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Agenda

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Reinsurance in the EU: voluntary or mandatory regulation?

The European Parliament has recently approved proposals to harmonise establishment and supervision rules of reinsurance as a way of promoting the single market in financial services. This legislation will introduce mandatory licensing by competent home country authorities and will require changes to the way reinsurance is regulated in a number of Member States. Has the right choice been made between voluntary or mandatory regulation?

The European Parliament approved the Reinsurance Directive on June 7th 2005. If the European Council accepts the Parliament's resolution, the Directive will establish harmonised supervision of reinsurers by competent authorities in their 'home countries'.[1] Once a reinsurance company is licensed in a particular Member State, requiring the company to meet certain EU-wide criteria, it will be able to conduct business across the EU without obtaining further authorisation. Currently, EU legislation does not regulate specialised reinsurers and there are significant differences in the regulatory approach to reinsurance across Member States. The European Commission considers these differences to have resulted in certain costs and has argued that the Reinsurance Directive will promote competition, benefit policy-holders and contribute to enhanced financial stability.[2]

The proposals contained in the Directive are the culmination of a study on supervisory arrangements, commissioned by the European Commission in 2000.[3] After a consultation exercise, the Commission made a number of policy decisions regarding the Directive's preferred approach to supervisory arrangements. In general, there was a choice between 'voluntary and market-based' or 'mandatory and supervisory-based' solutions. This policy choice has existed in other areas of financial services for which the Commission has proposed legislation, but is especially interesting in reinsurance, given the differences between this sector and other financial services sectors. Unlike some of these other sectors, reinsurance is already highly internationalised and is based on transactions between professional parties; furthermore, insolvencies among reinsurers are rare. This article discusses the merits of the chosen policy option.

Reinsurance: five functions[1]

1. **Provide flexibility for insurers in the size and level of risk, and in the volume of business they they can underwrite**
2. **Provide assistance in specialist areas**
3. **Assist insurers in limiting large fluctuations in underwriting results**
4. **Assist in financing insurance operations**
5. **Protect against large claims that can arise from catastrophic events**

Note: [1] See, for example, Oxera (2004), 'Competition Review of the Financial Services and Markets Act', report for the UK Office of Fair Trading, November, available at www.oxera.com.

The reinsurance market

Reinsurance is the structured transfer of risk from an insurance company (the cedant) to the reinsurer, a process referred to as cession. The actual level of cession, or the proportion of insurance premiums that are reinsured, is not particularly high, averaging only 10% in the EU.[4] As well as regulatory initiatives, reinsurance is especially topical because of the impact of global catastrophes. For example, Swiss Re, one of the largest international reinsurance companies (see Table 1), has recently estimated total insured claims arising from Hurricane Katrina at around $40 billion, which compares with total net premiums of the ten largest reinsurance companies of around $109 billion.[5] The table also indicates that offshore locations, such as Bermuda, have become increasingly important within reinsurance.

What are the methods for regulating the reinsurance market?

There are a number of public interest justifications for the regulation of reinsurance, including the fact that there is

Table 1 Reinsurance industry structure, 2004 ($m)

	Primary jurisdiction	Total net premiums written
Munich Re	Germany	28,889.4
Swiss Re	Switzerland	25,780.2
Berkshire Hathaway	USA	10,580.0
Hanover Re	Germany	10,125.9
GE Insurance Solutions	USA	8,173.0
Lloyd's	UK	7,653.1
Allianz Re	Germany	5,586.1
Everest Re	Bermuda	4,531.5
XL Re	Bermuda	4,149.3
Partner Re	Bermuda	3,852.7
Total top 10		109,321.2

Note: Net premiums are gross premiums less premiums ceded to other insurance companies.
Source: Standard & Poor's (2005), 'Global Reinsurance Highlights'.

no direct contractual relationship between the policy-holder and the reinsurer as well as the relative lack of transparency in the sector.[6] The regulation of the reinsurance market has also become increasingly important for international bodies, including the European Commission, the OECD and the International Association of Insurance Supervisors (IAIS), all of which have examined ways in which reinsurance can be supervised more effectively. Strengthening the existing approach to the supervision of reinsurers has therefore been on the agenda for some years.

