

GUIDELINES ON GENERAL REINSURANCE ARRANGEMENTS AND SOUND PRACTICES

1.0 Introduction

- 1.1 Reinsurance plays a crucial role in preserving the financial soundness of an insurer. It is an important risk management tool that can be used to reduce insurance risks and the volatility of financial results, stabilise solvency, make more efficient use of capital, better withstand catastrophic events, enhance underwriting capacity and to draw on reinsurers' expertise. However, an extensive reliance on reinsurance support exposes the insurer to greater risk of financial strain in the event that reinsurers are unable to fulfil their financial obligations when they fall due.
- 1.2. It is the responsibility of the insurer to design its reinsurance programme in line with its exposure and business portfolio, taking into account, among others, the insurance risk profile, and concentration of business. The guidelines have been developed in order to assist insurers in the preparation of their reinsurance programme to ensure prudence and professionalism.
- 1.3 These guidelines also set out Labuan FSA's expectation for effective reinsurance practices and procedures that should form an integral part of an insurer's overall reinsurance risk management policy.

2.0 Applicability

- 2.1 These guidelines are applicable to all Labuan insurers under the following categories:
 - 2.1.1 Labuan insurer and reinsurer licensed under Part VII of the Labuan Financial Services and Securities Act 2010 (LFSSA);
 - 2.1.2 Labuan takaful and retakaful operator licensed under Part VII of the Labuan Islamic Financial Services and Securities Act 2010 (LIFSSA); and
 - 2.1.3 Labuan takaful and retakaful window approved under Part VII of LIFSSA.
- 2.2 Under the guidelines, the term "insurer(s)" refers collectively to all Labuan insurance licensees as specified under paragraph 2.1 and should be taken to include reinsurer/retakaful operators/retrocessionaire while reinsurance should include retakaful arrangement/retrocession, whichever applicable.

3.0 Legal Provision

- 3.1 The guidelines are issued pursuant to Section 4A of the Labuan Financial Services Authority Act 1996 (LFSAA) for the purpose of clarifying the requirements pertaining to the general reinsurance arrangements and sound practices to be adopted by the Labuan insurers.
- 3.2 Any person who fails to comply with the Guidelines is guilty of an offence punishable under Section 36B and 36G of the LFSAA.

4.0 Effective Date

- 4.1 The guidelines shall come into effect on 1 April 2013 and would remain effective and applicable unless amended or revoked.
- 4.2 The guidelines supersede the Guidelines on General Reinsurance Arrangements issued on 14 March 2006.

5.0 Coverage of Guidelines

- 5.1. This set of guidelines is issued to facilitate the proper conduct of reinsurance placements and must be observed by all Labuan insurers. It covers aspects in determining the adequacy of reinsurance arrangements, namely, appropriateness of retention level, security of reinsurers, spread of reinsurers and appropriateness of reinsurance contracts.
- 5.2 The guidelines also provide Labuan FSA's expectation on Labuan insurers to develop prudent approaches to manage their reinsurance and retrocession risks.
- 5.3 The guidelines which are applicable to all types of reinsurance arrangements including retakaful arrangements except financial reinsurance¹, are not intended to be exhaustive. Each reinsurance arrangement is unique and may require a modified approach to be adopted consistent with the nature of reinsurance.

6.0 Appropriateness of Retention Level

- 6.1 The setting of monetary amounts for retention is an important task for an insurer especially for classes of business with wide range of sums insured coupled with high risk of accumulation. The primary considerations in setting retention include protection of the insurer's capital, stabilisation of financial results and availability of cashflow to meet large claims.

¹ The term "financial reinsurance" (also known in some jurisdictions as "finite reinsurance", "structured reinsurance", "non-traditional reinsurance" or "loss mitigation reinsurance") is used to describe an entire spectrum of reinsurance arrangements that transfer limited risk relative to aggregate premiums that could be charged under the contract. A typical transaction may include, but not limited to, provisions for aggregating risk, for aggregating limits of liabilities, for aligning the interests of insurers and reinsurers, and for explicitly recognising the time value of money.

- 6.2 The retention capacity of an insurer depends on its financial strength. Clear retention limits should be set for each class of business and for categories of risks within each class of business. A Labuan insurer's retention strategy must take into account not only single risk claims but also multi-risk events. The Labuan insurer shall ensure that its reinsurance arrangements provide adequate protection for all classes of business underwritten to enable it to pay its liabilities as they fall due.

