

## Prudential Standard GOI 3.3

### Reinsurance and Other Forms of Risk Transfer by Insurers

#### **Objectives and Key Requirements of this Prudential Standard**

*This Prudential Standard outlines requirements relating to reinsurance and other forms of risk transfer. The Standard requires insurers to document a Reinsurance and Other Risk Transfer Policy that sets out an insurer's strategies and procedures for the selection of suitable reinsurance programs and other risk transfer techniques.*

*The Standard also sets out requirements relating to the following aspects of reinsurance arrangements:*

- *Due diligence of reinsurance counterparties;*
- *Administration and documentation requirements related to reinsurance arrangements, including terms and conditions to be specified;*
- *Restrictions on fronting; and*
- *Certain inwards retrocession arrangements requiring prior approval by the Prudential Authority to mitigate the risk of market spirals.*

*The ultimate responsibility for ensuring that this Standard is met rests with the board of directors of the insurer.*

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#### **1. Application**

- 1.1. This Standard applies to all insurers, including reinsurers, licensed under the Insurance Act, 2017 (the Act), other than microinsurers, Lloyd's and branches of foreign reinsurers. The application of these Standards to insurance groups that have been designated as such by the Prudential Authority under section 10 of the Act is addressed in a separate standard, GOG (Governance and Operational Standard for Groups).

- 1.2. Unless otherwise indicated, all references to “insurer” in this Standard can be read as a reference to life insurers, non-life insurers and reinsurers. Where the term “reinsurer” is used in this Standard, it is used to refer to the counterparty providing reinsurance cover to a direct insurer or a reinsurer.
- 1.3. This Standard does not apply to reinsurance arrangements entered into in respect of linked insurance obligations.

## **2. Roles and Responsibilities**

- 2.1. An insurer’s board of directors is ultimately responsible for ensuring that the insurer complies with the principles and requirements of this Standard.
- 2.2. An insurer’s actuarial function must periodically review the insurer’s Reinsurance and Other Risk Transfer Policy (see section 5 below) and provide an opinion to the board of directors on its appropriateness in light of the insurance risks retained by the insurer.
- 2.3. An insurer’s actuarial function must also assess and express an opinion on the appropriateness of all reinsurance arrangements in light of the insurance risks retained by the insurer, and advise the board of directors on the appropriate treatment of reinsurance arrangements for financial soundness purposes.
- 2.4. The head of the actuarial function of the insurer must provide the Prudential Authority with his or her assessment of, and opinion on, any reinsurance arrangements used in financial soundness calculations, if requested.
- 2.5. An insurer’s auditor must provide assurance to the insurer and the Prudential Authority, if requested, that the insurer complies with the requirements of this Standard or a part thereof.

## **3. Commencement and Transition Provisions**

- 3.1. This Standard commences on 1 July 2018.

<b>Version Number</b>	<b>Commencement Date</b>
1	1 July 2018

- 3.2. Any reinsurance arrangement entered into prior to the effective date of this Standard must comply with this Standard within two years from the effective date.

## **4. Principles**

- 4.1. Risk transfer mechanisms, whether traditional reinsurance or otherwise, play an important role in managing an insurer’s financial soundness. For example, effective reinsurance can function as an alternative means of capital access for an insurer to absorb losses, and can provide insurers with lower or more predictable claims costs.
- 4.2. In order to be effective, reinsurance arrangements and other risk transfer techniques must be monitored on an ongoing basis by insurers. Reinsurance arrangements in particular must be subject to appropriate due diligence, administration and documentation.

- 4.3. Insurers must establish a Reinsurance and Other Forms of Risk Transfer Policy that sets out, among other things, its procedures for monitoring and managing its reinsurance arrangements and other risk transfer techniques.
- 4.4. Reinsurance arrangements and other risk transfer techniques may be used to mitigate an insurer's capital requirements under the Financial Soundness Standards for Insurers (FSI) where it satisfies certain eligibility criteria, outlined in Attachment 1 (Eligibility Conditions for Risk Mitigation Instruments) to FSI 4 (Calculation of the SCR Using the Standardised Formula). Reinsurance arrangements that do not satisfy the eligibility criteria may still be used by insurers, but must not be recognised as a risk mitigation instrument for financial soundness calculations.
- 4.5. The Prudential Authority applies limitations on certain reinsurance arrangements or transactions that could give to rise to fronting<sup>1</sup> and the risk of market spirals. These limitations are set out in Section 9 below.

