I. Introduction

Reinsurance constitutes a basic part of the insurance activity. From a technical point of view, a proper reinsurance scheme enables insurance companies to disperse risks among several other insurers and reinsurers. In this sense, reinsurance is the technical way to optimise the risk portfolio of an insurance company.

On the other hand, from the financial perspective, the retention capacity of an insurance market basically depends on its financial strength. The “excess” of that retention capacity has to be complemented with the support of foreign reinsurers. Therefore, through reinsurance, companies can expand their financial capacity to underwrite business, ceding part of the premium and reserves, thus limiting their losses, specifically in the case of large risks.

Due to the importance of reinsurance topics in insurance operations, it is an issue studied by all supervisory authorities around the world. Specifically, the IAIS (International Association of Insurance Supervisors) formed a reinsurance working-group, which plans to elaborate a paper that could be considered as an international standard on reinsurance regulation.

Among the key issues for this IAIS reinsurance paper are the following: (a) alternative risk transfer, or ART; (b) reinsurance captives; (c) the role of insurance exchange markets; (d) ceded reinsurance risks; (e) collateral (locally based trust funds) vs. risk spread; (f) equalisation reserves vs. reinsurance; (g) legal form vs. economic activity; (h) different opinions about reinsurer’s security between ceding insurers and supervisors.

Capital shortage, due to limited savings and a not fully mature capital market, is one of the main characteristics of the insurance industry in emerging markets (EM). In this financial environment, companies have to turn to reinsurance (foreign reinsurance, basically) in order to compensate for the limited retention capacity of their domestic markets.

Therefore, reinsurance, and specifically foreign reinsurance, is an issue that the regulatory and supervisory entities of EM have necessarily to deal with, in order to promote the development of their insurance markets.
II. Reinsurance regulatory approaches

In most cases, EM economies apply retention-oriented regulation schemes to supervise the insurance industry. However, regarding the relative lack of financial resources that characterises such economies, an insurance company that complies properly with the standards of a retention-oriented regulation may fail because of the financial weakness of the foreign reinsurers used. This situation may affect the solvency of domestic insurance companies, and the interests of policyholders.

Therefore, in insurance markets with a limited retention capacity and with a high dependence on reinsurance (as in the case of EM economies) it is necessary for the solvency regulation to implement a regulatory scheme to supervise reinsurance activities in their domestic markets.

Reinsurance regulation: Three approaches

In general, the development of the insurance market outlines the way reinsurance should be regulated. The regulatory scheme may vary from a very strict one, in which every reinsurer doing business with a domestic insurer should be licensed, to a very liberal one, in which there is no supervision at all. From this perspective, three general viewpoints may be considered: a domiciled oriented regulation, a fully liberalised regulation, and a quality-oriented regulation.

Domiciled oriented regulation

The highest level of regulation, what may be called a domiciled oriented regulation, would be that every reinsurer doing business in the domestic market should be licensed. In this scheme, all market participants, domestic insurance companies and reinsurers are supervised directly by the regulatory body. Reinsurance with non-licensed companies is punished and insurers have to disclose these operations in their financial statements.

A domiciled oriented regulation may offer the advantage of supervising reinsurance operations and reinsurers’ solvency on a national basis as a domestic insurance or reinsurance company. Because of these features, this regulatory approach might be used only in countries with high retention levels of premiums and with almost no reinsurance dependence.

Therefore, this scheme is possible in stable economies with strong financial markets, and would be very difficult to implement in EM economies.

Fully liberalised regulation

On the opposite side, a lesser degree of reinsurance regulation consists of no reinsurance regulation and supervision at all, that is, a fully liberalised regulation with free reinsurance trade between domestic insurance companies and foreign reinsurers. In this scheme, domestic insurers are free to choose their reinsurers and are responsible for their business.

This approach offers the advantage of high flexibility for the dispersion of risk among foreign reinsurers. However, especially in the environment of not fully mature insurance markets that characterises the EM economies, this scheme may lead to the use of low-quality reinsurers, affecting the solvency of domestic companies and of the insurance industry as a whole.
Quality-oriented regulation

Between those two regulatory approaches, quality-oriented regulation represents an indirect supervision of reinsurance that considers specific actions focused to monitor the quality of reinsurers that participate in the domestic market.

This approach generally considers that reinsurers doing business with domestic insurers must send specific information to the regulatory body. In most cases, foreign reinsurers are requested to be registered and to submit annual financial reports or rating agencies’ statements.

