

**GUIDELINE
ON
REINSURANCE**

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1. Introduction

1.1 This Guideline is issued pursuant to section 133 of the Insurance Ordinance (Cap. 41) (“the Ordinance”) with reference to the requirements set out in the Insurance Core Principles, Standards, Guidance and Assessment Methodology (“ICP”) promulgated by the International Association of Insurance Supervisors. It sets out prudent practices pertinent to reinsurance management and the general guiding principles of the Insurance Authority (“IA”) in assessing the adequacy of the reinsurance arrangements of an insurer. Specific references are:

- (a) Section 8(3)(c) of the Ordinance requires an insurer to have adequate reinsurance arrangements in respect of its insurance business unless it is justified otherwise.
- (b) ICP 13 stipulates that the supervisor should set standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes.

1.2 It is incumbent upon an insurer to adopt a prudent approach in arranging reinsurance cover for its insurance business. Inadequacy in the arrangement of reinsurance may jeopardize the financial position of an insurer and affect its ability to meet the obligations to policy holders. The IA may from time to time provide guidance to insurers on prudent reinsurance practices through the issue of guidelines and circular letters. An authorized insurer is obliged to follow any applicable guidance so provided. For the avoidance of doubt, the insurer should also follow the “Guideline on Reinsurance with Related Companies” (“GL12”) in respect of any reinsurance effected with related reinsurers.

2. Interpretation

2.1 In this Guideline, unless the context otherwise specifies:

- (a) “authorized insurer” means an insurer authorized under the Ordinance.

- (b) “governing body” of an insurer refers to the Board of Directors (“Board”) of that insurer or a reinsurance committee or any senior officer properly delegated by the Board.
- (c) “Hong Kong insurance business” and “Hong Kong long term insurance business” have the same meaning as in paragraph 1(1) of Schedule 3 to the Ordinance.
- (d) “professional reinsurer” means an insurer whose authorizations under the Ordinance are restricted to reinsurance business only.
- (e) “reinsurance” includes reinsurance and retrocession, whether on treaty basis or facultative basis.
- (f) “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.
- (g) “reinsurer” means a company accepting reinsurance cessions or retrocessions.
- (h) “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.

3. Scope of Application

3.1 This Guideline applies to the reinsurance arranged by:

- (a) an authorized insurer incorporated in Hong Kong; or
- (b) an authorized insurer incorporated outside Hong Kong pertaining to its Hong Kong insurance business or Hong Kong long term insurance business¹.

¹ The definitions of the “Hong Kong insurance business” or “Hong Kong long term insurance business” are set out in the respective interpretations in paragraph 2.1.

4. Reinsurance Management Framework

4.1 Reinsurance management framework relates to the rules and practices put in place to manage the selection, implementation, monitoring, control, review and documentation of reinsurance arrangements. A sound reinsurance management framework should include a documented reinsurance management strategy and proper systems and controls for implementation of the strategy.

Reinsurance Management Strategy

4.2 An authorized insurer should formulate a written reinsurance management strategy that is appropriate to the company's overall risk profile and financial condition. For an authorized insurer incorporated in Hong Kong, the reinsurance management strategy should be approved by its Board or the reinsurance committee designated by the Board. For an authorized insurer incorporated outside Hong Kong, the reinsurance management strategy should be approved by the governing body. In case that a non-Hong Kong incorporated insurer chooses to have its strategy approved by any senior officer delegated by the Board, the strategy should still be reviewed at least annually by the Board or the designated reinsurance committee. The reinsurance management strategy should form part of the insurer's overall underwriting and risk management strategies. The Board or the designated reinsurance committee should review the reinsurance management strategy at least annually and when there are material changes to the insurer's circumstances, its underwriting and risk management strategies or the credentials of its major reinsurers.