## **5. Reinsurance and Other Risk Transfer Policy**

- 5.1. An insurer's Reinsurance and Other Risk Transfer Policy must:
  - a) Outline appropriate strategies and procedures for the selection of suitable reinsurance programs and other risk transfer techniques, proportionate to the nature, scale and complexity of the insurer's risks, and to the capabilities of the insurer to manage and control the risk transfer technique used.
  - b) Ensure transparent reinsurance and other risk transfer arrangements that enable the Prudential Authority to understand the economic impact of these arrangements.
  - c) Provide for processes and procedures for ensuring that the strategies referred to in sub-section a) above are implemented and complied with, and that the insurer has in place appropriate systems and controls over its risk transfer transactions.
  - d) Identify the level of risk transfer appropriate to the insurer's risk appetite and the types of reinsurance and other risk transfer arrangements most appropriate to effectively manage the insurer's risk profile.
  - e) Establish principles for selecting, and assessing the appropriateness, creditworthiness and diversification of, reinsurance and other risk transfer counterparties.
  - f) Set concentration limits for credit risk exposure to reinsurance and other risk transfer counterparties and appropriate systems for monitoring these exposures.
  - g) Establish procedures for assessing the effectiveness of risk transfers.
  - h) Provide for liquidity management to address any timing mismatch between claims payments and reinsurance or other risk transfer recoveries.

## **6. Due Diligence on Reinsurers**

- 6.1. An insurer must regularly perform a sufficient level of due diligence on its reinsurers to ensure that the insurer is aware of its counterparty risk and is able to assess and manage such risk. In cases where an insurer may be subject to material incurred but not reported (IBNR) losses, an insurer must conduct due diligence that continues beyond the expiration date of the reinsurance arrangement and monitor the

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<sup>1</sup> Fronting is a term that describes a particular practice of reinsurance. Commonly, an insurer licensed in the jurisdiction from which the risk emanates issues a policy to the insured. Subsequently, the risk is transferred to another insurer by way of a reinsurance contract also known as a fronting agreement. The insured receives a policy written by the licensed insurer (and the ultimate liability remains with the fronting insurer), but the economic risk of that policy resides with the reinsurer.

reinsurer's capacity to meet reinsurance recoverables from future expected claims.

6.2. The level of due diligence an insurer must perform on its reinsurers must be:

- a) commensurate with its level of exposure to that reinsurer;
- b) not solely dependent on third-party assessments such as rating agency assessments or broker analysis and recommendations; and
- c) no less thorough even if the counterparty is a related or interrelated party of the insurer.

6.3. In performing its due diligence, an insurer must consider, among other things, the reinsurer's:

- a) skills and expertise in respect of the classes of insurance business that it offers to reinsure;
- b) claims payment record;
- c) expected future claims obligations;
- d) balance sheet strength;
- e) funding sources, including its level of and access to capital, and form, amount and sources of liquidity;
- f) operational management capabilities;
- g) governance, risk management and internal controls;
- h) retrocession arrangements and the direct or indirect impact they may have on the insurer's own arrangements with the reinsurer; and
- i) ability to meet liabilities under exceptional, but plausible adverse events on an on-going basis.

6.4. Where an insurer enters into an arrangement with a reinsurer that is neither licensed in South Africa nor licensed in a foreign jurisdiction determined by the Prudential Authority as an equivalent foreign jurisdiction, it must conduct an in-depth due diligence assessment of the reinsurer. The in-depth due diligence assessment must include, in addition to matters covered under section 6.3 above, an assessment of:

- a) the quality of the regulatory and supervisory regime in the foreign jurisdiction in which the reinsurer is domiciled;
- b) compliance of the foreign jurisdiction's regime with international standards and best practices; and
- c) the adequacy of the insolvency laws governing proceedings in the foreign jurisdiction.

6.5. Where the insurer is aware that a reinsurer relies significantly on retrocessions, the insurer must also identify and assess the financial standing of the reinsurer's retrocessionaires.

## **7. Administration of Reinsurance Arrangements**

7.1. An insurer must have appropriate internal controls and administrative arrangements surrounding its reinsurance arrangements to mitigate its operational risk. These internal controls and administrative arrangements should be commensurate with the nature and materiality of the operational risks associated with the reinsurance arrangements, and should include procedures related to:

- a) contract management (see Section 8 below);
- b) IT system capabilities;
- c) tracking of aggregate claims;
- d) collection of reinsurance receivables as they fall due; and

- e) timely reporting to reinsurers.