There has been less consensus on how to approach the supervision of reinsurance activities. Indeed, a number of approaches have been identified:[7]

– no supervision at all, or self-regulation;
– supervision of reinsurance is restricted to supervising the ceded reinsurance of primary insurers;
– the supervisor is authorised to request non-public information about a domestic reinsurers;
– every reinsurer doing business with a domestic reinsurer is licensed; and
– uniform licensing is extended, with additional requirements for the insurer or the reinsurers.

Differences in regulating reinsurance in the EU

Alternative approaches to the regulation of reinsurance can be observed in the EU. Table 2 details the differences in these approaches in several Member States.

Licences to operate are not required in Germany, France or the Netherlands for domestic or non-domestic companies, but are required in countries such as the UK and Italy. There is also a difference in the approach to financial supervision:

– *direct supervision*—any reinsurer conducting business in a Member State requires some form of authorisation by the supervisor;
– *indirect supervision*—the supervisor examines a reinsurer when it supervises primary insurers and assesses the adequacy of its reinsurance arrangements.[8]

In general, there has been a shift towards *direct* supervision of reinsurers among Member States. The UK, Denmark, Finland and Portugal adopt the comprehensive regulation and supervision that is applied for primary insurers to reinsurers; this implies that the Reinsurance Directive will have a limited effect on regulation in these countries. Domestic reinsurers, by contrast, are not subject to any reinsurance supervision in Belgium, Ireland and Greece, while Germany, France and the Netherlands apply elements of their primary insurance regime to the reinsurance sector.[9] Any system of harmonised legislation is therefore likely to change supervisory arrangements in a number of EU countries.

No supervision or self-regulation approach to regulation

Under this approach, primary insurers would assess the financial position of reinsurers themselves or with the use of information from credit-rating agencies. Another consideration is that actual cases of insolvency among reinsurers are rare and, where they have occurred, have often been in those reinsurance markets that are regulated by national supervisors. A study of supervisory arrangements commissioned by the European Commission argued:

Unregulated markets have shown in the past that the inherent risk does not seem to be higher than in regulated markets. There is also no evidence that cedants all over the world consider risks in these markets higher. Our analysis did not show that self-regulated companies have an inferior market position or have to accept lower premiums.

Source: European Commission (2002), op. cit., p. 72.

Table 2 Supervision of reinsurance in selected Member States

	Germany	France	UK	Netherlands	Italy	Denmark	Sweden
Licence required							
Domestic	×	×	✓	×	✓	✓	✓
Non-domestic	×	×	✓	×	✓	✓	×
Directly supervised	✓	×	✓	×	✓	✓	✓
Indirectly supervised	✓	✓	✓	✓	×	✓	×
Solvency margin	×	×	✓	×	×	✓	✓
Financial statements submitted							
Domestic	✓	✓	✓	✓	✓	✓	✓
Non-domestic	×	×	✓	×	✓	×	×
Licence can be withdrawn							
Domestic	×	×	✓	×	✓	✓	✓
Non-domestic	×	×	✓	×	✓	×	×

Source: European Commission (2002), op. cit.

Reinsurance Directive: features and objectives

According to the European Commission, the lack of a harmonised system of supervision of reinsurance companies has resulted in the following costs and consequences:

– *uncertainty for primary insurers (and policy-holders)*—different supervisory regimes may have made it more costly to choose a reinsurer;
– *barriers to trade*—certain EU countries have 'collateralised' systems where a reinsurer must pledge assets to cover outstanding claims. This may have acted as a barrier to trade;
– *administrative burden*—lack of mutual recognition means that reinsurance companies are subject to different supervisory regimes;
– *international trade negotiations*—international mutual recognition agreements may be more difficult.

