as from 1988

5.1.2 Motor Insurance (Directives 72/166, 84/5, 90/232, 2000/26)

Whilst motor insurance is part of non-life insurance, it has a couple of particular characteristics:
- Cross-border implications
- Compulsory coverage as regards third party liability coverage
- Not only policyholders but also third party claimants need to be protected

Therefore, the 4th motor insurance directive lays down the obligation of an insurer to maintain a local representative and the right of the victim to sue locally.

5.1.3 Life Assurance (Directive 2002/83/EC recast version)

Just like under the non-life insurance directives, the EU has also enshrined the principles of freedom of establishment and of services for life insurers whose head offices are based in the EU.

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[37] texts to be found under http://europa.eu.int/comm/internal_market/insurance/legis-inforce_en.htm#nonlife
[38] MARKT/2519/03–EN Orig. 18 June 2003, http://europa.eu.int/comm/internal_market/insurance/docs/markt-2519-03/markt-2519-03_en.pdf

[39]

European Parliament Fact Sheets, 4.3. Banking, insurance and securities, http://www.europarl.eu.int/factsheets/3_4_3_en.htm

On the solvency side, it is stipulated that a life insurer should show minimum solvency equivalent to 4% of mathematical provisions (with max. 15% credit given for ceded reinsurance) or of .3% of capital at risk.

5.1.4 Insurance Accounts Directive (Directives 78/660, 83/349, 91/674)

This directive as per its Art. 2 Para. 1 c also applies to reinsurance undertakings. Its Art. 6 prescribes a standard lay-out for balance sheets. Of particular relevance is that no netting off is permitted, i.e. technical provisions first have to be shown for gross and parts to be borne by reinsurers are then offset against this. The same applies to the profit & loss account (Art. 33ff).

There are separate provisions regarding the valuation of assets and liabilities. Key provision is Art. 58 which stipulates that technical provisions "must at all times be such that an undertaking can meet any liabilities arising out of insurance contracts as far as can reasonably be foreseen".

If one aims for similar regulatory approaches throughout the EU, this is perhaps the key directive as it ensures that all regulators will be using a similar vantage point (balance sheet and p/l account) when judging a particular insurance undertaking.

The draft Reinsurance Directive specifically references the Accounts Directive in its Article 17 para 1 as regards the creation of technical reserves.

5.1.5 Winding up Directive (Directive 2001/17)

This directive gives the home country supervisory authority exclusive jurisdiction over the winding up of an insurance undertaking including its branch operations in other Member States. This directive does not appear to cover reinsurers, which are not regulated by one of the referenced directives.

5.2 Quasi regulatory system via rating agencies

At present, there are four internationally recognised credit rating agencies, which focus on the insurance and reinsurance industries:

- Standard & Poors (market share 33%)
- A.M. Best (only rates insurers, market share 44%
- Moody's (market share 17%)
- Fitch (market share 7%)

They apply fairly similar rating standards and essentially follow a multi-criteria bench-marking approach.[40] So far, rating agencies are not yet subject to any regulatory oversight, but there is some public sentiment that banking and insurance regulators ought to be permitted to control rating agencies. The German Landesbanken recently placed pressure on S&P to postpone publication of rather damaging new ratings.

Either upon demand by the insurer to be rated or based on publicly available information ("pi" ratings are usually particularly conservative, their publication is often designed to force the rated insurer to submit to a full rating which will cost some US$ 50 to 100,000 p.a.) rating agencies will give their verdict regarding the claims-paying ability of a particular insurer or reinsurer. This will be based on the current balance sheet strength and also on the perceived probability of ruin under potential future claims and investment scenarios.

Reinsurance brokers will nowadays refuse to deal with any reinsurer not min. rated BBB (S&P, or equivalent from another agency[41]). This has for instance forced Gerling Global to cease underwriting, SCOR, the sole remaining major French reinsurer, needed two urgent capital infusions (in 2002 and 2003) to avoid a similar fate.

Generally, over the last 10 years there has been a downward drift of ratings, a consequence of a tightening of rating standards.

In some territories such as Australia, contractual wordings are prevalent which impose on the reinsurer to collateralise liabilities should his rating fall to BBB level. These treaty conditions are a function of regulatory authorities no longer allowing ceding companies to take statement credit in respect of amounts due from not well rated reinsurers, unless collateralised.

As from 2004, both Russian and Ukraine require that all reinsurance cessions from local direct insurance companies go to reinsurers featuring a min. rating of BBB from one of the major four rating agencies. This is a clear case of the insurance supervisors delegating powers to a private sector firm.

[40] Insurance company ratings, SwissRe Sigma 4/2003
[41] comparative table on p. 13 of Sigma 4/2003

5.3 IAIS member regulators applying standardised rules [42]

The International Association of Insurance Supervisors (IAIS) resides in Basel/CH. It is a sister organisation of the Bank for International Settlements (BIS). Its principles and standards are not mandatory for IAIS members, but the are increasingly becoming the yardstick used by the IMF and the World Bank in assessing countries' regulatory systems.

5.3.1 Standard No. 7 i.r.o. direct insurers' reinsurance arrangements

In January 2002 it published its Standard No. 7 "Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers"43. This paper acknowledges that individual States have different supervisory standards applicable to reinsurers. Therefore, no attempt is made to directly regulate reinsurers; instead the focus is placed on boards and senior management of direct insurers to demonstrate that they have an appropriate strategy of reinsurance management in place. Such strategy be part of any business plan to be filed by a direct insurer with its supervisory authority and should include

- Setting of net retention
- Scenarios for which reinsurance should be sufficient
- Criteria for selecting reinsurers
- Collateral to be obtained from reinsurers
- Additional risks created by the use of intermediaries

5.3.2 Standard No. 8 i.r.o. Supervision of Reinsurers

In the meantime, there appears to have been a shift from supervision of the ceding entity to supervision of the reinsurer. The "Standard On Supervision Of Reinsurers" was adopted by the IAIS' Singapore meeting in
October 2003. The underlying principle is similar to that governing direct insurance supervision in the EU: the regulator in the home country of the reinsurer should be responsible for its supervision, the host country regulator should then use the results of that supervision as a basis for its own supervision of direct insurers ceding business to that reinsurer.

However, on closer examination this IAIS standard No. 8 turns out to contain merely general points such as regarding technical reserves, solvency and risk management, but not clear regulatory standards.

[42] IAIS issues supervision standard, the Rereport 20.10.2003, p. 4
[43] http://www.iaisweb.org/02reinsurance.pdf

5.3.3 Need for accreditation of insurance regulators

Given the concentration of supervisory powers in the hands of the home country regulator, the question arises as to how a consistent regulatory standard by different regulators should be ascertained[44]. Home country regulators need to be reasonably certain that the various home country regulators governing e.g. reinsurers on a particular treaty cession by one of their supervised direct insurers are being measured against the same yardstick. Also, should there be tougher and more facile regulators, some reinsurers might be tempted to forum-shop by establishing their head-office under the auspices of a national regulator know to be easy to deal with.

The IAIS does not yet appear to have a view as to how a reasonably uniform regulatory approach should be guaranteed.

[44] Not standard, An exclusive first look at the IAIS Standard Eight shows its importance fore reinsurers as the industry readies itself for increased supervision, Ed Ion, The Review Ec. 2003/Jan. 2004, p. 30f

6 Status of Uniform EU Regulatory Approach

Reinsurers need to optimise the use of their capital. In order to do so, they need to create a diversified (i.e. consisting of low-correlation risks) portfolio, which should be spread over different classes of insurance as well as territorially. Territorial diversification can be achieved via

- Granting services in other than the head office country under freedom of services (Art. 49 EC) or
- Writing business from other EU countries via an établissement stable under the right of establishment enshrined in Art. 43 EC.

6.1 Quasi-constitutional rights in the EU

These two rights are basic ones secured by Community Law. They are part of the EU's quasi-constitutional law.[45] The EU needs valid reasons before via an approximation of laws (Art. 94f EC) regulating EU reinsurers' freedom of services and of establishment (which have been in place since 1964).

6.2 1964 Directive

The EU's initial regulatory approach taken to reinsurance was summarised by the Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession. It basically created complete freedom of establishment and of services for EU based reinsurers without first ensuring that they should be subjected to more or less uniform supervisory regulations at their domicile. Underlying this directive was a truly libertarian, non-interventionist spirit. The directive not only liberated the activities of professional reinsurers but also gave freedom of services and establishment to direct insurers in respect of their inwards reinsurance account. Hence, e.g. a German direct insurer was able to write French inwards reinsurance business via freedom of services.