## **8. Documentation of Reinsurance Arrangements**

- 8.1. The terms and conditions of a reinsurance arrangement must provide clarity and certainty on reinsurance coverage.
- 8.2. To achieve clarity and certainty on reinsurance coverage, a reinsurance arrangement must be unambiguous, and there must be complete and final agreement on all material terms and conditions of the arrangement, documented in writing, by all parties prior to the arrangement's effective date.
- 8.3. Where a comprehensive reinsurance arrangement can only be duly executed by all parties after the effective date, the insurer, in respect of the reinsurance coverage during this interim period, must:
  - a) ensure that the reinsurance arrangement is enforceable;
  - b) address any material issues most likely to arise, including all variable or unique agreement terms; and
  - c) ensure that the final comprehensive reinsurance arrangements are in place within a relatively short timeframe having regard for the nature, complexity and materiality of the arrangement.
- 8.4. The reinsurance arrangement must include specific terms and conditions relating to insolvency of the insurer and dispute resolution. Further detail of the specific terms and conditions that must be included on these matters is set out in Attachment 1.
- 8.5. Where it is necessary and appropriate for an insurer to enter into supplemental or subordinated reinsurance arrangements that are ancillary to, and form part of, the original reinsurance arrangement, these arrangements must meet the requirements of this Standard. The insurer must ensure that such amendments are appropriately reported in its statutory returns, and do not adversely change the terms or conditions of the original contract to the detriment of the insurer's policyholders.

## **9. Limitations on Reinsurance Arrangements to Mitigate Fronting and Market Spirals**

### **Fronting restrictions**

- 9.1. A local direct insurer must not engage in fronting arrangements in respect of a specific class or sub-class of insurance business.<sup>2</sup> This restriction on fronting arrangements does not apply to global insurance programs (i.e. insurance programs with a coverage territory encompassing at least 4 jurisdictions (including the country in which the insured is domiciled), that is arranged for a multinational business).
- 9.2. A local direct insurer (other than a microinsurer) that is licensed to conduct only direct business must not directly or indirectly reinsure more than 75% of the premiums it has underwritten to one reinsurer. This 75% limit applies on an aggregate basis across all of the insurer's business lines, and applies whether the reinsurance is with a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, or another (re)insurer in South Africa (including Lloyd's).
- 9.3. A local direct insurer (other than a microinsurer) that is licensed to conduct

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<sup>2</sup> Whether the reinsurance of a specific class or sub-class of business constitutes fronting or not will be assessed through supervision.

reinsurance must not directly or indirectly retrocede more than 75% of the premiums it has underwritten to one reinsurer. This 75% limit applies on an aggregate basis across all of the insurer's reinsurance business, and applies whether the retrocession is with a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, or another (re)insurer in South Africa (including Lloyd's).

- 9.4. A reinsurer (other than a reinsurer that only reinsures microinsurance business) that is licensed to conduct reinsurance must not directly or indirectly retrocede more than:
- a) 75% of the premiums it has underwritten in respect of its life insurance business to one reinsurer. This limit applies on an aggregate basis across all of the insurer's life insurance business lines, and applies whether the reinsurance is with a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, or another (re)insurer in South Africa (including Lloyd's).
  - b) 75% of the premiums it has underwritten in respect of its non-life insurance business to one reinsurer. This limit applies on an aggregate basis across all of the insurer's non-life insurance business lines, and applies whether the reinsurance is with a foreign (re)insurer on a cross-border basis, a branch of a foreign reinsurer, or another (re)insurer in South Africa (including Lloyd's).
- 9.5. The limits referred to in sections 9.2 to 9.4 above may be increased to 85% if the counterparty is an insurer within the same insurance group.

### **Mitigating Market Spirals**

- 9.6. A local direct insurer that is licensed to conduct reinsurance may not, without the prior written approval of the Prudential Authority, reinsure any insurance business that another insurer (whether in South Africa or not) within the same insurance group has reinsured. This restriction on inwards retrocession arrangements is to prevent the risk of market spirals and intra-group contagion.
- 9.7. Approvals for inwards retrocession arrangements must be requested on a contract-by-contract basis.

## **Attachment 1: Terms and conditions for insolvency and dispute resolution**

1. An insurer must ensure that all reinsurance arrangements contain an insolvency clause clarifying that the reinsurer must continue to make full payments to an insolvent insurer without any reduction resulting solely from the insurer's insolvency. Such a clause provides greater certainty that reinsurance receivables remain within the overall general estate of the insolvent insurer.
2. If a reinsurance arrangement provides for a funds withheld clause, the arrangement must clearly provide that, in the event of the insurer's insolvency, the funds withheld, after any deduction for the surplus due back to the reinsurer, must form part of the property of the insurer's overall general estate.
3. A reinsurance arrangement must not contain other types of terms or conditions that may limit a distressed or insolvent insurer's ability to enforce the contractual obligations of a reinsurer, or that may adversely affect the treatment of any claims in respect of the insurer's policyholders covered under the arrangement.
4. A reinsurance arrangement must stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes that are necessary to ensure the reinsurance arrangement and any disputes arising from such an arrangement are subject to the laws and courts of South Africa or another legal jurisdiction of, in the reasonable opinion of the insurer, equivalent or of greater reliability and certainty which has a natural connection to the arrangement.