4.3 The insurer should define and document in the reinsurance management strategy all aspects for reinsurance management, including but not limited to:

- (a) setting out the objectives of and key factors in formulating the strategy for reinsurance management;
- (b) identifying the parties involved and their roles and responsibilities in relation to the reinsurance management framework (e.g. for approving, monitoring and reviewing the reinsurance management strategy and managing reinsurance arrangements); specifying how those responsibilities may be delegated and details of any authority

limit;

- (c) describing the process for setting, monitoring and reviewing its risk tolerance level, including the key factors considered (e.g. business strategy, financial strength and cost of reinsurance);
- (d) describing the process for determining the most appropriate types of reinsurance arrangements and the risk retention levels to manage the insurer's risk exposure with regard to its risk tolerance level (e.g. assessment on the adequacy of the limit covering maximum exposure vis-à-vis an accumulation of several claims and the need for clash cover for employees' compensation / motor insurance business; or assessment on the need to acquire catastrophe cover to provide specific reinsurance cover against accumulation of employees' compensation claims arising from outbreak of infectious disease (i.e. buy-back arrangement) etc.);
- (e) without prejudice to paragraph 4.7, describing the process for selecting and ongoing monitoring of reinsurers, including the criteria for evaluating the creditworthiness and diversification of reinsurers and assessing the need for reinsurance deposits and collateral;
- (f) describing the process for identification and monitoring of credit risk exposure to reinsurance counterparties;
- (g) describing the process for identification and monitoring of liquidity risks to cover any timing mismatch between payment of claims and receipt of reinsurance recoverables;
- (h) describing the process for identification and monitoring of aggregation of risks (e.g. relating to a particular industry or geographical region) for relevant insurance business (e.g. property and casualty);
- (i) describing the process and control for managing reinsurance arrangements (e.g. reinsurance placement, reinsurance recovery collection and audit examination);
- (j) describing the involvement of reinsurance brokers, if any, in the

procurement of reinsurance and the selection criteria of the brokers;

- (k) describing the process for ensuring accurate and proper documentation of reinsurance arrangements; and
- (l) describing the criteria and process for the use of facultative reinsurance, which should be secured before the insurer accepts a risk that exceeds its capacity and/or risk appetite.

Systems and Controls

4.4 The governing body of an authorized insurer is responsible for establishing appropriate systems and controls to ensure that the reinsurance management strategy is being delivered and complied with by the insurer's management. The systems and controls should be subject to regular audit examination.

4.5 The governing body's monitoring of compliance with the reinsurance management strategy should include approval of the reinsurance program. Deviations from the strategy should be approved by the governing body. The performance of the reinsurance program should be subject to regular reviews to ensure that it functions as intended and continues to meet its strategic objectives.

4.6 Underwriting control system should be put in place to ensure that all underwriting is carried out in accordance with the company policy and that the planned reinsurance cover is in place. The system should be able to identify and report on a timely basis where underwriters infringe authorized limits, breach company guidelines or otherwise assume risks exceeding the ability of the company's capital base and reinsurance covers.

4.7 There should be proper due diligence measures for selecting participating reinsurers during reinsurance placement and on an ongoing basis. The selection process should take into account factors such as the reputation, financial soundness, expertise and counterparty risks of reinsurers. The insurer should have its own methodologies of assessment for counterparty risks of reinsurers and due diligence on the reinsurers. Such assessment should not solely rely on the ratings of external credit rating agencies. The insurer should maintain a list of reinsurers that have been approved for reinsurance placements

and set the procedures for dealing with situations where there is a need to assess reinsurers outside the approved list. It should set prudent limits or guidelines reflecting security of the approved reinsurer, in relation to its maximum aggregate exposure to any one reinsurer or to a group of reinsurers. It should also put in place procedures for monitoring this aggregate exposure to ensure that these limits or guidelines are not breached; including procedures to ensure that excess concentrations are brought back within limits or guidelines, or otherwise managed, going forward. The insurer should also consider requesting for collateral from reinsurers as a means for security.

4.8 Appropriate procedures should be put in place to ensure the timely finalization of reinsurance contracts. Reinsurance contract documentation should be written in clear contract language and preferably a reinsurance agreement (or pending the finalization of the terms of a reinsurance agreement, i.e. a reinsurance cover slip or other similar documentation) be finalized prior to the inception of coverage.

4.9 The insurer should have in place processes to ensure that all reporting due to and from reinsurers is timely and complete and that settlements are made as required by the contract. There should be proper credit control procedures to ensure prompt collection of reinsurance recoverables from the reinsurance counterparties. The insurer should also have appropriate measures to manage its liquidity risk including funding requirements in reasonably adverse circumstances.

4.10 The reporting system of the insurer should be able to ensure timely and effective communication of information for identifying potential discrepancies to the reinsurance management strategy. Specifically, the insurance information system should be reliable and capable of producing updated and essential information to facilitate the management of reinsurance arrangements.