6.3 UK, German and CEA Approach end of the 1990s

It appears that towards the end of the 1990s (i.e. prior to the most recent round of reinsurer failures) UK and German regulators with the blessing of the Comité Européen des Assurances decided that the status quo ought to change[46]. On 1.5.1999 the CEA replied to an EU questionnaire in the sense that uniform regulatory approaches to reinsurance throughout the EU would be desirable.[47] There was a specific question whether a direct (i.e. of reinsurers themselves) or an indirect (i.e. via

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[45] Fundamental Rights In The EU, The ABC of Community Law, http://europa.eu.int/eur-lex/en/about/abc/abc_10.html

[46] European Reinsurance Regulation: A Global Model?
Patrick Devine and Andrew Crouchman, *Global Reinsurance Magazine*, November 2000
http://www.akingump.com/docs/publication/171.pdf

[47] Towards a single "passport" for reinsurance in Europe
Questionnaire by the European Commission
CEA Note - May 1999
http://www.cea.assur.org/

supervision of ceding companies) regulatory approach was preferred. The CEA appears to pronounce itself in favour of a dualistic approach and advocates the creation of a single passport for European reinsurers.

6.4 KPMG Study 2002

The EU Commission asked KPMG (authors Keith Nicholson and Joachim Kölschbach) to compile a paper titled „Study into the methodologies for prudential supervision of reinsurance with a view to the possible establishment of an EU framework". The 157 pages were delivered in January 2002[48]. The report concerns the issues whether a standardised supervisory approach to reinsurance throughout the EU is at all indicated and what the appropriate approach should be[49].

[48] http://europa.eu.int/comm/internal_market/insurance/studies/reins-sup_en.htm
[49] by this author: Künftige Einheitliche Spielregeln für EU-Rückversicherer?, Versicherungswirtschaft Heft 10/2002, S. 710, down-loadable from http://www.aequi-libria.com/index_2.html

6.5 Draft directive 2003

The EU Commission published its "proposal for a Directive of the European Parliament and of the Council on Reinsurance" on 28.5.2003.[50]

As per Art. 2, the directive is to apply to all reinsurance undertakings established in a Member State. It is to cover only pure reinsurers, not direct insurers incidentally also writing inwards reinsurance (they are already regulated via existing directives).

Many of the draft's articles are more or less verbatim copied from the preceding non-life and life insurance directives.

The below table summarises the main (apart of those dealing with formalities) articles of the directive:

6.5.1 Preamble

The preamble has not yet been formulated. Quite likely, it will explain the need for uniform EU supervisory standards as arising out of recent reinsurer insolvencies or "near death" experiences.

[50] http://europa.eu.int/comm/internal_market/insurance/docs/reinsurance/2531-02-rev2_en.pdf

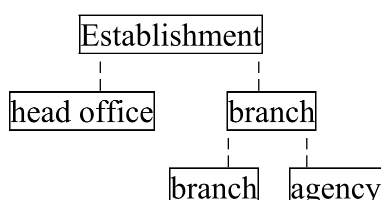
6.5.2 Title I: Definitions and Scope

6.5.2.1 Art. 1 Definitions

14 terms are defined. Only the most relevant ones are commented in the following:

6.5.2.1.1 Establishment, Branch, Agency

The hierarchy of terms is as follows:



Under the term "branch" any permanent presence in another Member State shall be subsumed, irrespective of whether it

- Is staffed by the reinsurer's employees or by an independent service provider (i.e. also maintenance of an underwriting authority, e.g. with a reinsurance broker falls under the definition)
- Has authority to bind the reinsurer. Hence, also a mere representative or liaison office falls under the definition. The differentiation between branch and representative office is relevant as regards the tax situation (profits attributed to a branch are taxed locally whereas no profits can be attributed to a mere unempowered liaison office), but not as regards the supervisory situation.

6.5.2.1.2 Member State

Whilst the EU currently (Jan. 2004) counts 15 Member States, their number will on 1.5.2004 increase by a further 10 (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia) to 25[51]. Art. 42 Implementation does not give the new Member States an extended deadline for transposing the Directive into national law.

There is a distinction between the

- Home Members State: where the reinsurer's head office is located
- Members State of the branch: where the branch is located
- Host Member State: where either the branch is located or where the reinsurer provides services.

[51] http://europa.eu.int/comm/enlargement/enlargement.htm

6.5.2.1.3 Competent Authority

This is the national authority in charge of supervising reinsurers, the designation of such national authority being in the exclusive domain of the Member State concerned. Hence, Member States are still free to entrust a specific Insurance Supervisory Authority or to create an all-encompassing Financial Services Authority. On the other hand, Member States which so far failed to control reinsurance at all (Ireland, Belgium) will now need to designate a competent authority.

6.5.2.1.4 Corporate Control Issues

- Qualifying holding: 10% or more of capital or votes, or significant influence on management
- Control: as per Directive 83/349 (7th Council Directive on Consolidated Accounts), i.e. majority of voting rights or board control
- Close links: a situation where min. 20% of the shares are controlled by a related party

The above definitions are relevant drivers as regards:
- The need for changes in shareholdings to be approved by the regulatory authority
- Supervision of related party transactions

6.5.2.1.5 Captive Reinsurance Undertaking

The last defined term "captive reinsurance undertaking" appears unusually defined in the following respect:
- A captive may only write parent organisation risks, any non-related risks will go beyond the definition of captive. This is not in line with commercial reality: in many instances, captive reinsurers are forced to accept non-related risks in order to satisfy the tax authorities that a genuine reinsurance organisation exists which involves exposure to a pool of unrelated risks as well.
- Parent companies are only to be industrial or commercial firms, but financial firms have been deleted from the definition. Hence, a reinsurer owned by a bank and only reinsuring the bank's own risks will not fall under the definition but be treated as a normal reinsurer.

On the other hand, group captives, i.e. captives owned by and insuring the risks of several firms will also fall under the captive definition.

6.5.2.2 Art. 2 Scope

The scope of the directive is somewhat narrowed in the sense that not all reinsurance related activities are covered:
- direct insurers are presently excluded. However, there is a discussion that those featuring large inwards reinsurance accounts should also be covered by the Directive. Should the final version of the Directive indeed impose tougher

solvency standards on reinsurers than on direct insurers, it would otherwise be rather tempting for existing reinsurers to change their status to that of a direct insurer. They would perhaps on a pro-forma basis write a couple of direct policies and thus be subject to the less onerous solvency standards applicable to direct insurers.

- Reinsurers established outside the EU are likewise not covered
- Furthermore, only those accepting risks are targeted whereas brokers act only as intermediaries. It is, however, not quite clear whether an underwriting agent who accepts risks but does not do so under his own name falls under the directive.

6.5.3 Title II: The Taking-UP of the Business of Reinsurance

This title deals with steps preceding the authorisation and actual commencement of business.

6.5.3.1 Art. 3 Principle of authorisation

Taking up of reinsurance business shall require a prior authorisation. This presently is not yet the case e.g. in Ireland (but in spit of lacking legislation the local authorities are doing their best to make life hard for apparently unprofessionally run and undercapitalised reinsurers) and Belgium.

This article also regulates the competency between national supervisory authorities: it is the regulator of the country where the head office is located which is to be solely competent.

6.5.3.2 Art. 4 Scope of authorisation

Authorisation by the head office supervisor shall apply to the entire EU, whether by freedom of services or by setting up further permanent establishments.

A distinction is being made between life reassurance and non-life reinsurance (note the slightly different term used for life- and non-life activities). It is clear that a single undertaking can be authorised for both life and non-life activities.

Authorisation shall be preceded by a "scheme of operations", apparently a term used synonymously with "business plan".

6.5.3.3 Art. 5 Conditions for obtaining authorisation

The conditions for obtaining authorisation are of both a formal and a material nature:

- Only limited legal forms permitted; these are listed per Member State. This will for instance make it illegal to establish a reinsurer in Germany as a limited or unlimited partnership, something that used not to be ruled out by national legislation. On the other hand, the S.E. (societas europea) is specifically mentioned in para. 1 a).
- As per para 1 b), a reinsurer is to limit its operations to reinsurance business and related operations. There is no definition of related business, but one could e.g. imagine:
    - Gathering of statistical information
    - Claims adjusting (as an example, Swiss Re used to own Audatex, an IT solution allowing to estimate motor own damage claims)
    - Captive insurance management
    - Reinsurance broking
    - Investment management (including offering that service to clients)
    - Trading in insurance bonds and derivative contracts
- The head office needs to be located in the same Member State as the registered office. This is to prevent forum-shopping of e.g. setting up the registered office in a country which is considered to feature not overly clued-up

regulators (for argument's sake: Belgium) and maintaining the actual head office in another member state the regulators of which are feared (e.g. the UK's FSA which tends to be very much clued up with what goes on in the insurance industry).
- Those having "close links" to a reinsurance undertaking must be able to exercise effective control.