7.0 Reinsurance Counterparties Due Diligence

- 7.1 Labuan insurers should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under exceptional but plausible adverse events on an on-going basis. The level of the insurer's due diligence on any reinsurance counterparty including risk assessment must commensurate with its level of exposure to that counterparty.
- 7.2 The Labuan insurer should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of all reinsurance counterparties and not rely solely on third parties, including rating agency assessments or broker analysis and recommendations.
- 7.3 Labuan FSA expects a robust due diligence by the Labuan insurer in respect of any current or prospective reinsurance arrangement with non-Labuan licensed reinsurer or with a reinsurer that is not regulated by Labuan FSA. This assessment of counterparty risk should consider the regulatory and supervisory regime as well as insolvency frameworks of the foreign counterparty's home jurisdiction.
- 7.4 When performing its due diligence, the Labuan insurer should give consideration to, among others, the reinsurance counterparty's:
- a) claims payment record;
 - b) expected future claims obligations;
 - c) balance sheet strength;
 - d) funding sources, including its level of and access to capital, and form, amount and sources of liquidity;
 - e) management, including the quality of its governance practices and procedures; and
 - f) retrocession arrangements and the direct or indirect impact they may have on the insurer's own arrangements with the reinsurer.
- 7.5 The evaluation of each of the insurer's reinsurance counterparties should be updated throughout the life of the reinsurance contract. In cases where there may be material exposures to incurred but not reported (IBNR) losses, management should ensure that the evaluation continues beyond the expiration date of the contract. This is to ascertain that the insurer assesses potential reinsurance recoverable from expected future claims.

7.6 Labuan insurers should take all appropriate steps to assess adequately the soundness of the reinsurers they cede their insurance risks. This is to ensure that the reinsurers are financially capable of fulfilling their financial obligations and promptly meet their obligations to pay. The selection of panel of reinsurers should be based on information relevant to ascertaining the reinsurer's reliability and security. The main factors which Labuan insurers should consider when assessing a potential reinsurer are as follows:-

7.6.1 Legal and statutory framework

- a) The Labuan insurer should verify that the reinsurer has been legally set up in accordance with the laws of its home country and has been authorised to carry on reinsurance business in other countries. The Labuan insurer must be satisfied that the reinsurer is under proper regulation and supervision by its home authority;
- b) To minimise the possible legal risk involved in any reinsurance transaction, information on the legal status of the reinsurance company should be verified; and
- c) The Labuan insurers should ensure that the reinsurer is legally and geographically entitled in accordance with its articles of association to accept the business ceded.

7.6.2 Financial capacity and resources

- a) Apart from financial statements and published accounts, articles on foreign reinsurers in the specialist press and evaluations by analysts and international rating agencies are useful to assess the capacity and financial strength of the reinsurer. Labuan insurers must undertake robust counterparty assessment on the credit worthiness of the reinsurers. In addition, for the reinsurance placement with non-Labuan licensed reinsurers, Labuan insurers may consider reinsurers which are rated by an internationally recognised rating agency and as approved by its board of directors (the Board) as part of the criteria for assessing their reinsurance counterparties;
- b) The financial standing in terms of asset size and the types of assets, premiums, solvency margin, technical provisions and profitability record of the reinsurer for at least the preceding five years should be analysed. As a matter of prudence, Labuan insurer must undertake on-going credit assessment against the reinsurers;
- c) In terms of financial requirements, the Labuan insurer should ensure that the reinsurer has complied with the financial requirements of the home country; and

- d) Details regarding the general methods of valuation of technical provisions should be ascertained where possible. The provisions in relation to the business written and its risk exposure (e.g. in long-tail business) should provide an indication whether the reinsurer is able to fulfil its obligations at any time.

7.6.3 Structural indicators

- a) Due regard should be given to the financial strength of the parent company and other companies within the group; and
- b) Information on change in ownership and relevant business relationships with other companies such as strategic alliances and intra-group retrocessions should be considered. Influence could be exercised by other parties in the group to which the reinsurer is part of, possibly pursuing interests not related to reinsurance, on account of such relationship. The information to be obtained by the Labuan insurer should show to what extent the reinsurer is independent and free from the influence of third parties in its underwriting policy.

7.6.4 Independent and fit and proper management

- a) The reputation and integrity of the management including their conscientiousness, competence and stability and experienced underwriters are indicators of management quality of the reinsurer; and
- b) The members of the management of the reinsurer preferably should have the relevant professional qualifications, practical knowledge and experience.

7.6.5 Market behaviour

- a) Labuan insurers should consider the reinsurer's past and present behaviour, its permanent presence in the market and commitment as indications of its reliability as the Labuan insurer's partner;
- b) Substantial business volume from a correspondingly large number of renowned reinsurers of international repute can be an indication of confidence in a solid reinsurer;
- c) Attention is to be paid to the reinsurer's underwriting policy and to what extent it uses retrocession or bears the accepted risk itself;
- d) The direct insurer should choose a reinsurer which will be able to provide the required technical support; and
- e) Past performance in reinsurance claim payments including the speed with which the claims are paid is one of the factors to be considered in choosing the reinsurer.