This regulatory scheme seems to be more adequate for economies with weak financial markets and less capability to offer enough reinsurance to domestic insurers. The approach also offers the advantage of reducing the scope of supervision, and focusing it on the quality of foreign reinsurers that can be evaluated directly by the local regulator, or on reports prepared by the regulator of the foreign reinsurer or on ratings of specialised international agencies.

This approach has the advantage of transferring the cost the regulator incurred while rating foreign companies to the foreign reinsurers interested in operating in the domestic market. The use of this regulatory scheme also offers the possibility of implementing additional regulatory actions. For instance, premiums ceded to low-quality reinsurers can be considered as an “additional retention” for the domestic company and, therefore, the regulation can oblige domestic insurers to constitute an additional unearned premium reserve and complement the solvency margin with capital resources.

III. The Mexican regulatory scheme

There are currently 65 insurance companies, 3 licensed reinsurers and 20 surety firms operating in Mexico. The market share of the 5 largest insurance companies is 63 per cent; it is 78 per cent for the 5 largest surety firms. In December 1998, total premiums in the Mexican insurance and surety markets were equal to $5.6 billion, representing 1.4 per cent of gross domestic product.

In general, Mexican law establishes that reinsurers can operate in Mexico without a license, but they have to be registered at the Ministry of Finance. In the past, this register, however, was granted to almost every foreign reinsurer that asked for it; in other words, there used to be no real control of the reinsurers’ quality.

On the other hand, the former regulatory scheme focused on solvency throughout the retention limits of domestic insurance companies. Insurance companies that followed this regulation scheme could face liquidity and solvency problems because of reinsurers’ failures. Therefore, the main deficiency of the Mexican regulation was the lack of adequate incentives to motivate domestic insurers to cede their risks to high-quality foreign reinsurers. In other words, it was necessary to emphasise not only in a retention regulation, but also in a cession one.

To correct this deficiency, the National Insurance and Surety Commission (CNSF) implemented in 1996 a new reinsurance regulation based on the following premises: for domestic insurance companies, (a) to establish a specialised reinsurance surveillance scheme within the CNSF, (b) to support specialised inspection activities, (c) to establish a legal framework to regulate maximum retention limits, (d) to establish a technical reserve for domestic companies considering the reinsurers’ quality, and (e) to impact the solvency margin of ceding companies in the case of use of a low quality reinsurer; for foreign reinsurers, to modify the registration basis in order to have an updated situation of their claim pay ability (General Foreign Reinsurers Register); and for reinsurance brokers, (a) to implement the use of domiciled reinsurance brokers, and (b) to strengthen the legal sanctions regime for intermediaries’ malpractice.
**General foreign reinsurers register**

The Register is granted only to reinsurers that have a satisfactory evaluation of an international specialised rating agency. Almost all the requirements of legal, administrative and financial information (considered in the former regulatory scheme in Mexico) have been switched to a rating certificate.

The use of rating certificates gives flexibility to this regulatory and supervision scheme. The local regulator in each country may have a better financial diagnosis of a domiciled reinsurer. However, the proper implementation of this scheme would imply the use of international regulatory standards, as well as establishment of formal agreements between countries for the exchange of this kind of information.

The register can be revoked automatically if the rating of the reinsurer fails to meet the minimum required rank, or if the reinsurer does not present annually to the CNSF a current and adequate evaluation certificate issued by an international specialised rating agency.

On the other hand, to provide appropriate information to consumers, the CNSF publishes periodically a list of acceptable rating agencies, the minimum rating needed for the register, and the rating of foreign reinsurers employed by each domestic company in the market.

The current list includes the most important rating agencies, and the minimum ratings to obtain the register:-- Standard & Poor’s: BBB- or higher-- A.M. Best: B+ or higher-- Moody’s: Baa3 or higher-- Duff and Phelps: BBB- or higher.

The application in Mexico for three years of this new regulation has shown important changes in the quality of the foreign reinsurers to which the Mexican market is ceding its risks. In 1996, when this scheme was established, the Mexican market operated with 710 foreign reinsurers. From those 710 reinsurers, 267 (38 per cent) were registered, and 53 per cent of these 267 were not rated by any internationally recognised agency. It is important to mention that only half of the reinsurers that were rated by agencies had an adequate rate.