6.5.3.4 Art. 6 Scheme of operations

A detailed business plan "Scheme of Operations" needs to be filed prior to commencing underwriting. This needs to forecast annual accounts for the first 3 years. Key parameters for the business plan are:

- Nature of risks (i.e. in particular the class of business: motor, marine, fire, aviation etc.)
- Type of reinsurance arrangement. Whilst this is not stated in the directive, one would expect to find the following details:
    - Proportional (quota-share, surplus) or non-proportional nature of arrangement (excess of loss per risk or per event, stop loss/annual aggregate excess of loss).
    - any limitation to the reinsurer's risk acceptance would be noteworthy such as limited reinstatements, sliding scale commissions, loss limits. An extreme case would be a reinsurer only wishing to underwrite financial reinsurance, i.e. products devoid of any risk transfer.
- "guiding principles" as regards retrocessions, i.e.
    - type of exposure for which retrocessions are bought, e.g. the once every 200 year event
    - counterparty risk, e.g. only retrocessionnaires rated in. BBB
    - type of protection (proportional/non-proportional as above)
- constitution of the minimum guarantee fund: this appears to concern the investment thereof (bonds, shares etc.)
- start-up expenses. These are the one-off initial expenses such as for legal advice on company formation, external consultants, executive search for key employees, purchase of IT equipment, capital raising via investment bankers, initial PR etc. Whilst accounting rules may often permit accruing and then depreciating such expenses (e.g. over 20 years) they do not constitute real assets which can serve to satisfy creditors.

Furthermore, there is to be a 3 year projected profit and loss statement and balance sheet showing the expected solvency ratios at the end of each period. This is a somewhat unsophisticated deterministic approach where only a given set of parameters will be used, the key ones being

- Claims ratio
- Expense ratio
- Pay-out pattern of claims (or in other words the build-up of insurance funds)
- Investment yield

More appropriate approaches would be to

- To demand at least 3 scenarios (pessimistic/realistic/optimistic) or, better

- A Monte Carlo simulation[52] which substitutes the key parameters believed to be realistic with random generated values in line with an pre-set expected value and a distribution function. Typically, some 5 or 10,000 simulations are run which can then be compiled into an overall distribution function for expected key result parameters such as
  - Net asset value end of each period/end of multi-year observation period
  - Solvency ratio
  - Regulators ought to insist that the thus synthetically generated probability of ruin or probability of featuring less than the min. regulatory solvency will be within acceptable bounds, e.g. once ever 200 years.

What is also somewhat surprising is that it will be sufficient for a business plan drafted by management to be submitted. Its credibility might be considerably enhanced by requiring that it be vetted by an independent actuary with the appropriate professional qualifications.

6.5.3.5 Art. 7 Qualified shareholders and members

Major shareholders need to be identified to the competent authorities. Such qualifying holdings are defined in Art. 14: 20%, 33% and 50% of a reinsurance undertaking. The licence shall be refused if the shareholders do not appear to guarantee the sound and prudent management of the reinsurer.

6.5.3.6 Art. 8 Refusal of authorisation

In case of refusal of permission, a reinsurer may seek redress from the national courts. Furthermore, national regulators are to decide within 3 months. This may for instance cause some discomfort to the UK's FSA, which is known for its protracted licensing procedures. Decisions must always be reasoned.

6.5.3.7 Art. 9 Prior consultation with the competent authorities of other Member States

Whilst the regulators of the Member State hosting the head office are in charge of the authorisation process, they are to consult the regulators where a financial sector parent organisation or holding company is based. They shall also seek their input regarding the suitability of shareholders and directors hailing from other Member States.

[52] product description for @risk, an MS Excel add-in under http://www.palisade-europe.com/html/risk.html

6.5.4 Title III Conditions Governing the Business of Reinsurance, Chapter 1: Principles and methods of financial supervision

Once a reinsurer is licensed, supervision shall be in line with Title III. The chapters thereof concern:

- **Chapter 1** concerns supervision in a formal sense (competent authority etc.)
- rules on technical reserves which are of paramount importance have been allocated to a separate **Chapter 2.** Rules regarding the solvency margin would make no sense if there were no rules in respect of technical reserves: by under-reserving a reinsurer could create profits/net assets and hence the required solvency margin.
- Having stated the rules according to which the technical reserves are to be established, the Directive then imposes minimum solvency standards in the sense of net assets (after deduction of properly estimated reserves) in **Chapter 3**
- **Chapters 1 to 3** regard all reinsurers, **Chapter 4** is particular to reinsurers in difficulties, i.e. breaching solvency rules as defined in Chapter 3.

6.5.4.1 Art. 10 Competent authorities and object of supervision

This is the key provision: the Member State where the reinsurer maintains its head office shall solely be responsible for supervising it, also as regards branches in other Member States. Supervision shall be governed by home Member State legislation which in turn is to be in line with the Directive.

There is an obligation of the Home Member State to ensure sound administrative and accounting procedures and adequate internal control mechanisms. Hence, should a Member State permit reinsurers under its tutelage to behave irresponsibly, it thus violates EU law and can be taken to the EU Court of Justice by the EU Commission. A concrete example would be a Member State permitting the creation of captive reinsurers which are mere letterboxes and which charge premiums at fictitious levels thus allowing their industrial shareholders to transfer profits to a more tax-benign jurisdiction.

6.5.4.2 Art. 11 Supervision of branches established in another Member State

This allows home country supervisors to conduct on-the-spot verifications also in respect of branches in other Member States. In other words: other Members States cede part of their sovereignty to the home country supervisor who may exercise sovereign rights at the seat of the branch. An example would be the German BaFIN inspecting the records of Munich Re's Paris branch. This derogation to territorial sovereignty is somewhat mitigated by the right of the Host Member State to participate in the inspection.

6.5.4.3 Art. 12 Accounting, prudential and statistical information: Supervisory powers

This concerns the maintenance of proper accounts and the filing of regulatory returns. Member States are obliged to ensure that reinsurers under their jurisdiction will comply. In particular, they need to ensure that they have the means to enforce compliance, e.g. also as regards the non-EU branch operations of a reinsurer under their supervision (e.g. Munich Re's Tokyo branch/representative office).

In addition, Member States are empowered to ensure that information on reinsurance contracts held by intermediaries (brokers/underwriting agents) will be available. Whilst it is not obligatory that Member States transpose this into national law, if they so choose they may create similar inspection rights regarding intermediaries. The most straight-forward situation will be where the intermediary is based in the Member State of the reinsurer, however matters become more complicated when e.g. BaFin in Germany would like to see the records of Aon London who have broked a contract to Munich Re's Paris branch.

6.5.4.4 Art. 13 Transfer of portfolio

The case of a portfolio transfer from one Member State to another is to involve the regulators of both the ceding reinsurer and those of the accepting reinsurer. Practical situations are:

- Change of strategy, e.g. withdrawal from a particular geographic market or class of business. As an example, Gerling Global (in liquidation) recently hived off its life reinsurance business into a separate (also German) subsidiary Gerling Global Life Re, later Revios Rückversicherung AG[53] which was then sold to VHV Vermögensanlage AG.
- Realisation of the goodwill inherent in a portfolio, in particular pre-paid acquisition cost
- Speeding up of the liquidation of a reinsurer: since the portfolio transfer replaces the current reinsurer with a new one (without approval by the ceding company being required), it becomes possible to liquidate a reinsurer and repay its residual capital to shareholders within a year rather than having to wait for all contracts to run to their natural expiry.

Art. 13 concerns the cross-border portfolio transfer. The adequacy of the pricing of the transaction will be a matter solely between the parties, only criterion will be whether the accepting reinsurer will post-transfer still feature an adequate level of solvency.

6.5.4.5 Art. 14 Qualifying holdings

Holdings of 20%, 33% and 50% will require a prior home supervisor authorisation. The same also applies to disposal of a holding, probably to prevent situations where

[53] www.revios.com

upon the discovery of difficulties at a group reinsurer the holding company decides to dispose of its as a “hot potato”.