These costs do not directly relate to the public interest justifications for regulating reinsurance, but rather to the lack of a harmonised system of regulation in the EU. It is not clear how significant these 'costs' are, as the Commission did not quantify them as part of its analysis.

A main proposal within the Directive is that a mandatory licensing system should be established. This proposal requires all reinsurance companies to be licensed or authorised to conduct reinsurance business.

Other aspects of the mandatory licensing approach are that supervisors are permitted to refuse to authorise companies and to remove 'unsuitable' companies. The competent authority is based in the same country as the head office and registered business address of the reinsurers, and this competent authority may carry out on-the-spot verification of information relating to overseas branches (Article 16). Reinsurers that switch the location of their head office and registered business address to another Member State will therefore also change 'home country' supervisor.

The main alternative to this would have been to establish a voluntary scheme, or what is referred to as a 'voluntary passport'. A voluntary passport would allow companies to choose whether they wish to benefit from being able to conduct business in all Member States without obtaining further authorisation once they have met certain EU-wide criteria and obtained a licence from their home country.

Other key features of the Directive relate to whether solvency requirements should be similar to those in direct non-life insurance, or should be 50% higher to reflect the more risky nature of reinsurance. In general, Member States that 'export' reinsurance, such as the UK, Germany, Ireland and Luxembourg, favour an approach to solvency similar to that used in direct non-life insurance, while countries that 'import' reinsurance services prefer higher solvency requirements. The Commission eventually proposed that solvency requirements would take a similar approach to that of direct non-life insurance, unless technical decisions at the EU level increased these requirements by up to 50% in certain reinsurance business lines or contracts.

Pros and cons of a mandatory licensing system

While the proposals in the Directive reflect policy choices made after a consultation exercise, voluntary and market-based solutions might also have met the Directive's objectives, had they been adopted. The way in which the Commission chose between competing alternatives is significant since the arguments in favour of a voluntary and market-based approach are likely to be stronger in reinsurance than in other financial services sectors.

Pros and cons of a mandatory licensing system

Pros	Cons
Mandatory licensing would ensure a level playing field (all stakeholders)	May be perceived as being contrary to 'deregulation' agenda (reinsurance companies)
Efficiency of mandatory licensing has been proven in the financial sector (all stakeholders) and gives mandate to insurance supervisor (supervisor)	Could create problems, as existing companies would have to meet licensing criteria (reinsurance companies)
System will ensure financial soundness of all reinsurance undertakings (all stakeholders)	Since certain companies could be removed, this may reduce the choice of reinsurer (primary insurers, policy-holders)
Unsuitable companies can be removed (supervisors)	Difficult to sell to the industry (reinsurance companies)

Note: Text in brackets refers to the stakeholders affected.
Source: European Commission (2004), 'Proposal for a Directive of the European Parliament and of the Council on Reinsurance and Amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC: Extended Impact Assessment', Commission Staff Working Paper.

As discussed above, the main aim of the Reinsurance Directive is to establish a system of mandatory licensing of reinsurance companies in their home countries. The boxes above and below show the pros and cons identified by the Commission of a mandatory licensing and a voluntary passport scheme. A mandatory scheme will provide Community reinsurers that fulfil licensing requirements with a 'passport' for cross-border business in the EU. All reinsurance companies will be required to obtain authorisation from the competent authorities of the Member State where the head office is located. If this licence is not provided, or is subsequently revoked, no reinsurance business can be undertaken. This contrasts with existing arrangements in, for example, Germany and France, where licences cannot be withdrawn.

