MAS 316

18 Aug 1999

NOTICE TO LIFE INSURERS
INSURANCE ACT, CAP 142

FINANCIAL REINSURANCE

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1 Financial reinsurance, as an alternative to traditional reinsurance, is increasingly gaining significance as a component in insurance companies' approach to total risk management. The use of financial reinsurance, which represents a combination of risk transfer and risk financing, could add value to an insurer's risk management programme by providing flexibility and liquidity.

2 The purpose of the Notice is to set out a framework that will facilitate the development of financial reinsurance, ensure clarity and consistency in accounting treatment by the insurers and provide users of financial statements with adequate information to accurately assess the financial positions of the insurers.

3 This Notice sets out the Authority's stance on the use of financial reinsurance, the definition of financial reinsurance, the application of risk transfer rules and accounting treatment as well as disclosure requirements.

Authority's Stance on Financial Reinsurance Transactions

4 Registered insurers (direct insurers, reinsurers and captive insurers) can enter into financial reinsurance transactions in respect of *life business*. However, direct and captive insurers are required to obtain approval of the Authority on a case-by-case basis and for every transaction entered into. If there has been a material change in contract terms during the period of the contract, the insurer must reapply for approval. Direct insurers are also required to inform their Board of Directors of any such transactions. They are advised to use financial reinsurance arrangements that involve elements of risk transfer.

Definition of Financial Reinsurance

5 Financial reinsurance contracts are contracts of insurance effected by the company, which have the effect of increasing the amount of assets included at line 26, of Form 14, representing assets of the company which are available to meet its required minimum margin for life business, and which include terms for:

i. the transfer of assets to the company or creation of a debt to the company (or both); and

ii. either an obligation for the company to return (with or without interest) some or all of such assets or a provision for the diminution of such debt, in each case, in specific circumstances.

Guidelines for Information Required on Application to Buy Financial Reinsurance

6 An application to the Authority to buy financial reinsurance should include a detailed description of the proposed arrangement including the following information:;

i. reasons (which should include why the deal is desirable and what it is supposed to achieve) for buying financial reinsurance;

ii. an analysis of the projected cash flows (which should include the net present value) giving various probable outcomes of the treaty;

iii. details of the expected impact of the proposed deal on the actuarial reserves and the statutory surplus;

iv. a description of the proposed accounting treatment and a justification of the proposed treatment.

v. certification by the auditors on their concurrence of the proposed accounting treatment.

7 A presentation to the Authority on the information provided in paragraph 6 may be required prior to approval.

Risk Transfer Rules and Accounting Treatment

8 Financial reinsurance contracts entered into by an insurer shall be accounted for in its quarterly and annual returns, according to their economic substance in accordance with generally accepted accounting principles.

Risk Transfer Rules

9 To determine the substance of the transaction, it is necessary to assess whether there has been a *significant transfer* of insurance risk between the ceding insurer and the assuming insurer. With respect to life business, insurance risk may comprise of one or more of the following types of risks:

i. **mortality**, that is the risk of death of the assured, or, in the case of an annuity, the continued survival of the annuitant;

ii. **morbidity**, that is the risk of incapacity covered by the contract;

iii. **investment**, that is the risk of not generating adequate returns to meet the agreed level of benefit;

iv. **persistency**, that is the risk of incurring a loss from early termination of the contract by the policyholder; and

v. **expenses**, that is the risk of the margins within the contract being insufficient to cover future expenses.

10 A significant transfer of insurance risk is deemed to have taken place under a contract of reinsurance when the following conditions are met:

i. it is reasonably possible that the assuming insurer may realise a significant loss from the contract; and

ii. it is reasonably possible to have a significant range of outcomes under the contract.

"Significant" should be assessed in the context of the commercial substance of the contract or contracts being evaluated as a whole, and should be judged with reference to the range of outcomes that would reasonably be expected to occur in practice.

11 The assessment as to whether insurance risk is transferred should be made prospectively, at the time the contract is entered into.

Accounting Treatment

12 Financial reinsurance contracts that meet the risk transfer rules i.e. involve a significant transfer of insurance risk, shall be accounted for as contracts of insurance in the revenue and profit and loss account. On the other hand, contracts that do not meet the risk transfer rules shall be treated as deposits by both the ceding and assuming insurers. That is, amounts in respect of such contracts are to be excluded from the revenue and profit and loss account.

13 The method of accounting should follow consistently over the whole period of the contract.

Disclosure and Reporting for Life Business Ceded

14 For each financial reinsurance contract in-force during the accounting period, under which life business has been ceded by the insurer, the insurer shall include in the Abstract of the Actuary's Report:;

i. the amount of any undischarged obligation of the company and a brief description of the conditions for the discharge of such obligation; and

ii. a description of how, if at all, such undischarged obligations have been taken into account in the valuation.

Disclosure and Reporting for Life Business Assumed

15 For each financial reinsurance contract in-force during the accounting period, under which life business has been assumed by the insurer, the insurer shall include in the Abstract of the Actuary's Report:;

i. the amount of any future expected repayments from the cedant and a brief description of the conditions for the cedant to make repayments; and

ii. a description of how, if at all, such future expected repayments have been taken into account in the valuation.

Effective Date

16 This Notice shall apply to both annual and quarterly returns relating to accounting periods ended 30 September 1999 and later.

17 The above guidelines, however, shall not apply retrospectively to financial reinsurance transactions that have been entered into prior to the issuance of this Notice.

Last modified on 31/8/2006