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**Re: Comments on Draft IAIS Guidance Paper on Risk Transfer, Disclosure and Analysis of Finite Reinsurance, Dated July 2006**

Dear Commissioner Bowler:

Reinsurance is a global industry that is built on contractual relationships between professional, knowledgeable parties. Differences in regulatory approaches tend to distort the market and impact the availability of effective (re)insurance solutions and the allocation and free flow of capital. As the leading global reinsurer, Swiss Re is impacted by these variations and has a significant interest in ensuring appropriate and consistent treatment of transactions.

We have reviewed the Draft IAIS Guidance Paper on Risk Transfer, Disclosure and Analysis of Finite Reinsurance, dated July 2006, (“Guidance Paper”) and commend those involved for their substantial work and efforts. While the Guidance Paper is, in many ways, a useful overview of non-traditional reinsurance, its development and its current treatment in key jurisdictions, we have continuing concerns about the foundational premise upon which it is based and the inconsistent messages that it will send to regulators seeking clarification.

**1. Reinsurance Transactions Fall Into a Continuum of Risk Transfer**

The Guidance Paper artificially categorizes reinsurance contracts as traditional or non-traditional when, in fact, reinsurance transactions fall along a continuum based on the degree of risk transferred. In other words, each contract represents one point on a continuous line between full risk transfer and full risk retention.

It is not practical, nor is it accurate, to make a distinction between “traditional” and “non-traditional” reinsurance. The elements that the Guidance Paper relies on as characteristics of finite contracts are misplaced. The fact that the paper correctly notes that some of them may be present in traditional reinsurance implies that they might be problematic in both and, in any event, fails to provide the uninformed reader with guidance the paper seeks to provide.

Recognizing this reality of a continuum, the American Academy of Actuaries Committee on Property & Liability Financial Reporting has recently concluded that an accounting system that forces this polarized approach based on arbitrary distinctions, without allowance for judgment, is not an optimal approach. Discussions are now ongoing in international accounting on this very issue. We do not believe that the Guidance Paper should be furthering an approach when the efficacy of that approach is currently in question.

## **2. Assumption of Limited Risk**

One of the characteristics noted as being present in non-traditional contracts is the assumption of limited risk by the reinsurer. The capital of any commercial entity is limited, and in light of this, no prudent company would expose their balance sheet to unlimited risk. In this sense, nearly every reinsurance contract has limited risk. Indeed, regulators should be concerned about a company that purports to expose itself to such *unlimited risk* in the absence of unlimited capital and claims paying ability.

As noted above, risk transfer is properly seen along a continuum. There are times when the amount of risk transferred will be more limited than others. As discussed in a recent CEA Paper,<sup>1</sup> there are sound commercial reasons to structure reinsurance protection that “boxes in” the potential upside and downside of reinsurance coverage. Without these legitimate provisions, reinsurers might be unable or unwilling to put their capital at risk to offer certain coverages in emerging markets where insufficient historical loss statistics exist. We believe that creative solutions that bring strong and reliable capital to a market should be encouraged – not discouraged -- by regulators.

Another important example of the legitimate use of structures providing “limited risk” cited by the CEA Paper<sup>2</sup> is to support clients where improvements have been made to underwriting practice where there has been a history of underperformance. In such instances, reinsurance support can be offered at a lower price than the historical data would otherwise suggest, by “boxing in” the potential downside. The result is lower cost of reinsurance in the event that favorable loss experience is achieved by the insurer while protecting the reinsurer if loss experience does not improve. We believe that regulators should encourage – not discourage – techniques that can make reinsurance coverage available to insurers at a lower cost and reward better underwriting management.

## **3. Multi-Year and Multi-Line Reinsurance Contracts**

The Guidance Paper also lists “the transfer of volatility” as one of the characteristics of a non-traditional reinsurance contract, citing the use of multiple years and multiple lines as examples. Yet this is one of the long accepted purposes of a reinsurance contract. It goes without saying that spreading risk over a longer time horizon will require less capital than doing so on an annual basis. Similarly, the combination of multiple lines with limited correlation will reduce the amount of capital required than if those risks were reinsured independently. In either case, the aggregate exposure can be more efficiently planned and managed, thereby leading to more efficient capital management. Additionally, multiple year- contracts provide certainty to the ceding insurer in terms of both capacity and cost which contribute to stability of the primary insurance market.