In 1999, there are 218 foreign reinsurers registered, with the following levels of ratings:

- Superior: 21 per cent
- Excellent: 35 per cent
- Very good: 2 per cent
- Good: 27 per cent
- Adequate: 15 per cent

In the opinion of the CNSF, as well as of the insurance companies, the quality of the foreign companies now registered offers a level of security in reinsurance operations that did not exist before, and this helps to reduce the solvency problems that domestic companies might face due to ceded risks.

**Special reinsurers quality technical reserve and solvency margin**

Besides the sanctions that insurance companies will receive because of their operation with non-registered reinsurers, they must create a Special Reinsurers Quality Technical Reserve, in order to prevent the failure of a bad-rated reinsurer.
In general, if the foreign reinsurer is a bad-rated one, what the insurance company is really doing is creating an “additional retention”. This Special Reserve considers the resources that are necessary to support the risk of this additional retention. The constitution method is as follows:

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R_{\text{tcr}} = \sum_{i=1}^{n} \left[ (P_{c} - P_{rrc}) + C_{np} \right]
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- \( R_{\text{tcr}} \) = Special Reinsurers Quality Technical Reserve
- \( P_{c} \) = Premium ceded to a non-registered reinsurer \( i \).
- \( P_{rrc} \) = Retained premium ceded to a non-registered reinsurer \( i \).
- \( C_{np} \) = Non-proportional reinsurance cost paid to a non-registered reinsurer \( i \).
- \( n \) = Total number of non-registered reinsurers which the insurance company worked with.

As a complement of the unearned premium reserve, the Special Reinsurers Quality Technical Reserve is considered part of the technical reserve investment basis in order to adjust it to a regulated investment regime. The reserve can be liberated up to 100 per cent at the end of the first year of its creation, or until the reinsurance contract ends. The Reserve can be used in the case of failure of the non-registered reinsurer.

Since all the ceded risks to bad-rated reinsurers are considered an additional retention, operating with non-registered reinsurers will also affect the solvency margin of insurance companies. Therefore, insurance companies that use non-registered reinsurers have to increase their capital requirement and present to the CNSF a plan to adequately protect their reinsurance programme in the short term.

When a Mexican insurance company is expecting to recover from a non-registered foreign reinsurance company for pending claims, it cannot consider this asset for its technical reserves coverage.

**Reinsurance brokers**

Reinsurance brokers play an important role in reinsurance operations. In 1998, they handled 75 per cent of the premiums ceded by the Mexican market through contracts. Of this percentage, 54 per cent regards excess of loss contracts. Reinsurance brokers are obliged to inform the ceding companies in timely fashion of the placing of advances with reinsurers, their confirmations, the costs and conditions of contracts and the names of all participating reinsurers.

Formerly, Mexican law established two types of reinsurance brokers: those domiciled in the country, which had to have the authorisation of the CNSF, and those not domiciled in Mexico, which had only to be registered at the CNSF.

However, several irregularities were detected in the reinsurance brokers’ operations, such as the negotiation of different conditions from those stipulated in contracts with domestic insurers, irregularities in payments to reinsurers, the use of low-quality reinsurers, delayed or omitted delivery of documents to the ceding company, operating without authorisation, etc.
In order to execute efficient supervision and to do "on-site" examinations to verify their operations and identify such irregularities, and since the behaviour of reinsurance brokers is very important for the domestic insurers' solvency, it was decided to adopt exclusively a domiciled brokers scheme. Additionally, in the new law, it is considered a crime if reinsurance brokers misuse a ceding companies’ resources, thus threatening the stability and solvency of insurers, as is the delivery of false information to the CNSF with fraudulent intentions.

IV. Conclusions

In the financial environment that characterises EM economies, reinsurance regulation is necessary in order to supervise the solvency of domestic insurance companies.

In the specific case of insurance markets of EM economies, an indirect regulatory approach such as quality-oriented regulation seems to be the most appropriate. The use of this regulatory scheme offers several advantages: First, this approach enables the regulatory body not only to provide the right incentives to motivate domestic insurance companies to use high-quality foreign reinsurers, but also to establish capital requirements to mitigate the financial impact of the failure of a foreign reinsurer. Second, since the quality of the foreign reinsurer can be evaluated through a rating issued by an international specialised agency, the scheme transfers the cost from the regulator to the foreign reinsurer. And finally, from the perspective of the regulatory body, the scheme simplifies the reinsurance supervision process.