6.5.4.6 Art. 15 Professional secrecy

Very detailed rules are laid down in respect of the standards of professional secrecy to be maintained by regulators. However, exchange of information between national authorities of the same State (e.g. insurance regulator and tax office) and between Member State insurance regulators are permissible. Member States are also permitted to conclude bilateral information exchange agreements with non-EU states, but only if minimum standards are adhered to.

6.5.4.7 Art. 16 Duties of auditors

External auditors are obliged to turn into whistleblowers and inform the regulatory authorities of material breaches of the law and similar phenomena. This is part of a general development of turning external auditors from an institution normally working in harmony with management and the board into an instrument of supervision, largely responsible to a government agency.

6.5.5 Title III, Conditions Governing the Business of Reinsurance, Chapter 2: Rules relating to technical provisions

6.5.5.1 Art. 17 Establishment of technical provisions

In respect of technical provisions (claims and unearned premium reserves) to be maintained by reinsurers, reference is made to Directive 91/674[54] **on the annual accounts and consolidated accounts of insurance undertakings**. This directive has been in force and applicable as of 1.1.1994. As per its Art. 2 para 1c) it is also applicable to reinsurance undertakings, not just to direct insurers.

Most of its articles are of a purely formal nature and institute a standardised presentation of insurer balances sheets and profit & loss accounts. However, there are also rules on the valuation of assets. Art. 56ff of the directive are concerned with the valuation of technical liabilities. Art. 60 specifically concerns claims reserves which are to be calculated on the basis of actuarial methods and shall include reserves for IBNR claims (incurred, but not reported, i.e. an estimate of the claims tail still likely to hit the insurer). That article also prevents the discounting of most claims reserves for future investment yield.

Art. 60 of that directive does not describe appropriate actuarial methods in detail nor does it make the involvement of external consulting actuaries obligatory. This may explain why the draft Reinsurance Directive permits Member States to be more explicit.

Art. 17 para 2 of the draft Reinsurance Directive is of considerably importance: it precludes supervisory authorities looking after a direct insurer from only recognising that insurer's ceded technical reserves if these are collateralised by the reinsurer liable, e.g. by a cash deposit, a bank letter of credit or a pledging of securities. Generally, it would appear that as long as an EU reinsurer is in good standing with its home supervisory authority, the supervisory authority looking after a ceding insurer of that reinsurer will have to accept ceded reinsurance at face value, irrespective of whether the reinsurer may be Munich Re or say some smallish outfit in for argument's sake Portugal.

Art. 17 para 3 on the other hand appears to encourage Member States to only give partial credit for reinsurance ceded to a reinsurer located outside of the EU. Should a Member State wish to permit credit for ceded technical provisions it is to set the %age of credit, the implied suggestion being that that %age be inferior to 100%. This would appear to constitute an encouragement of protectionism, e.g. as regards Bermudan (essentially, it is there that the growth of the reinsurance industry is currently taking place, thanks to a benign taxation environment) reinsurers. It appears questionable whether such an element of "Fortress Europe" will be in line with WTO rules concerning Financial Services[55].

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[54] http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=1991&nu_doc=674

[55] http://www.wto.org/english/docs_e/legal_e/48-dsfin.pdf

6.5.5.2 Art. 18 Equalization reserves

Fluctuation reserves are a deviation from a reinsurer presenting a true & fair view of its current financial situation. Any amount attributed to fluctuation reserves diminishes the stated shareholders' funds. Conversely, losses met via a diminuition of fluctuation reserves have a buffered impacted on the profit & loss statement. From a modern accounting perspective, fluctuation reserves are thus a rather dubious concept.

This stipulation originally only concerned equalisation provisions in respect of credit insurances written. The particular emphasis on credit insurance probably stems from the interchangeability of insurance and banking products in this area, e.g. whereas a bank will issue a letter of credit, an insurance company can issue a financial guarantee in respect of performance by a covered debtor.

However, the EU will apparently also permit equalisation reserves to be established in respect of other classes. Typical existing examples:

- The German Schwankungsrückstellung which applies to both direct insurers and reinsurers and which is based on actuarially observed fluctuations
- The Luxembourgish provision pour fluctuations which nowadays features an actuarial veneer but the main objective of which remains to permit the creation of tax-deferred "technical" reserves
- The UK's fluctuation reserve

Typically, contributions to fluctuation reserves required by a Member State are considered legitimate expenses and lead to a deferral of corporate taxation. In particular when their basis is not really actuarially driven they come dangerously close to being a measure of harmful taxation.

6.5.5.3 Art. 19 Assets covering technical provisions and the minimum solvency margin

This paragraph concerns liquidity and currency etc. matching between assets and liabilities. As an example, prudent management will hedge/match a technical reserve in respect of motor insurance which is expected to be paid out in five years' time by purchasing a min. single A rated bond of similar maturity.

Apparently, there are particular concerns with share and real estate market which present particular problems as regards price volatility and market liquidity.

6.5.6 Title III, Conditions Governing the Business of Reinsurance, Chapter 3-Rules relating to the solvency margin and to the guarantee fund

This chapter deals with the solvency margin (i.e. the required capitalisation) and the guarantee fund.

6.5.6.1 Art. 20 Solvency margin

This article lists assets permitted to cover the required solvency margin (Art. 20) to be maintained by an insurer. Essentially:

- starting point is the paid-up capital to which reserves and profits (losses) carried forward are added.
- The effect of discounting most claims reserves if permitted by national law is deducted. This creates a level playing field: even though a reinsurer may be able to show larger shareholders' funds by way of discounting claims reserves, this needs to be neutralised as regards the solvency margin calculation.
- From this, participations in and debt instruments issued by financial subsidiaries and group companies are deducted. This avoids using the same solvency funds several times, i.e. at subsidiary level, at intermediate operating company level and at operating head office level as well. As an example, Allianz AG[56] is nowadays the listed group holding company but simultaneously also one of the largest European reinsurers (essentially a captive operation). It may is obliged for solvency calculation purposes to deduct funds invested in its subsidiaries. In certain cases, a consolidated perspective of solvency is also permitted.
- On the other hand, certain sub-ordinated loans may be added back. They need to feature a minimum term of five years and only up to 50% of the solvency margin may be thus constituted (but max. 25% in case of fixed maturity subordinated capital).
- Equalisation reserves as per Art. 18, probably not only those regarding credit insurance which are made mandatory by the Directive but also those which Member States may decree as regards other classes. This will signify quite a change e.g. for Luxembourg which has always maintained that fluctuation reserves are part of technical reserves (same as unearned premium and claims reserves) and hence cannot contribute towards a reinsurer's solvency.
- Half of unpaid capital. It has in the past been customary to issue not fully paid shares and to call up additional shareholders' funds e.g. after a major catastrophe.
- Potential cash calls of mutual reinsurers on their members
- Hidden reserves on the asset valuation side

6.5.6.2 Art. 21 Minimum solvency margin

This key provision describes the calculation of the min. solvency margin:

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[56] Allianz Report 2002 Form 20-F for US regulators, page 9, http://www.allianzgroup.com/Az_Cnt/az/_any/cma/contents/154000/urlObj_154623_Allianz_AG__20_F_2002.pdf

- Premium index: net retained premiums (the higher of written and earned), multiplied by a factor of 18% up to EUR 50m, of 16% for premiums in excess of EUR 50m
- Claims index: claims incurred, multiplied by a factor of 26% up to EUR 35m, of 23% for claims in excess of EUR 35m. There is discussion of increasing the claims basis for the truly long-tail classes 11 (Aircraft liability), 12 (Liability for ships (sea, lake and river and canal vessels))and 13 (General liability) by a further loading[57].

Unfortunately, the text of Art. 21 is still full of struck-through prior draft passages and new suggestions, so it is not yet possible to gain a full insight.

6.5.6.3 Art. 22 Required solvency margin for life reassurance activities

Whilst Art. 21 covers the min. solvency margin applicable to non-life business on a mandatory basis (i.e. not leaving Member States any discretion as to whether they wish to transpose the directive into national law), Art. 22 merely suggests that the life insurance directive's prescribed solvency margin be made applicable to life reinsurance as well. It would appear that should a Member State not follow this suggestion life insurance premiums will need to be aggregated to non-life premiums when calculating the solvency margin requirement.