As the box above indicates, most of the costs of a mandatory scheme fall on reinsurance companies. These costs will also fall on primary insurers and policy-holders if choice in the market becomes more restricted. Nonetheless, primary insurers and policy-holders will only really benefit from such a mandatory licence scheme if it leads to improved financial soundness of companies. However, as there does not seem to be significant evidence to suggest that inherent risk is greater in unregulated reinsurance markets, this potential benefit may be small in practice.[10]

A voluntary passport system would allow reinsurers to choose whether they wish to adhere to the system providing the benefit of mutual recognition of reinsurers. If they did not, reinsurers would be supervised in line with existing arrangements. Such an approach would be especially advantageous to companies that do not provide reinsurance services in more than one country, and that therefore do not face administrative burdens from operating across borders. The main pros and cons of such a voluntary passport scheme are described in the box below.

The benefits of a voluntary scheme would appear to accrue to reinsurance companies, as well as to primary insurers, and, because the scheme would be easier to implement than mandatory licensing, to supervisors. With respect to the disadvantages, while a voluntary system could be perceived as providing weaker assurance of financial standards than a mandatory system and would introduce differences in treatment between primary insurers and reinsurers, these are only disadvantages relative to a mandatory scheme and not to the status quo.

Pros and cons of a voluntary passport system

Pros	Cons
Comparatively easy to implement (insurance companies, reinsurance companies and supervisors)	Could be perceived as providing a weaker assurance than a licensing system, as only some companies would be supervised (all stakeholders)
Leave companies the choice of whether to adhere to the system (reinsurance companies)	Position of supervisor would be weaker than in a mandatory licensing system (supervisors)
Easier to gain acceptance from the industry (reinsurance companies)	If licensing system is already in place, it would seem illogical to replace this with a voluntary passport system (supervisors)
Might be easier to implement internationally (insurance and reinsurance companies, and supervisors)	A voluntary system would introduce differences in treatment between primary insurers and reinsurers (all stakeholders)

Note: Text in brackets refers to the parties affected.
Source: European Commission (2004), 'Proposal for a Directive of the European Parliament and of the Council on Reinsurance and Amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC: Extended Impact Assessment', Commission Staff Working Paper.

Concluding remarks

In practice, remains to be seen whether the benefits of the mandatory licensing system, as well as the other aspects of the Reinsurance Directive, will outweigh the costs. Over time, the impact of the Directive on the reinsurance industry may increase if, for example, licence or solvency requirements are made more stringent. Clear policy decisions between competing alternatives have been made. In the case of mandatory licensing, part of the justification was that this approach had been used elsewhere in EU financial services legislation. However, more so than other financial sectors, the case for a voluntary and market-focused approach to supervision may have been stronger in reinsurance.

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[1] Member States will have two years to adopt the Directive. European Commission (2004), 'Proposal for a Directive of the European Parliament and of the Council on Reinsurance and Amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC'.
[2] European Commission (2004), 'Proposal for a Directive of the European Parliament and of the Council on Reinsurance and Amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC: Extended Impact Assessment', Commission Staff Working Paper.
[3] European Commission (2002), 'Study into the Methodologies for Prudential Supervision of Reinsurance with a View to the Possible Establishment of an EU Framework', study prepared by KPMG, January 31st.
[4] European Commission (2004), 'Proposal for a Directive of the European Parliament and of the Council on Reinsurance and Amending Council Directives 73/239/EEC, 92/49/EEC and Directives 98/78/EC and 2002/83/EC'.
[5] Swiss Re (2005), 'Swiss Re Updates Estimates for Hurricane Katrina Claims to be in a Range of $1.2bn', news release, September 12th.
[6] See, for example, Financial Stability Forum (2004), 'Ongoing and Recent Work Relevant to Sound Financial Systems', note by the FSF Secretariat for the FSF meeting, September 8th–9th.
[7] IAIS (2002), 'Principles on Minimum Requirements for Supervision of Reinsurers', Principles No. 6, October.
[8] Source: European Commission (1999), 'Report: Results of Questionnaire on the Supervision of Reinsurance Undertakings', doc XV/2040/99 and annex.
[9] European Commission (2002), op. cit.
[10] Ibid.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d.holt@oxera.com

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