We believe that the goals of any regulatory regime should include both efficiency and stability, and regulators should encourage – not discourage -- products that support those goals.

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<sup>1</sup> Guidance Paper on Reinsurance Including Finite Reinsurance, published by the CEA, dated June 2006 (“CEA Paper”). See page 6.

<sup>2</sup> CEA Paper, see Page 6.

#### **4. Market Innovation Should Not be Stifled by Regulation**

The general approach to the Guidance Paper is from the perspective that non-traditional reinsurance contracts have certain common characteristics and that these need to be closely analyzed by the regulator to determine the amount of risk transferred. We believe that instead, the Guidance Paper should educate regulators on the development of non-traditional reinsurance, the important commercial needs that these creative solutions can address, and focus on how regulators might ensure that transactions on the far end of the continuum which receive limited risk transfer accounting treatment are adequately disclosed in a transparent manner. At what point on the continuum a transaction falls, should be principles-based and guided by the respective accounting rules. As the CEA Paper points out, inventing separate rules for supervisory reporting, different than the accounting rules for the transactions, will lead to a parallel reporting regime with borderline cases being treated differently in both systems.<sup>3</sup>

#### **Conclusion**

As the emerging standard setter for global insurance and reinsurance regulation, we believe that the IAIS has a unique opportunity to play an important role in an area of regulation that has been brought under close scrutiny in recent months. Evidence has been publicly brought to bear that certain individuals have manipulated financial or regulatory reporting rules -- but improper behavior is not new, nor is it likely to ever be eliminated. We believe that despite front page news, regulators should take a measured approach aimed at revisiting the accounting rules to ensure that they properly reflect the characteristics of a transaction while avoiding the temptation to layer on yet more rules that disrupt the ability of the market to respond to commercial needs and create an even greater capacity to manipulate more rules. Reinsurance plays a vital role in risk and capital management and contributes to enhancing the size and competitiveness of insurance markets.<sup>4</sup> The imposition of inappropriately focused regulatory rules can have a chilling effect on how companies structure their commercial relationships which, in turn, can inhibit the free flow of capital with resulting effects on the availability of insurance capacity, the growth of emerging markets, and the daily lives of insurance consumers.

We encourage the IAIS to take another look at the Guidance Paper and restructure it in a positive way that provides guidance to regulators on how to achieve what we believe is the appropriate balance – to ensure that the financial credit taken for these transactions is commensurate with the level of risk transferred to a third party with the need to encourage market innovation for legitimate and beneficial solutions to increasingly complex commercial needs.

Sincerely yours,

Debra H. Hall

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<sup>3</sup> CEA Paper, see Page 13.

<sup>4</sup> CEA Paper, see page 3.

## APPENDIX

If the IAIS determines that the current structure of the Draft Guidance Paper on Risk Transfer, Disclosure and Analysis of Finite Reinsurance (“Guidance Paper”) should stay as currently drafted, Swiss Re has the following specific comments:

### A. Life Finite Reinsurance

1. The Guidance Paper references US GAAP, regulatory accounting and IFRS accounting throughout. We believe that though the references are clear on the face of the document, it can be confusing to the reader. In our experience, we believe there is a tendency to confuse these differences now, e.g., some countries attempt to apply US GAAP standards for risk transfer to regulatory statements. This confusion is typified in Appendix VI on page 65 where what is indicated to be the United Kingdom’s approach relates to GAAP statements, not regulatory statements.

- Perhaps the GAAP references should be restricted to an Appendix while the text of the paper addresses regulatory statements.
- We also suggest that the UK’s approach for regulatory purposes be included in the Guidance Paper.