The solvency requirements for direct life insurers are found under Art. 28 of the Life Insurance Directive[58]. A life insurer's solvency margin has to be the higher of

- 4% of gross mathematical reserves (with max. 15% credit given for ceded reinsurance)
- .3% of the capitals at risk (i.e. aggregate sums insured, reduced %ages for policies with a term up to 3 years: .1%, for policies between 3 and 5 years: .15%, with max. 50% credit given for ceded reinsurance)

Whereas on the non-life side solvency requirements are based on premium and claims flows (i.e. items found in the profit & loss statement), the solvency driver on the life side are exposures (i.e. balance sheet items).

In the typical case of a proportional life reinsurance cession, should a Member State not declare the direct life insurance solvency standard applicable to life reinsurance this will lead to considerably larger solvency requirements, but there may also be transactions involving little in terms of premiums but substantial mathematical reserves where the inverse will apply: lower solvency requirement if the specific life insurance standards are not declared applicable.

The only reason why the EU gives Member States discretion regarding applicability of the solvency rules already applicable to direct life insurers to life reinsurance may

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[57] listing of the non-life insurance classes as annex to the 1973 non-life directive, http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31973L0239&model=guichett

[58] Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance, http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32002L0083&model=guichett

be that for most reinsurers life insurance acceptances constitute a minor part (less than 10% of total premiums written) of their portfolios. However, the in this respect possibly non-uniform tranposition of the Reinsurance Directive into national law by Member States may well entail a significant distortion of competition, i.e. prevent the creation of an EU-wide level playing field. There may be an incentive for regulatory arbitrage via the creation of a dedicated life reinsurer in another Member State.

6.5.6.4 Art. 23 Guarantee fund

The guarantee fund is defined as amounting to one third of the minimum solvency required. The relevance of the introduction of the concept of the guarantee fund is that the assets with which it may be covered are more restrictively defined that those assets which may be used to cover the minimum solvency requirement as per Art. 22:

- 1/3 of min. solvency requirement: restrictive definition of coverage; this effect is created by having Art. 23 refer to Art. 20 para 2 and para 3, but not to para 4. Hence, the guarantee fund cannot be covered by unpaid capital, possible cash calls on the members of mutual insurers and hidden reserves.
- further 2/3 of min. solvency requirement: more generous admissible assets

This article stipulates that the guarantee fund shall not be less than EUR 3m. However, there is an exception as regards captive reinsurers (as defined in Art.1 para 14: EUR 1m only. This exception will probably make it easier for Luxembourg (some 250 captives[59], current min. capitalisation for reinsurers Flux 50m≈EUR 1.25m) and Ireland (appr. 20 reinsurance captives who are members of the association, but in addition there are also quite a number of fly-by-night operators; current informal min. capitalisation EUR 625,000[60]) to accept the new minimum guarantee fund rules.

6.5.6.5 Art. 24 Review of the amount of the guarantee fund

The min. amounts for the guarantee fund shall be indexed (Eurostat Consumer Price Index). It is rather questionable whether at a time of 1 or 2% inflation rates such indexation still appears appropriate, in particular since indexation (a typical example is the Italian scala mobile) creates the impression that EU authorities themselves are not convinced of monetary stability.

[59] listing under http://www.commassu.lu/fr/operateurs/default.asp?id=%7BCC2CE3EA-6F2F-46D1-9997-9C30EF023048%7D
[60] http://www.insuranceireland.com/live/ireland/index.shtml

6.5.7 Title III, Conditions Governing the Business of Reinsurance, Chapter 4: Reinsurance undertakings in difficulty or in an irregular situation

6.5.7.1 Art. 25 Reinsurance undertakings in difficulty

This article concerns the special rights of the supervisors authority to intervene, in particular in case of breach of min. solvency. In particular, the disposal of assets may be prevented.

6.5.7.2 Art. 26 Financial recovery plan

In case of an irregular situation, reinsurers may be asked to file a special business plan describing how the situation is to be addressed "financial recovery plan". As regard content, the financial recovery plan is not different from an initial business plan. However, it is being drawn up under special circumstances.

Obviously, a reinsurer operating under afinancial recovery plan may not actively (i.e. as the accepting reinsurer) engage in a portfolio transfer as per Art. 13.

Art. 26 para 4 allows the supervisory authority to deny credit for ceded reinsurance (retrocession) where no or insufficient risk transfer is involved, i.e. the situation of ceded financial or finite reinsurance. It is odd to find this stipulation in an article applicable only to reinsurers in difficulties. One would normally expect this to be a general rule, applicable to all reinsurers.

6.5.7.3 Art. 27 Withdrawal of authorisation

Withdrawal of authorisation shall be the ultima ratio and may only happen via a reasoned decision, not arbitrarily. Only the Home Member State authority is in charge, but it shall inform Member States where branches are maintained accordingly. Member States hosting branches may not themselves close down branch operations (unless perhaps under other laws such as the criminal code).

It is only permitted for specific reasons such as

- non-commencement of activities within 12 months (this would for instance prevent a speculative investor from seeking authorisation for a new reinsurer with the intention of leaving the licence dormant until market conditions will have hardened substantially)
- no longer fulfilling conditions of admission
- non compliance with a financial recovery plan
- other serious failure. Quite likely, engaging in dubious types of reinsurance agreements might fall under this category.

6.5.8 Title IV Provisions relating to right of establishment and freedom to provide services

6.5.8.1 Art. 28 Reinsurance undertakings not complying with the legal provisions

Strangely, in case of local infringements committed by a branch of a reinsurer or by the same reinsurer via freedom of services, the host Member State may still take appropriate measures. This appears to breach the principle of home country supervision.

6.5.8.2 Art. 29 Winding up

The term is synonymous with “orderly liquidation”.

This seems to rule out separate per country winding up, i.e. there will only be one winding up procedure at head office level, controlled by the Home Member State.

6.5.9 Title V Rules applicable to agencies or branches established within the Community and belonging Reinsurance undertakings whose head offices are outside the Community

6.5.9.1 Art. 30 Principle and conditions for conducting reinsurance business

A Member State is not to treat non-EU branches more favourably than reinsurers with head offices within that Member State. This may be based on the fear that by virtue of bi-lateral agreements individual Member States might be overly hospitable to non-EU reinsurers, perhaps in particular as regards to those which hail from the US.

There may be a bit of a parallel to bi-lateral aviation treaties between Member States such as the UK and the US which also are viewed with great suspicion by the EU Commission.

6.5.9.2 Art. 31 Agreements with third countries

This opens the way for bi-lateral agreements between the EU and non-EU States regarding reciprocal treatment. It would appear that Switzerland might be a prime candidate for such reciprocal dealing.

6.5.10 Title VI – Rules applicable to subsidiaries of parent Undertakings governed by the laws of a third country and to Acquisitions of holdings by such parent undertakings

6.5.10.1 Art. 32 Information from Member States to the Commission

The Commission is to be informed regarding EU subsidiaries (directly or indirectly held) of non-EU reinsurers. This is a mere information requirement with information flowing from Member States to the Commission. It has not relevance to reinsurers themselves.

6.5.10.2 Art. 33 Third country treatment of Community Reinsurance undertakings

Overriding objective is to assure national treatment for EU reinsurers in third countries.

This is a complaints procedure for EU reinsurers finding market access in a non-EU market difficult. Any form of market access by an EU reinsurer is relevant:
Via mere services without a permanent establishment

- Via a representative office
- Via a branch
- Via an underwriting agent
- Via a subsidiary

In such cases, the Commission is to attempt to negotiate a bi-lateral agreement. The Commission is to compile periodic information for the Committee defined under Art. 35. Furthermore, the Commission shall then commence negotiations with the third country to obtain national treatment for EU reinsurers. In order to put pressure on third countries to eventually grant national treatment, the EU may order Member States to limit or to suspend the authorisation from reinsurers from that third country (not only branches but also EU based subsidiaries). On the other hand, no basis is created for pressure to be put on reinsurers from the third country already operating in the EU. As an example, in case of friction regarding the treatment of EU reinsurers in the US, the EU could not order BaFin in Germany to suspend the operations of General & Cologne Re which is a subsidiary of Berkshire Hathaway in the US.

6.5.11 Title VII Powers Conferred On The Commission And Committee Procedure

This title governs the further development of the Directive by way of

- Technical adjustments
- Involvement of the Insurance Committee

6.5.11.1 Art. 34 – Technical adjustment

Art. 34 concerns the modification of key quantitative parameters such as the minimum guarantee fund and e.g. of the legal forms under which an EU reinsurance undertaking is permitted to operate.

