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LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY, MALAYSIA

LEMBAGA PERKHIDMATAN KEWANGAN LUAR PESISIR LABUAN
(LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY)

Circular No.: 82/2006/ALTC/LIIA

14 March 2006

A/s distribute to Members
09/3/06

GM's OFFICE
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14 MAR 2006
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Chairman
Association of Labuan Trust Company (ALTC),
Labuan International Insurance Association (LIIA)

Dear Sir/Madam,

Guidelines On General Reinsurance Arrangements

The above matter refers.

We are pleased to inform you that in order to further enhance the operations of offshore insurance, LOFSA has decided to introduce the "Guidelines on General Reinsurance Arrangement" (Guidelines). The Guidelines cover four main areas in determining the adequacy of reinsurance arrangements, namely:

i. Appropriateness of retention level;
ii. Security of reinsurers;
iii. Spread of reinsurers;
iv. Appropriateness of reinsurance contracts.

The above Guidelines would be effective from **1 January 2007**. This is to allow all offshore insurers and reinsurers to be familiar with the requirements of the Guidelines.

Attached is a copy of the Guidelines for distribution to your members. Please contact our officers Encik Mohamed Akbal Mohd Yunos at 087-591336 or Cik Eesah Abd Manaf at 087-591312 if you require any further clarification.

Please be guided accordingly.

Yours sincerely,

Md Yunus Atip
Director
Regulation Department
36/1/08-BG

Tingkat 17, Menara Pejabat Utama, Ujana Kewangan, Jalan Merdeka, 87000 Wilayah Persekutuan Labuan, Malaysia.
Tel : + 6 - 087 - 591 200 Faks : + 6 - 087 - 413 328

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LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY, MALAYSIA

GUIDELINES ON GENERAL REINSURANCE ARRANGEMENTS

Introduction

1. The guidelines are initiated to assist offshore insurers in the preparation of their reinsurance programme and facilitate the proper conduct of reinsurance placements to ensure prudence and professionalism.

2. Section 24(1)(a) of the Offshore Insurance Act 1990 (OIA) requires every offshore insurer to conduct its business with due diligence and care in accordance with sound insurance principles. In this regard, it is the responsibility of the offshore insurer to design its reinsurance programme in line with its exposure and portfolio of business, taking into account, among other things, the insurance risk profile and concentration of business.

Scope

3. The guidelines, which are applicable to all types of reinsurance arrangements, except financial reinsurance, serve as a guide and 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. It covers four aspects in determining the adequacy of reinsurance arrangements, namely:

I. *Appropriateness of retention level*

4. The retention capacity of an offshore insurer largely 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. 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. The retention strategy an offshore insurer must take into account not only single risk claims but also multi-risk events. The offshore 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.

ii. Security of reinsurers

5. Offshore Insurers should take all appropriate steps to assess adequately the soundness of the reinsurers they cede their insurance risks. The selection of reinsurers should be based on information relevant to ascertaining the reinsurer's reliability and security. The main factors which Insurers should consider when assessing a potential reinsurer are as follows:

a. Legal and statutory framework

- 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 including Malaysia. It is under proper regulation and supervision by its home authority.

b. Financial capacity and resources

- The reinsurer must has strong financial statements and accounts, i.e., interm of assets, premiums, solvency margin, technical provisions and profitability. In addition, articles on the reinsurer in the specialist press and evaluations by analysts and international rating agencies are useful to assess the capacity and financial strength of the reinsurer; and
- 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 on its payment ability.

c. Structural indicators

- Due regard should be given to the financial strength of its parent company and other companies within the group; and
- Information on change in ownership and relevant business relationships with other companies such as strategic alliances and intra-group retrocessions should be monitored to ensure that the reinsurer is independent in its underwriting policy.

d. **Independent and fit and proper Board of Directors**

- The reputation and integrity of its Board, and the conscientiousness, competence and stability of management and experienced underwriters are indicators of management quality of the reinsurer.

e. **Market behaviour**

- The reinsurer's past and present behaviour, its permanent presence in the market and commitment including speed of claim payment, can be indications of a reliable reinsurer; and
- Substantial business volume from a correspondingly large number of renowned cedents of international repute can be an indication of confidence in a solid reinsurer.

f. **Legal, economic and political conditions in the home country of the reinsurer**

- The political and currency stability of the home country of the reinsurer; and
- Reinsurance activities including transfer of claims payments and the movement of its capital should not be restricted;

6. The offshore insurer is responsible for the regular update of information compiled on its reinsurers. The offshore insurer should also keep abreast with developments in the International reinsurance markets especially developments relating to the reinsurers on its panel.

iii. Spread of reinsurers

7. To avoid exposure to excessive credit risk concentration of reinsurers, reinsurance protection should be well-spread among a number of reinsurers.

iv. Appropriateness of reinsurance contracts

8. The terms and conditions of reinsurance contract must be checked very carefully to ensure that there is a clear understanding of the classes of business being covered, the types of loss to which the treaty applies and the way in which the

amount recoverable by the insurer is calculated. As additional protection, the offshore insurer shall ensure that the proportional treaty reinsurance contract contains an errors and omissions clause, which provides that cover, continues to be valid where errors that are inadvertently made, are rectified immediately upon discovery.

Reinsurance placements

9. The offshore insurer shall ensure prompt placement of all its reinsurance requirements. For facultative reinsurance, confirmation of the necessary reinsurance facilities shall be obtained before acceptance of any risk exceeding the insurer's gross automatic capacity. The offshore insurer should also ensure that persons representing the reinsurer are properly authorised to accept reinsurance on behalf of the reinsurer.

10. Reinsurance programmes must be scrutinised properly to ensure that there are no gaps in cover or shortfall in placements and the offshore insurer must diligently communicate to the reinsurer all material facts relating to the risk being reinsured. This is to avoid undue exposure.

11. Where placements are made through brokers, the offshore insurer should ensure that the brokers possess appropriate qualifications.

Responsibility of the Board

12. The Board is ultimately responsible for the reinsurance programme of an offshore insurer. The reinsurance arrangements including facultative placements should be in accordance with the limits and criteria approved by the Board.

Implementation Date

13. The guidelines shall be observed by all offshore insurers licensed under the OIA in respect of treaty and facultative reinsurance placements with effect from 1 January 2007.

Labuan Offshore Financial Services Authority
24 January 2006