5. Adequacy of Reinsurance Arrangements

5.1 Under the Ordinance, the IA is charged with the principal function of regulating and supervising the insurance industry for the promotion of the general stability of the insurance industry and for the protection of the interests of existing and potential policy holders. For the purpose of ensuring the financial

soundness of an authorized insurer, the IA must be satisfied, among other things, that adequate arrangements are in force, or will be made, for reinsurance of risks of each and all classes of the insurance business underwritten by the insurer.

5.2 In considering the adequacy of an authorized insurer's reinsurance arrangements, the IA will generally take into account, among other things, the following factors:

- (a) reinsurance management framework of the insurer;
- (b) type of reinsurance arrangements;
- (c) maximum retention of the insurer;
- (d) spread of risks among reinsurers; and
- (e) security of reinsurers.

5.3 Authorized insurers should also consider conducting stress testing under different stressed scenarios regularly (e.g. systemic or market risk environment) for material reinsurance arrangements to ensure the reinsurance cover is adequate in adverse situations.

Reinsurance Management Framework of an Authorized Insurer

5.4 The Board or the designated reinsurance committee of an authorized insurer should establish a reinsurance management framework to steer the company in effecting a reinsurance program that adequately addresses its risk profile and financial condition. In assessing the adequacy of the reinsurance arrangements of an authorized insurer, the IA will consider whether the insurer has put in place a sound reinsurance management framework with regard to the components set out in section 4 above.

Type of Reinsurance Arrangements

5.5 An authorized insurer should clearly understand the nature and scope of its underwritten risks and pay due regard to its risk tolerance level in order to look for suitable type of reinsurance protection.

5.6 In entering into a reinsurance contract, the insurer should ensure that the terms and conditions of the contract are compatible with the size and profile of the risks of the underlying business. It should also have clear understanding on the content of the contract, particularly the class of business covered, the type of loss to which the contract applies and the way in which the amount recoverable from reinsurers is calculated.

Maximum Retention of an Authorized Insurer

5.7 An authorized insurer should exercise due diligence in setting the maximum retention levels. The retention strategy should take into account not only single risk claims but also multi-risk events (e.g. the occurrence of catastrophic or disastrous events). The insurer should also be mindful of possible gaps in the reinsurance program which may cause undue exposure. The insurer should set its own retention levels having regard to its risk profile, risk tolerance, business strategy, capital levels and other factors relevant to its risk assessment.

Spread of Risks among Reinsurers

5.8 An authorized insurer should have control in place to ensure that reinsurance is properly spread among reinsurers to minimize the risks of over-concentration on a small number of reinsurers. It should also set prudent limits in relation to its maximum aggregate exposure to any one reinsurer or to a group of reinsurers having regard to the nature, size and security of the relevant reinsurers.

Security of Reinsurers

5.9 In determining the adequacy of the reinsurance arrangements made by an authorized insurer, the IA will have regard to the security of the reinsurer or other security provided by the reinsurer. The IA will be satisfied that such security is adequate if the reinsurer satisfies the following criteria:

- (a) It is an authorized insurer or Lloyd's; or
- (b) It has strong financial strength and is under the supervision of a robust insurance supervisory authority. In this respect, the insurer should demonstrate to the satisfaction of the IA that they have

evaluated the financial strength of the reinsurer by going through the due diligence process as mentioned in paragraph 4.7.

5.10 Where the security is provided by a related reinsurer, the related reinsurer should additionally satisfy the criteria as set out in paragraph 4.1 of the GL12.

6. Alternative Risk Transfer

6.1 Apart from traditional reinsurance, an authorized insurer may migrate its insurance risks by using alternative risk transfer (“ART”) arrangements. The IA expects that an authorized insurer should put in place a robust framework in managing and monitoring the ART arrangements, which is comparable to the reinsurance management framework set out in section 4 above. The insurer should ensure that its ART management framework is adequate and proportionate to the nature of the underlying risks and to the complexity of the ART arrangements.