6.5.11.2 Art. 35 – Committee procedure

Art. 35 describes the involvement of the EU's Insurance Committee which has already been in existence since 1.1.1992[61]. The Committee consists of representatives of the Member States. It is to be consulted on all matters pertaining to the direct non-life and life insurance sectors "with the exclusion of specific problems relating to specific insurance undertakings" (Art. 3). Art. 35 of the Draft Reinsurance Directive will extend the jurisdiction of the EU's Insurance Committee also to reinsurance.

[61] Council Directive 91/675/EEC of 19 December 1991 setting up an insurance committee, http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31991L0675&model=guichett

6.5.12 Title VIII Amendments To Existing Directives

This title concerns necessary amendments to the following existing directives:
Non-life insurance

6.5.12.1 Art. 36 – Amendments to Directive 73/239/EEC

The directive concerned is the first one governing direct non-life insurance.

Direct insurers writing whose inwards reinsurance premium exceed 10% of their total premiums or EUR 500,000 or where more than 10% of technical provisions stem from inwards reinsurance will I respect of inwards reinsurance business be subject to the (probably more onerous) solvency rules laid down by the Draft Reinsurance Directive.

However, most important is that the Home Member State insurance supervisor will not be allowed to refuse a reinsurance contract concluded with an EU based reinsurer on the basis of that reinsurer's financial situation. The Home Member State will, on the other hand, still be able to criticize the nature and structure of the reinsurance cessions itself (e.g. financial reinsurance transferring little or no risk).

Furthermore, the introduction of deposit requirements regarding technical reserves for which a direct non-life insurer takes credit in respect of an EU based reinsurer shall not be allowed. Again, there is mention that a Member State is to fix the %age at which a non-life insurer may take credit for non-collateralised technical reseves falling onto a non-EU reinsurer. This can be viewed as encouragement to discriminate against non-EU reinsurers.

6.5.12.2 Art. 37 – Amendments to Directive 92/49/EEC

Art 15 of the third non-life directive[62] is about the acquisition of sizeable shareholdings in financial institutions.

The modifications to its Art. 16 concern the exchange of information between supervisors in the sense that the supervision of reinsurers becomes a legitimate purpose for such exchange of information and that supervisors may e.g. use information gained from an insurance undertaking also to supervise a reinsurance undertaking and vice versa .

62 http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31992L0049&model=guichett

6.5.12.3 Art. 38- Amendments to Directive 2002/83/EC

The essential modividations to the Life Insurance Directive are:

A direct life insurer underwriting inwards reinsurance business shall if such business is of relevant volume (same definition as under Art. 36 in respect of a direct non-life insurer) be in respect of that business subject to the same solvency standards as a reinsurer.

As on the non-life side, a supervisory authority is not able to oppose a life reinsurance cessions to an EU reinsurer on the basis of that reinsurer's financial standing (the sole domain of the reinsurer's home Member State).

6.5.13 Title IX Final Provisions

6.5.13.1 Art. 39- Rights acquired by existing reinsurance undertakings

In the sense of "grand-fathering", pre-existing reinsurers are to be deemed authorised, even if so far operating in a completely unregulated environment (such as in Belgium and largely also in Ireland). In respect of their solvency margin, Member States may grant a two year adaptation period. This should be viewed in the context of Art. 36, specifically its prohibition to discriminate against EU reinsurers. A drastic example would be a fly-by-night reinsurer established in Ireland at EUR 100,000 of capital, so far not subject to any solvency standards, writing a 50% motor liability quota share cession from a major German insurer. During the first two years post coming into force of the directive, the Irish reinsurer might be exempted from complying with solvency standards and the German ceding insurer might be able to take full credit for the cession. An interesting temporary loophole for those trying to enhance their solvency margin at minimal expense.

6.5.13.2 Art. 40 – Right to apply to the courts

Member States are obliged to grant reinsurers the right to appeal to the national courts regarding any administrative procedure. The insertion of this provision may be an early effect of the Draft Treaty establishing a Constitution for Europe, specifically its Article II-47: Right to an effective remedy and to a fair trial[63].

6.5.13.3 Art. 41 – Collaboration between the Member States and the Commission

This very generally worded stipulation requires close cooperation between the Commission and the Member States supervisory authorities, aim being the supervision of reinsurers. Strangely, the draft text mentions "direct reinsurance", this adjective "direct" is normally used in the context of direct insurance (as opposed to reinsurance) and may be inserted in error.

6.5.13.4 Article 42 – Implementation

This article will mention the date (presently left blank) by which Member States will have implemented the directive into national law and their obligation to notify the Commission accordingly. In particular, they are to demonstrate to the Commission implementation of individual provisions of the Directive in tabular form, i.e. each provision of the Directive needs to be matched by a provision of revised national law.

6.5.13.5 Art. 43 – Entry into force

This will depend on the date of publication in the Journal Officiel. The date of entry into force will obviously need to be reflected by the deadline for Member State implementation as per Art. 42.

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[63] http://european-convention.eu.int/docs/Treaty/cv00850.en03.pdf

6.6 Issues awaiting clarification

6.6.1 Solvency

The choices are:

6.6.1.1 Adapted unsophisticated model currently used for direct insurers

Starting point would be the solvency standards already applicable to direct insurers, i.e on the non-life side (life reinsurance is usually less than 10% of a reinsurer's portfolio and hence almost negligible) 16% of premiums or 23% of paid claims, whichever is higher.

However, given the inherently more risky nature of reinsurance the EU is alternatively considering a "150% alternative", i.e. 25% of premiums or 35% of paid claims[64]. In particular France appears to be favouring this approach, perhaps as a consequence of the series of crises having affected the national reinsurer SCOR.

A further alternative is "enhanced alternative 1" under which a 50% loading would only apply to certain classes of insurance. Starting point would be the 16%/23%, but by way of comitology[65] over time loadings would be introduced in respect of certain classes which are perceived as particularly hazardous. No details are given as to the classes to which this might apply, but if one takes the ratio between premiums written and reserves as a yardstick, in particular credit/surety and liability are likely candidates.

6.6.1.2 Risk based capital adequacy (more sophisticated)

This is the approach taken by rating agencies. Capital requirements are triggered by

- Written premiums
- Investment volatility
- Operational risk
- Counterparty risk

Risk diversification can be a mitigating factor.

The UK's Financial Services Authority is already commencing to introduce such a supplementary capital adequacy standard in parallel to the EU solvency standard, initially on a purely reporting basis, in a 2nd phase also as a basis for regulatory

[64] Fast-track Reinsurance Supervision project, Overview and issues for consideration by the Insurance Committee, Markt/2513/03-EN 18.6.2003, page 7; the legal basis of the Insurance Committee itself is Council Directive 91/675/EEC of 19 December 1991 setting up an insurance committee, http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=31991L0675&model=guichett

[65] proposal to be established by the Committee of European Insurance and Occupational Pensions Supervisors – CEIOPS -

action[66]. Already for a couple of years has a risk based capital adequacy standard applied to Lloyd's, which is operating under the FSA's jurisdiction.[67]

6.6.2 Need for Equalisation Provisions

Some Member States already prescribe Equalisation Provisions (e.g. Germany, UK and Luxembourg). Such provisions have a two-fold effect:

- Drain on capital since equalisation provisions are considered technical provisions, any amount attributed to them reduces available profits and hence the ability to self-finance growth
- On the other hand, tax deferral since normally the national tax authorities will take profits post attribution to fluctuation reserves as a basis for taxation.

Whilst such unequal national rules regarding equalisation reserves continue, no level playing field for EU based reinsurers will exist. However, the same can also be said regarding corporate taxes, which range from 10% (Cyprus), 12.5% (Ireland), 30% (UK) to close to 50% in many EU Member States.

6.6.3 Equalisation Provisions counting towards solvency requirements

In the past, any attribution to an equalisation provision was lost as regards solvency. There now appears to be a consensus that the entire equalisation provision would count for solvency. In other words, should a Member State permit/require the creation of equalisation provisions this will allow the reinsurer concerned to build up solvency in a tax-efficient manner.

6.6.4 Effect on ceding companies' credit for ceded reinsurance

So far, the solvency calculations for direct insurers permit only limited credit for ceded reinsurance (up to 50%, based on ceded claims, not ceded premiums). Apparently, the EU may be willing to increase the reinsurance reduction factor, i.e. allow those ceding companies which cede more than 50% of their business to also take credit for excess cessions. This can only be achieved by modifying the relevant direct insurance directives. The EU has come to the conclusion that an increase in the reinsurance reduction factor to 75% and even to 90% would only have a small impact, the reason being that most direct insurers already are running retentions way above the currently still effective 50% of gross premiums level. Therefore, there now appears to be a consensus that the maximum reduction factor should be increased to 75%[68].