2. Throughout the Guidance Paper, the level of risk is judged by subjective tests indicated by words such as “remote,” “significant,” and “material.” This is unfortunate and unnecessary when there is a very straightforward objective test that can be applied to any reporting standard, as follows:

If the regulations applying to the particular reporting methodology under consideration require reserves or capital to be held against a risk which is subsequently reinsured then those reserving and capital obligations should be released.

It is always essential to carry out the analysis in the context of the risk and capital obligations imposed by the relevant standard. It does not make sense to deny credit for reinsurance if a risk which is deemed not to be “significant” nevertheless carries a significant reserving or capital obligation under that framework.

3. The Guidance Paper fails to note that finite life reinsurance treaties may introduce additional reserving requirements, e.g., for legal risk because of the complexity of the documentation or for the credit risk of the reinsurer.

4. The UK regulations have very clear rules with respect to whether financing can be repaid other than through the emergence of surplus, i.e. not contingently. Those conditions are:

- non-payment of the reinsurance premium or similar financial obligation

- fraud
- material misrepresentation
- transferring business out of the life company to the detriment of the reinsurer without the reinsurer's agreement

Such standards are necessary if reinsurance is to provide high quality capital.

5. The analysis and risk transfer standards in the Guidance Paper should apply to all reinsurance, not just finite reinsurance.
6. The Guidance Paper is ambivalent on whether lapse (or persistency) risk is to be considered as insurance risk. The UK regulatory standard allows this. Of course, any reinsurance treaty must meet the legal requirements to be a life (re)insurance contract.

#### **B. Deletion of Sigma LPT Example**

The Loss Portfolio Transfer (LPT) example on page 37 should be put in the correct context as contained in the source quoted in the Appendix. The LPT example has to be understood as a theoretical description of the mechanics and effects of a LPT which is always dependent on the specific local accounting treatment in effect in the relevant jurisdiction, e.g., according to US GAAP the profit as shown in the example had to be spread over the period of uncertainty regarding the underlying losses. Such a reference to the specific local accounting treatment, especially in respect of the accrual of profits is missing in this example which makes it misleading.

**Swiss Re recommends that this example be deleted since it is misleading and does not properly reflect the accounting treatment for these types of transactions. Alternatively, we request that it be included without reference to Swiss Re or the Sigma publication. If this second alternative is chosen, the paper will continue to provide misleading information; therefore, we suggest that the IAIS add the following language in the event that the example is retained: “The accounting for a retrospective Loss Portfolio Transfer under US GAAP requires that the profits to be realized are to be recognized over the actuarial determined life of the exposures covered by the transaction.”**

#### **C. Definitions**

We believe it is not helpful to include the various definitions of finite re in Appendix III. As noted in Swiss Re's comment letter, the Guidance Paper artificially categorizes reinsurance contracts as traditional or non-traditional when, in fact, reinsurance transactions more appropriately and accurately fall along a continuum in risk transfer analysis. A listing of definitions is inconsistent with the recognition of this continuum which should be determined on the basis of proper accounting treatment. The more specifics and rules (including definitions) that are imposed, the greater the opportunity to manipulate financial and regulatory statements to get around those rules.

As noted in the CEA Paper,<sup>5</sup> the EU Reinsurance Directive contains a principles-based definition of both reinsurance in general and finite reinsurance in particular. Those definitions are as follows:

*Reinsurance* – means the activity consisting in accepting risks ceded by an insurance undertaking or by another reinsurance undertaking. In the case of the association of underwriters known as Lloyd’s, reinsurance also means...

*Finite Reinsurance* –means reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following two features:

- (i) explicit and material consideration of the time value of money,
- (ii) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer.

As the CEA Paper also notes that while the Reinsurance Directive’s definition of finite reinsurance may not, in all cases, capture all the essential elements of all contracts having finite characteristics and may well sweep in reinsurance contracts transferring significant insurance risks, the definition is superior to others and fits well in a principles-based prudential approach.<sup>6</sup>

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<sup>5</sup> CEA Paper, see page 9.

<sup>6</sup> CEA Paper, see pages 9, 10.