6.2 Risk transfer to the capital market might entail the creation of an Special Purpose Entity (also known as Special Purpose Vehicle etc.) (“SPE”) which is specifically constituted to carry out the transfer of risk. A key element of any SPE structure is the transfer of insurance risk to a “fully funded”, “bankruptcy-remote” vehicle whereby the claims of any investors are subordinated to the cedant and whereby the investors have no recourse to the cedant in the event of an economic loss to the vehicle. In such case, the insurer should ensure that the SPE has sound investment and strategies on its underlying risks. The insurer should also put in place adequate systems and controls on the SPE, in addition to those required for a traditional reinsurer, to ensure that:

- (a) investment restrictions are not breached;
- (b) interest payments, dividends, expenses and taxes are properly accounted for;
- (c) movements above established thresholds in assets and collateral accounts are properly reported;
- (d) assets are legally existent and technically identifiable; and

- (e) liabilities can be determined on a timely and accurate basis and obligations satisfied in accordance with the underlying contracts.

6.3 In considering if an SPE structure meets the “fully-funded” criterion, the IA will take into account the following:

- (a) ownership structure of the SPE;
- (b) investment and liquidity strategy of the SPE;
- (c) the SPE's strategy in relation to credit, market, underwriting and operational risks;
- (d) the ranking and priority of payments (e.g. waterfall);
- (e) the extent to which the cash flows in the SPE structure have been stress tested;
- (f) the arrangements for holding the SPE’s assets (e.g. trust accounts) and the legal ownership of the assets;
- (g) the extent to which the SPE’s assets are diversified; and
- (h) use of derivatives, especially for purposes other than risk reduction and efficient portfolio management.

6.4 To ensure that an SPE structure meets the “bankruptcy remote” criterion, the insurer should obtain an appropriate legal opinion as to the bankruptcy remoteness. There should also be a full disclosure of the bankruptcy remoteness of the SPE in any prospectus, offering circular or private placement memorandum.

6.5 Except for a professional reinsurer, an authorized insurer should seek the written approval from the IA before effecting an insurance risk transfer to the capital market through an SPE. The IA may give approval subject to any condition as it considers appropriate.

6.6 The insurer should provide to the IA in relation to the proposed SPE arrangement for approval:

- (a) an outline of the proposed SPE structure which should include,

among others, the “fully-funded” features as mentioned in paragraph 6.3;

- (b) a copy of the legal opinion on the bankruptcy remoteness as mentioned in paragraph 6.4;
- (c) whether there is any event or circumstance whereby the insurer will remain exposed to primary insurance losses without having recourse to the SPE;
- (d) extent to which key parties have been fully disclosed (e.g. sponsor, insured, reinsured, investors, advisors, counterparties, etc.) and are known to the IA;
- (e) extent to which potential conflicts of interest between all parties to the SPE have been adequately disclosed and addressed (such as situations where sponsors also take a managing role);
- (f) degree of basis risk that is assumed by the sponsor and to what extent this could have immediate ramifications for the sponsor’s financial position in case of a loss;
- (g) details of the SPE’s management arrangements and key personnel;
- (h) third party assessments of the SPE structure (e.g. by external agencies);
- (i) expertise of the legal advisors involved;
- (j) robustness of any financial or actuarial projections, if applicable (e.g. if triggers are indemnity based);
- (k) disclosure of outsourcing agreements; and
- (l) credit risk associated with key service providers, including financial guarantors used to protect the position of investors.

6.7 For ongoing monitoring of those SPE arrangements which have been approved by the IA, the insurer should report to the IA, at least annually, the level of capital and the ability of the SPE to continue responding adequately should covered events occur. This should cover the SPE’s courses of action in the event of fluctuations in the value of invested assets vis-à-vis mismatch between collateral account and exposure.

6.8 For those SPE arrangements which have been approved by the IA, in the case when there is a dismantling arrangement on the SPE, the insurer should report to the IA about the arrangement, which should include:

- (a) the process related to the generation, mitigation and management of any residual risk emerging from the dismantling of the SPE;

- (b) the process on the share buy-back and disposal of the investment portfolio, if any; and
- (c) any residual risks that will revert to the sponsor/insurer on termination of the arrangement.

7. Arrangement with Insignificant Risk Transfer

7.1 Except for a professional reinsurer, an authorized insurer should seek the written approval from the IA before entering into a new arrangement with insignificant risk transfer or varying an approved arrangement with insignificant risk transfer to a material extent. The IA may grant approval subject to any condition as it considers appropriate.