It needs to be emphasised that this will only apply to situations where reinsurance is placed with an EU reinsurer. In other words, there is likely to be discrimination against non-EU reinsurers. This may explain the rather clear position Swiss Re has been taking against the draft directive.

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[66] FSA Press Release 15.7.2003, http://www.fsa.gov.uk/pubs/press/2003/073.html, there is also a Consultation Paper 190 more fully describing the standard.

[67] This approach is explained in an earlier FSA Consultation Paper No. 16, published in 1998: The future regulation of Lloyd's, http://www.fsa.gov.uk/pubs/press/2003/073.html

[68] Note to the IC Reinsurance Subcommittee, Markt/2523/03-EN, 28.5.2003, page 8, http://europa.eu.int/comm/internal_market/insurance/docs/markt-2523-03/2523-03_en.pdf

6.6.5 Relationship between EU directive and IAIS rules

The EU clearly refers to the IAIS regulatory debate regarding reinsurers. However, there appears to be relatively little coordination:

> "The ***international projects on reinsurance supervision, solvency and insurance accounting are not yet finalised*** and it is unlikely that we will know the clear direction before adopting a proposal for a Directive on reinsurance based on a fast-track approach."

The EU's new directive would not be applicable to non-EU reinsurers operating via freedom of services. Should they establish a branch in the EU, this would be subject to supervision by the Members State where it is located.

6.7 Timing

Originally, the EU Commission intended to establish the harmonised framework for reinsurance supervision via a "fast-track" approach[69], essentially basing supervisory standards applicable to reinsurers on those already to be met by direct insurers. The EU appears keen to adopt a "quick and dirty" approach, based on existing rather non-technical solvency standards applicable to direct insurers, and in a 2nd phase replace the initial rules by something more sophisticated.

However, it appears that the project has become bogged own in

- Discussions regarding the solvency standard to be applied
- The upcoming 2005 EU elections.

Hence, the new reinsurance directive is now only expected to come into force in 2006 with Member States having perhaps another year to transpose it into national law. This has already caused the German government to commence tightening rules applicable to reinsurers post the Gerling Global debacle without awaiting the EU directive.

[69] Fast-track Reinsurance Supervision project, Overview and issues for consideration by the Insurance Committee, Markt/2513/03-EN 18.6.2003, http://europa.eu.int/comm/internal_market/insurance/docs/markt-2513-03/markt-2513-03_en.pdf

7 Need for cost/benefit analysis

7.1 Economic concept of cost/benefit comparison

Regulation of a particular industry is no end onto itself. It should only be imposed following a thorough cost-benefit analysis. The UK's Financial Services Authority is for instance advocating this principle. Its chief executive, John Tiner, recently declared e.g. that the investment services directive would not pass any serious cost/benefit analysis.[70]

7.2 Legal principle of proportionality

In **legal terms**, this test is known as the **principle of proportionality**, defined as follows:

> "objectives pursued and the means deployed must be weighed up and an attempt made to keep them in proper balance so that the citizen is not subjected to excessive burdens"[71]

This requires the Commission to use

> " the approach which is capable of resolving the identified
> problem with the lightest form of intervention in market functioning or national regulatory systems."[72]

[70] Graham Mather, The race to stay ahead of Europe's regulators, The EU's networks of economic regulators may be achieving a double whammy: too many directives and too few results, Financial Times 18.12. p. 23

[71] Fundamental Rights In The EU, The ABC of Community Law, http://europa.eu.int/eur-lex/en/about/abc/abc_10.html

[72] Proportionality: a guiding principle for the internal market
by Mario Monti, Member of the European Commission
Directorate-General 'Information, Communication, Culture and Audiovisual Media'
Monthly newsletter 9-95, http://europa.eu.int/en/agenda/sm/esf9_95/en.pdf

7.3 Effective Realisation of policy objective/Benefit

7.3.1 Definition of legitimate policy objective

Before checking whether the objective of the EU's policy can be met by implementing the draft directive, the preceding question arises what the purpose of the EU's policy may be. The preamble of the directive following "whereas" remains blank, so by way of speculation five potential purposes come to mind:

7.3.2 Implementation of the Internal Market

Progressive establishment of the internal market, in particular as regards the movement of services (Art. 14 para. 2 EC) is one of the objectives of the EU.

However, the 1964 Reinsurance Directive already created precisely that integrated internal market and as a consequence EU reinsurers are operating without barriers throughout the EU. What the Commission now intends is a step back from the original laisser-faire approach to a more interventionist attitude.

7.3.3 Reduced chance of bankruptcy of ceding direct insurers

Bankruptcies of direct insurers can conceivably be triggered by the failure of their reinsurers. Such bankruptcies tend to have adverse consequences for consumers. Art. 153 EC in conjunction with Art. 94 EC might hence be viewed as an appropriate basis for the draft directive.

However, there three counterarguments:

- There have been no direct insurer insolvencies brought about by reinsurer insolvencies. If one applies the principle "if it ain't broke, don't fix it" it would appear that there is nothing really to be fixed as regards reinsurer failure having a domino effect on ceding companies.
- The objective of ensuring enhanced direct insurer stability could also be achieved by less intrusive means, i.e. by leaving reinsurers essentially unregulated but only giving full credit for ceded reinsurance if the reinsurer concerned meets certain criteria. For instance, full credit for ceded reinsurance could be limited to reinsurers rated at a minimum BBB by one of the four main rating organisations; reinsurers not thus rated would need to collateralise their liabilities for their ceding companies to obtain full statement credit.
- The IAIS is already preparing a system of coordinated reinsurance regulation which is rather advanced and which would have the advantage of not initially stopping at the EU's borders but which would also include other major domiciles of reinsurers such as the US, the Bermudas, Canada and Japan with which the EU would need to bi-laterally negotiate otherwise.

7.3.4 Fear of systemic failure

Systemic risk is defined by Swiss Re[73] as "the danger of an event leading to a loss of economic value and/or of confidence in the financial system with real consequences for the economy." Manifestations of systemic risk cited are Long Term Credit Management (a hedge fund which went under during the 1998 Russian debt crisis and which almost triggered massive US bank insolvencies) as well as the Federal Home Loan Mortgage Corp., which as a prime issuer of US mortgages greatly exposes the holders of such mortgages to valuation fluctuations. Another example were the 1929 depression bank runs which caused 1/3 of all US banks to fold, thus lead to a general drying up of credit in the economy and a considerably reduction in overall economic activity.

Swiss Re distinguishes two types of manifestation of reinsurance related systemic risk:

- "Lack of reinsurance cover"
- "Bankruptcies of banks and direct insurers caused by reinsurer insolvency"

However, Swiss Re argue that since in respect of 91% of all reinsured technical reserves (i.e. claims by direct insurers against their reinsurers in respect of yet unpaid past and future claims) the reinsurer is rated AA or better, the counterparty risk facing direct insurers out of ceded reinsurance is actually not that alarming.

Another argument brought by Swiss Re concerns the "run on the bank" issue. Swiss Re claims that whilst an irrational run on the bank is possible with regard to actual banks (where many deposits can become due on a daily basis) this does not apply to reinsurers as reinsured claims only need to be paid when the underlying direct insurance claims become due. Whilst this argument is rather convincing, a word of caution is appropriate. A number of reinsurance contracts now incorporate a clause which permits the ceding company upon e.g. the counterparty rating of the reinsurer falling beneath a critical level (such as BBB-) to either demand a premature payout of claims reserves or to impose collateralisation, e.g. by way of bank letter of credit. An external fact such as a re-rating can then indeed trigger an automatic liquidity crunch. Should this type of contractual clause become more prevalent a run-on-the bank type situation will also be imaginable for reinsurers.

[73] Reinsurance – a Systemic Risk, page 3 and 7, Sigma 05/2003, http://www.swissre.com/INTERNET/pwsfilpr.nsf/vwFilebyIDKEYLu/MPDL-5QYDTT/$FILE/sigma%205_2003_e.pdf

7.3.5 Money laundering issues

Reinsurance transactions can act a smoke-screen for what effectively is a money-laundering operation. This is facilitated by the often opaque nature of reinsurance contracts. The essence of a contract may be hidden amongst dozens of pages of standard but in the context meaningless clauses. An industry outsider, e.g. a bank compliance officer, is unlikely to spot the true objective of the contact, which may serve as a mere conduit for the recycling of illicitly obtained funds. The often offshore location of the non-major player reinsurers involved will further cloak such operations.