- 7.6.6 Legal, economic and political conditions in the home country of the reinsurer
- a) The Labuan insurer must be aware of political and currency stability of the home country of the reinsurer;
 - b) Reinsurance activities and the movement of capital should not be restricted; and
 - c) There should be no restrictions on the transfer of claims payments out of the home country.
- 7.7 The Labuan insurer is responsible for the regular update of information compiled on its panel of reinsurers and should also keep abreast with developments in the international reinsurance markets especially developments relating to the reinsurers on its panel. Reinsurance magazines, newsletters, press releases and internet news pages can provide up-to-date information on reinsurance market developments.

8.0 Spread of Reinsurers

- 8.1 Labuan insurers are expected to have policies and procedures that describe and set concentration limits for credit risk exposure to reinsurance counterparties based on their risks appetite and maintain an appropriate system to monitor these exposures.

9.0 Appropriateness of Reinsurance Contracts

- 9.1 When considering the appropriateness of a reinsurance contract, the Labuan insurer should take into account the impact of the contract on the effectiveness of its overall reinsurance programme. For example, the Labuan insurer can compare the different combinations of types and thresholds of reinsurance cover purchased (e.g. by varying retention level, limits, proportion ceded), to ensure an optimal reinsurance programme.
- 9.2 The rights and obligations of the insurer and the reinsurer relate directly to the terms and conditions of the policies falling within the scope of the contract. The contract terms therefore must be carefully checked by the insurer and each clause should be read and carefully understood. Great care must be taken by both parties to be certain that there is a clear understanding of the classes of business being covered, the types of loss to which the contract applies and the way in which the amount recoverable by the insurer is calculated. The contract wording may affect or limit Labuan insurer's cover or increase its net exposure. As additional protection, the Labuan insurer shall ensure that the proportional and non-proportional treaty reinsurance contract contains an "errors and omissions" clause which provides that reinsurance cover continues to be valid where errors which are inadvertently made, are rectified immediately upon discovery. Labuan insurers should also ensure that the reinsurance contract provides the safeguard measures, such as by having an appropriate "hours

clause” that specifies the limited period during which claims can be aggregated for the purpose of one claim on the reinsurance contract and the “rating downgrade and termination clause” stipulating the obligations to terminate the participation of the reinsurer (by giving written notice) as a result of, among others, the downgrade of the reinsurer’s rating, or where the reinsurer ceases underwriting new business, or renewing existing risks of the class of business which the contract covers, experiencing major loss or any other adverse conditions. This by no mean exhaustive and Labuan insurers must ensure that they implement proper protection mechanism and risk management measures in line with the approved policy under their PRRM.

- 9.3 Labuan FSA recognises that there may be situations where a comprehensive reinsurance contract is only duly executed by all parties after the effective date. In such circumstances, the reinsurance coverage during this interim period is usually set out in a less formal document (e.g., slip, cover note, letter of proposal, binding letter of intent, hereinafter referred to as the “summary document”). If an event were to occur within this interim period, the lack of certainty relating to the terms and conditions of the reinsurance coverage in the summary document could result in actual operational and reputational risks for both the insurer and the reinsurer. In mitigating these risks, Labuan FSA expects Labuan insurers to undertake the following measures:-

9.3.1 Obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, including, but not limited to electronic copies, or original hard copies, of signed documents that set out:

- a) the premium / consideration paid by the insurer;
- b) the percentage of risk assumed by each reinsurer;
- c) the risk(s) reinsured;
- d) the duration of the coverage;
- e) where applicable, any exclusions to terms of coverage; and
- f) any standard clauses that are to be relied upon or incorporated by reference into the reinsurance contract;

9.3.2 Address, within the summary document, any material issues most likely to arise, including all variable or unique agreement terms; and

9.3.3 Ensure that all final comprehensive reinsurance contracts, including any amendments thereto, bear the duly authorised signature of both the Labuan insurer and the reinsurer(s) within a relatively short timeframe having regard for the nature, complexity and materiality of the agreement.

10.0 Reinsurance Placements

- 10.1 The insurer shall ensure prompt placement of all its reinsurance requirements. Labuan insurers are advised to commence renewal negotiations not later than two months before the renewal date so as to allow them sufficient time to compare rates and obtain competitive terms, and confirm full placement well

before expiry. For facultative reinsurance, confirmation of the necessary reinsurance facilities shall be obtained before acceptance of any risk exceeding the Labuan insurers' gross automatic capacity. Labuan insurers should also ensure that persons representing the reinsurer are properly authorised to accept reinsurance on behalf of the reinsurer.