7.2 While such arrangement may be used to strengthen the insurer's solvency position (e.g. where there is a genuine transfer of risks), there are circumstances where it can distort or disguise the true financial position of the insurer that may ultimately pose risks to policy holders.

7.3 In applying approval from the IA for a new arrangement with insignificant risk transfer, the insurer should make full and frank disclosure of all material information to the IA, including specified particulars of the arrangement. In applying approval from the IA for a proposed material change to an approved arrangement with insignificant risk transfer, the insurer should make full and frank disclosure of all material information including the purpose and details of the proposed change and specified particulars of the arrangement as if the change had been effected ("varied arrangement"). The specified particulars are:

- (a) the purpose of the arrangement;
- (b) main features of the arrangement, including such details as necessary to facilitate proper understanding of the nature of the cover;
- (c) a description of the risks covered;
- (d) details on retention level and cover limit;
- (e) effective period of the contract;
- (f) the name of the proposed reinsurer and the credit assessment of the proposed reinsurer carried out by the insurer;
- (g) draft contract wording and any other documentation or information

relevant to the arrangement (including a written description of any verbal understandings, side agreements or undertakings that are material to the operations of the arrangement);

- (h) the extent of insurance risks transferred;
- (i) details of the proposed accounting treatment and whether the proposed arrangement can be booked following reinsurance accounting requirements, confirmed by the appointed auditor, and the manner in which the arrangement will be disclosed (e.g. in the reinsurance summary in the Directors' Report); and
- (j) confirmation by the insurer's appointed actuary on the extent of insurance risks transferred in the proposed arrangement, and details of the effect of the proposed arrangement on the financial and solvency position of the insurer over the period of the arrangement (before and after the arrangement, under base and stressed scenarios).

The IA has the right to ask for further information where it considers it necessary in order to assess the potential impact of the new or varied arrangement with insignificant risk transfer.

7.4 The IA, in assessing the application for approval, will take into account all relevant factors, including but not limited to:

- (a) whether the new or varied arrangement has a legitimate purpose and effect;
- (b) the extent of insurance risks transferred between the insurer and the reinsurer;
- (c) whether the new or varied arrangement is likely to disguise, or is designed to disguise the profitability, solvency or capital position of the insurer;
- (d) whether the insurer is able to demonstrate to the IA's satisfaction on the credentials of the reinsurer and the adequacy of the security provided by it under the new or varied arrangement;
- (e) whether the new or varied arrangement is likely to adversely affect the interests of policy holders; or
- (f) whether the new or varied arrangement provides any substantial cash

transaction.

7.5 In considering whether an arrangement involves a significant transfer of insurance risks, the insurer should take into account, amongst other things, the following factors:

- (a) the nature of risk (e.g. mortality risk, morbidity risk, underwriting risk and timing risk) to be transferred;
- (b) whether the transfer is considered significant in the context of the commercial substance of the contract and with reference to the range of practical outcomes that could reasonably be expected to occur; and
- (c) whether assessment on the transfer of insurance risks has been made prospectively at the time the contract is entered into.

7.6 Any arrangement with insignificant risk transfer that has been approved by the IA should be accounted for as a reinsurance arrangement in the revenue and profit and loss accounts. Otherwise, it should be treated as a financing arrangement and is to be excluded from the revenue and profit and loss accounts / other comprehensive income statement.

8. Reinsurance Reporting

8.1 The Directors' Report as required under Part 2 of Schedule 3 to the Ordinance should contain a summary of the material reinsurance arrangements effected by an authorized insurer. If the insurer has any reinsurance arrangement that has been approved by the IA and effected during the accounting period, it should also include information relating to such arrangement in the summary.

8.2 In addition, an authorized insurer should submit to the IA any supplementary information as required by the IA from time to time to enable it to monitor the insurer's reinsurance and ART arrangements effectively.

8.3 In case an authorized insurer identifies that a problem is likely to arise out of its reinsurance or ART arrangements that may materially and adversely affect its solvency position or its capacity to meet any regulatory obligations, it should notify the IA forthwith and take appropriate actions to address the problem promptly.

9. Commencement

9.1 This Guideline should apply to the reinsurance, ART arrangement and arrangement with insignificant risk transfer, including any renewals, of an authorized insurer with effect from 26 June 2017.

9.2 Where an authorized insurer has any existing ART arrangement or arrangement with insignificant risk transfer, it should immediately notify the IA of such arrangement.

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