Typical cases might be the creation of bogus life insurance policies (under which periodic premiums are paid cash, just beneath reporting thresholds), which are then bundled together and reinsured to an offshore entity. Reinsurers probably fall under the Financial Action Task Force's definition.[74]

7.3.6 Tax avoidance via reinsurance

Similarly, reinsurance transactions can be used to effectively avoid corporate taxes by creating tax deductible business expenses (premiums) in a high corporate tax country which via reinsurance resurface as ceded (and essentially claims-free) reinsurance premium at e.g. the seat of a captive reinsurer which does not pay any corporate tax at all. The efficiency of such an operation is, however, greatly diminished in countries, which levy insurance premium tax at a high rate, e.g. France and Germany.

It is also highly questionable whether it may be legitimate to motivate the need for a greater degree of supervision with the potential for tax avoidance. Combating tax avoidance should remain the exclusive domain of the national Inland Revenue.

[74] http://www1.oecd.org/fatf/40Recs_en.htm#Competent%20authorities

7.4 Minimum restrictions on market operators / Cost

7.4.1 Increase of cost of capital (new solvency rules)

Post the WTC event the reinsurance industry is already facing an ongoing capital shortage. Solvency margins have dropped due to a combination of technical losses and investment losses. Reinsurers are forced to reflect this scarcity of capital in their pricing.

So far, most EU reinsurers are not yet subject to regulatory solvency standards. Instead, at least the larger and more respectable ones are governed by the risk based capital adequacy models used by rating agencies.

However, should they become subject to the Em's intended simplistic capital adequacy standards, they will need to stop writing or to reprice large volume/low volatility business which will be subject to the same capital adequacy standards as highly volatile high layer non-proportional liability business.

7.4.2 Further bureaucracy

The new regulatory compliance requirements will trigger additional costs of compliance. It is noteworthy that as per Art. 28 of the Directive in spite of the principle of home country supervision host country regulators will still have a limited say as regards branch or freedom of services operations affecting their territories.

It is quite likely that ultimately the EU will find that its (re)insurance supervisory directives are not transposed/applied in a uniform fashion by Member States and that therefore the creation of a centralised insurance regulator at EU level will be unavoidable. There is a comparable situation in the US where for decades a discussion has been ongoing whether State supervision of the insurance industry (somewhat coordinated by the National Association of Insurance Supervisors) should not be replaced by a Federal system.[75]

7.4.3 Driving Reinsurance as an industry out of the EU

Already since the last major capacity crunch in 1993 there has been an inexorable move of the reinsurance industry offshore, in particular to the Bermudas where the advantages can be summarised as follows:

- Zero corporate tax until 2020: it is a great deal easier to generate a say 15% post-tax target return to investors if there is no corporate tax to be paid, at an EU- typical 30% tax rate a pre-tax return of 21.4% will be required.
- Cluster of other market participants in the sense of a local talent pool

7.4.4 Barriers to entry for non-Europeans

[75] Industry Experts Ask: State or Federal Regulation?
Insurance Journal 30.4.2003,
http://www.insurancejournal.com/news/exclusive/national/2003/04/30/28444.htm

In particular, non-EU reinsurers will probably have to withstand a triple test:

- By their home office regulators (e.g. in the Bermudas)
- By rating agencies
- By European regulators

Since corporate tax conditions are a great deal more hospitable in the Bermudas than anywhere within the EU (including even Ireland at 12.5% corporate tax), there has been a rapid shift of reinsurance capacity to the Bermudas. The local carriers are generally

- Extremely well capitalised (US$ 500m plus)[76], the total industry in 2001 had US$65b in capital and only wrote 49b in premiums
- Well rated (bigger players: A or better)
- Since they were created fairly recently not encumbered by concerns over their reserves for US asbestos liability

This makes them attractive counterparties for EU based direct insurers who frequently consider that the counterparty risk associated with one of these relative newcomers is a great deal lower than that associated with a long-established traditional European reinsurance carrier.

On the other hand, it is not inconceivable that the EU will be tempted to use free market access for Bermudan reinsurers as a trade-off in its quest for worldwide tax harmonisation.

[76] market directory of Bermudan reinsurers: http://www.bermuda-insurance.org/bim/home.nsf/index2.html

8 Possible Legal Challenges to a future EU Reinsurance Directive

8.1 By a Member State

Quite possibly, a member state might find that the new directive will have substantial negative repercussions on its national reinsurance industry. In particular, a number of nationally established reinsurers such as industrial captives might find it difficult to comply with the new stringent solvency regulations. Whilst Ireland is adopting a more sophisticated approach to reinsurers based locally and whilst there appears to be a move away from mere captives to market reinsurers, many of them featuring Bermudan capital, Luxembourg so far only demands a 10% solvency standard from the 267 "reinsurers" (except perhaps 3 all of them mere captives). It is therefore conceivable that Luxembourg might wish to challenge the new directive.

This would be an action as per Art. 230 para. 2 EC.

Alternatively, the Member State antagonistic to the directive might also just fail to transform it within the time frame set. In this event, the Commission could bring the matter before the Court of Justice in accordance with Art. 226 para. 2 EC. Alternatively, another Member State might do so as per Art. 227, but this would only be feasible if the Commission had failed to take action itself.

8.2 By a reinsurer domiciled in a Member State

A reinsurer wishing to challenge a future directive might choose to do so at any one of the following stages:

8.2.1 Prior to adoption of the directive

As there would not yet be any direct effect on the reinsurer, neither action in the EU courts nor – probably – in the national courts could be considered.

8.2.2 Post adoption but prior to member country implementation

Again, without national legislation in place, there would not yet be a direct effect onto the reinsurer concerned. Furthermore, the situation of a decision specifically addressed to that reinsurer as per Art. 230 para 4 EC would not exist.

8.2.3 Post member country implementation

Whilst the national legislation would indeed be producing direct effects (e.g. imposing a minimum solvency margin), it will depend on national laws whether a right to challenge a law rather than a resulting administrative decision exists.

8.2.4 Post national supervisory decision addressed at a particular reinsurer

Following a decision by a national regulator (e.g. citation for infringement of the new national legislation), the reinsurer could challenge that decision through the national courts which might then have to submit the case to the ECJ as per Art. 234 EC.

9 Conclusion

In summary, a unified EU-wide system of reinsurer supervision appears superfluous given

- The fact that direct insurers themselves are already supervised and that national regulators are free to impose minimum standards on the counterparty quality of reinsurers supporting them (e.g. via not giving solvency credit for reinsurance ceded to reinsurers not meeting these standards)
- The increasing importance attached to counterparty rating of reinsurers which has almost lead to the stage where reinsurers not able to demonstrate a min. BBB or equivalent rate from Standard&Poors, AM Best, Fitch or Moody's are no longer able to attract any business
- Significant and increasing parts of reinsurance coverage are going to the Bermudas which would fall outside of the reach of national regulators anyhow
- It merely attacks the legal form – reinsurance - through which typically operators in the risk transfer business are adversely impacted, but not the substance: essentially all of the industry's problems stem from the US and its out-of-control legal fraternity. The best way to protect European direct insurers and reinsurers from their own follies and from the sinister suggestions of brokers would be to
    - bar them from accepting any inwards business from the US, in particular should it involve liability exposures.
    - Of course a great deal of damage is done already, perhaps it would be appropriate for the EU to put trade pressure on the US in order to force tort reform, preferably with effect also for already existing US asbestos etc. liabilities which are likely to lead to a haemorrhaging of funds from European insurers and reinsurers over the next two if not three decades.

The EU appears to be distancing itself from the fully libertarian approach taken by the original 1964 reinsurance directive and moving to a "belt" (supervision of direct insurers in respect of reinsurance purchased) plus "braces" (supervision also of the reinsurers) approach. This is likely to create a duplicating bureaucratic involvement.

By making the unsophisticated solvency rules applying to non-life insurers (rather than a risk-based capital adequacy approach) also applicable to reinsurers, the EU will perpetuate an obsolete regulatory approach.

Furthermore, the consequences in respect of reinsurers from non-EU countries remain to be seen. It may well be that in the future they will, in spite of appropriate financial standing and counter-party rating, find it increasingly difficult to attract business from European ceding companies. Such narrowing of choice for European insurers may entail an increase in the price of reinsurance coverage and be part of a "Fortress Europe" approach.