- 10.2 Reinsurance programmes must be scrutinised properly to ensure that there are no gaps in cover or shortfall in placements and insurers must diligently communicate to the reinsurer all material facts relating to the risk being reinsured to avoid undue exposure.
- 10.3 Labuan insurers may participate in the global programmes of their affiliated companies and must ensure that such programmes do not incur unnecessary additional expenditure that may impact their financial security and solvency. Transactions with associated foreign companies should be carried out at arm's length at market terms and conditions.
- 10.4 Where placements are made through brokers, Labuan insurers should ensure that the insurance intermediaries possess appropriate qualifications. The brokers must provide adequate information to Labuan insurers including any shareholding interest the broker has with the reinsurers.

11.0 Reinsurance Risk Management

- 11.1 All Labuan insurers must establish adequate policy for managing the reinsurance risks, subject to the oversight of their Board² and implementation by senior management. This policy for reinsurance risk management (PRRM) must reflect the scale, nature and complexity of the Labuan insurer's business, and have regard for its risk appetite and risk tolerance.
- 11.2 The PRRM encapsulates the significant elements of the insurer's approach to managing risks through reinsurance, including the purpose and objectives for seeking reinsurance, risk diversification objectives, risk concentration limits, ceding limits, and the practices and procedures for managing and controlling its reinsurance risks.
- 11.3 Labuan FSA also expects the PRRM, at a minimum, specifies the roles and responsibilities for those positions in-charge of implementing the PRRM, the process for ensuring that the PRRM is updated to reflect changing market conditions and the Labuan insurer's policy on the use of registered and unregistered reinsurance.
- 11.4 Labuan insurers must assess the adequacy and effectiveness of the reinsurance arrangements to ensure that exposures to large and catastrophic losses are

² For branches, Labuan FSA looks to the Principal Officer, Chief Agent of the branch or any persons (by whatever name called) with the delegated authority and oversight over the branch to oversee the management of the branch and to be aware of Labuan FSA's guidelines on General Reinsurance Arrangements and Sound Practices.

adequately addressed. This may require stress testing of exceptional but plausible scenarios to determine if the reinsurance arrangements entered into are adequate at mitigating losses to acceptable levels in accordance with their risk appetite and risk tolerance.

- 11.5 The Board and senior management of the Labuan insurers are responsible to ensure that appropriate policies, procedures, and internal controls, are in place to monitor the effectiveness of, and operational compliance with, the PRRM on on-going basis. These requirements must be read together with the Guidelines on Minimum Audit Standards for Internal Auditors of Labuan Insurance and Insurance-Related Companies and the Prudential Framework of Corporate Governance for Labuan Insurance and Insurance-Related Companies issued by Labuan FSA.

12.0 Reporting Requirements

- 12.1 It is important that the Labuan insurer conducts its own evaluation of its reinsurer's claims-paying ability, taking into account both qualitative and quantitative considerations. The Board is ultimately responsible for the reinsurance programme of the Labuan insurer. The reinsurance arrangements including facultative placements should be in accordance with the limits and criteria approved by the Board or the committee appointed by the Board or persons representing the Board. Any departure from the approved limits and criteria must be declared to and approved by the Board or its appointed committee or representative prior to implementation.
- 12.2 The senior management of the Labuan insurers are required to report to their Boards confirming that the reinsurance arrangements are adequate in relation to the business undertaken on annual basis.
- 12.3 Labuan insurers are to submit the summary of Reinsurance Arrangements (as attached in Appendix I) by 15 January every year starting from 2014 to:

Director
Supervision and Enforcement Department
Labuan Financial Services Authority (Labuan FSA)
17th Floor, Main Office Tower
Financial Park Complex
Jalan Merdeka
87000 Federal Territory of Labuan, Malaysia

Telephone no.: 087 591 200
Facsimile no.: 087 453 442 / 413 328
Email: supervisioninsurance@labuanfsa.gov.my

13.0 Supervisory Information

- 13.1 Labuan insurers are required to maintain and provide to Labuan FSA, upon request, their PRRM and a complete description of all reinsurance arrangements, including levels of reinsurance, the due diligence performed on reinsurance counterparties, and the proportion of reinsurance cession with Labuan licensed reinsurers and foreign reinsurers.
- 13.2 Labuan FSA may ask for modification, impose new requirements or additional terms upon the PRRM of the Labuan insurer if it reasonably believes that such policy to be detrimental to the interest of its beneficiaries, investors, creditors or any other such similar interested parties.
- 13.3 Labuan insurers are required to promptly inform Labuan FSA if they become aware of any reinsurance issues that could materially impact their financial condition or financial strength rating.
- 13.4 Labuan captive insurers will continue to submit its reinsurance cover slip and report to Labuan FSA on quarterly basis. Labuan FSA should be notified in writing of any change to the reinsurance programme within two weeks from the effective date of the change.

14.0 Transition

- 14.1 Labuan FSA expects each Labuan insurer to implement the principles and regulatory requirements set out in these guidelines within six (6) months from the effective date of the guidelines.

Labuan Financial Services Authority
1 April 2013