

GUIDANCE NOTE

ON

REINSURANCE WITH RELATED COMPANIES

Office of the Commissioner of Insurance
30 June 2003

**Guidance Note
on
Reinsurance with Related Companies**

I. INTRODUCTION

Under section 8(3)(c) of the Insurance Companies Ordinance, Chapter 41 of the Laws of the Hong Kong Special Administrative Region (“the Ordinance”), an insurer shall arrange adequate reinsurance protection unless there are justifications not to do so. However, what constitutes adequate reinsurance protection has not been specified. According to the Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers promulgated in 2002 by the International Association of Insurance Supervisors, an insurer should arrange reinsurance protection appropriate to its overall risk profile, having regard to, amongst other things, the security of reinsurers, the need to avoid concentration of reinsurers, and the need to obtain collateral securities, if appropriate.

2. In the normal course of business, an insurer is expected to exercise prudent control on its reinsurance arrangements. However, such control may be compromised when the reinsurer is a related company, thus posing a higher risk to the regulatory control of the Insurance Authority (“IA”). For the protection of policy holders, the IA has to ensure that an insurer is able to withstand financial vulnerabilities and hence a higher security is expected of the related reinsurer to commensurate with the higher risk posed. This Guidance Note aims to promulgate how reinsurance arrangements with related companies will be considered adequate by the IA in terms of financial security; and how the IA intends to address the supervisory concern if such reinsurance

arrangements are not considered adequate. However, this Guidance Note shall not affect the operation of the provisions of the Ordinance.

II. APPLICATION OF THIS GUIDANCE NOTE

3. This Guidance Note applies to :-
- (a) an authorized insurer incorporated in Hong Kong;
 - (b) an authorized insurer incorporated outside Hong Kong if
 - (i) 75% or more of its annual gross premium income for general business pertains to Hong Kong insurance business; or
 - (ii) 75% or more of its annual gross premium income for long term business pertains to Hong Kong long term insurance business;and
 - (c) an authorized insurer which is required under section 25A of the Ordinance to maintain assets in Hong Kong in respect of its liabilities pertaining to its Hong Kong insurance business, irrespective of whether it is incorporated in or outside Hong Kong.

III. INTERPRETATION

4. In this Guidance Note, unless the context otherwise specifies :-
- (a) “insurer” means a ceding company or retroceding company.
 - (b) “reinsurance” includes reinsurance and retrocession, whether on treaty basis or facultative basis.

- (c) “reinsurer” means a company accepting reinsurance cessions or retrocessions.
- (d) “reinsurance payable” includes Premium Deposits Withheld and Claims Reserves Withheld by the insurer, and other amounts due to the reinsurer.
- (e) “reinsurance recoverable” includes the reinsurer’s share of Unearned Premium Reserve, the reinsurer’s share of mathematical reserve for long term business and the reinsurer’s share of Claims and Claims Reserves, together with other amounts due from the reinsurer in respect of reinsurance contracts.
- (f) “net reinsurance recoverable” is the amount of reinsurance recoverable less reinsurance payable.
- (g) “related reinsurer” means one within the same grouping of companies, as defined in section 2(7)(b) and (c) of the Ordinance, to which the insurer belongs.

IV. ADEQUACY OF REINSURANCE ARRANGEMENTS

5. In determining the adequacy of reinsurance arrangements made by an insurer, the IA would have regard to the security provided by a related reinsurer. The IA would be satisfied that the security provided is adequate if the related reinsurer satisfies the following criteria:

- the particular reinsurer is an authorized insurer in Hong Kong;
- or

- the particular reinsurer or any one of its holding companies^{Note} has an Insurer Financial Strength Rating of AA- or above by Standard & Poor's, Aa3 or above by Moody's or A+ or above by A. M. Best or equivalent rating; or
- the particular reinsurer or any one of its holding companies is otherwise considered by the IA as having a status comparable to the above.

6. If neither a particular reinsurer nor any one of its holding companies meet the criteria set out in paragraph 5 above, the IA would not consider the security offered by the particular reinsurer as acceptable and hence would have supervisory concern on such reinsurance arrangement. In assessing the impact on the ceding insurer's ability to withstand financial vulnerabilities posed by such reinsurer(s)-

- (i) for an authorized insurer referred to in paragraph 3(a) and (b) above, the IA would restrict the net reinsurance recoverable due from the particular related reinsurer or the aggregate net reinsurance recoverable due from all such related reinsurers to 10% of the ceding insurer's Net Assets Amount; and
- (ii) for an authorized insurer referred to in paragraph 3(c) above, notwithstanding whether that insurer is also subject to the impact assessment made under (i), the IA would restrict the net reinsurance recoverable due from the particular related reinsurer or the aggregate net reinsurance recoverable due from all such related reinsurers arising from the ceding insurer's Hong Kong insurance business to 10% of its Hong Kong Net Assets Amount.

^{Note} The holding companies concerned include the holding company, intermediate holding company and ultimate holding company of the reinsurer.

If the ceding insurer would wish to have a higher amount of net reinsurance recoverable to be included in the impact assessment, it may cause to be produced collateral securities acceptable to the IA for the additional amount so included.

7. For the purpose of this Guidance Note, “Net Assets Amount” means the surplus amount of the insurer’s assets over its liabilities as reported in its own (unconsolidated) financial statements submitted pursuant to section 17 of the Ordinance for the period concerned. For the avoidance of doubt, the assets and liabilities of the insurer so reported shall be determined in accordance with section 8(4) of the Ordinance.

8. On the other hand, the “Hong Kong Net Assets Amount” means the amount of assets maintained in Hong Kong pursuant to section 25A of the Ordinance by the ceding insurer less 80% of its liabilities net after reinsurance arising from Hong Kong insurance business (i.e. the amount specified under section 25A(3)(a)(i) of the Ordinance).

9. In general, the IA will consider the following collateral securities to be acceptable :-

- (a) clean, irrevocable, unconditional and permanently renewable (evergreen) letter of credit drawn on a bank in Hong Kong which holds a valid banking licence granted under section 16 of the Banking Ordinance (Cap. 155) and made payable to the IA; or
- (b) other securities or arrangements as may be accepted by the IA.

The IA has the absolute discretion to determine whether a particular collateral security produced by an insurer is acceptable for the purpose of this paragraph.

10. For monitoring purposes, an insurer is required to inform the IA :-
- (a) whether there has been any reinsurance arrangement made with related reinsurers as defined in paragraph 4 above; and if so
 - (b) the names of the related reinsurers; and
 - (c) the respective breakdown of reinsurance payable and reinsurance recoverable (paragraph 4 above) at its financial year end for each related reinsurer. Where the amount of the related reinsurer's share of Unearned Premium Reserve cannot be precisely computed, the insurer shall make an estimate thereof and inform the IA of the amount of the estimate with the underlying bases and assumptions.

Such information shall be submitted as and when required by the IA.

V. COMMENCEMENT

11. This Guidance Note shall apply to the reinsurance arrangements, including renewal of reinsurance arrangements, made in respect of the financial years of an insurer commencing on or after 1 January 2004.