

REINSURANCE SECURITY

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1. Introduction

- 1.1 Reinsurance is often the second biggest cost of an insurance company, after claims. The management of this cost is certainly important. What is surprising to find in an insurance company is the lack of attention paid to this cost, both at the strategic and the management level. The reinsurance cost is often an add-in to the business plan, and not necessarily a fundamental part of it. The extent of any reinsurance purchased is often on the basis of the previous years' purchase, with little thought on the value of alternatives, or even whether the programme meets the needs of the insurer in the most efficient way. It is also often placed with reinsurers of various quality, who have run the risk for many years and whose fortunes themselves may have changed radically in a short space of time. Furthermore, it has been known for insurers to purchase reinsurance that was unlikely ever to be used, (such as when the deductible is above the gross exposure to any loss) due to incompetence or to reduce investors' naive concerns.
- 1.2 With the recent increasing cost of reinsurance, the decline in capacity for certain lines, and the questioned ability of some major reinsurers to meet their obligations, insurance companies are now placing more attention to these issues. This paper deals with the issue of reinsurance security, with particular emphasis on the actuarial issues.

- 1.3 Actuaries are becoming more involved with these issues in the following ways.
- (i) The treatment of outwards reinsurance in the reserving process.
 - (ii) The rating of reinsurance companies for the purpose of placing the business.
 - (iii) The commutation of certain treaties.
 - (iv) The wind up of “insolvent” insurers.

2. A Perspective

2.1 In the past reserves have often been set only net of reinsurance. With the implementation of the Insurance Accounts Directive, companies now have to set provisions gross, and then take explicit account for a new type of asset, reinsurance recoveries, rather than simply set up net provisions. These new assets should therefore be “valued”, and due account taken of any likelihood that future recoveries may not be collectable in full.

2.2 There are four types of reinsurance recovery;

- (i) Those claims which have already been paid by the insurer but recovery not yet collected from the reinsurer.
- (ii) Those claims which are still outstanding, and not yet paid
- (iii) Those recoveries relating to IBNR claims
- (iv) Future claims in respect of the unearned premiums

Ideally each of these amounts would be available split by reinsurer. This may not be known, since historically some amounts may have only been identified by the broker who has dealt with the recoveries, and not the individual reinsurers. This lack of identification of reinsurer is clearly inadequate for current and future needs.

2.3 The amounts can also (in theory) be associated with a date of expected recovery. For amounts already claimed, the date of claim is known, and the amount of any overdue payment and the overdue period will also be known. For future claims (i.e. outstanding claims and IBNR), the pattern of expected receipt can be modelled.

2.4 Typically, accountants deal with any bad debt provisions relating to overdue actual claims. More doubt will probably be associated with amounts which have been outstanding the longest. There is also the need to distinguish between insolvencies, slow payers, and payments in dispute.

- 2.5 There appears to be no typical practice in respect of bad debt provisions for future claims. From the prudential supervision viewpoint, as well as that of an insurer or broker assessing the security of the reinsurer, it is an unsatisfactory situation when a reinsurer could gradually fall into insolvency due to reinsurance bad debts, when this could be effectively known today by making a reasonable assessment of the security of future reinsurance recoveries.
- 2.6 It would seem to be essential to look at the pattern of expected reinsurance recoveries in the future for each reinsurer, and attempt to assess the likelihood of full or partial recovery. This could be an onerous task if a company has very many reinsurers, as is the case for London Market operations in particular. A clear option is to group reinsurers according to their perceived strength today.
- 2.7 It may not be safe to assume 100% recoveries in the future for all "secure" (i.e. currently paying claims in full and promptly) companies today. It may also be difficult to convince senior management that a company with an AAA rating from Standard & Poors may become insolvent. Past experience shows that some historically well regarded companies have "fallen over" and are unlikely to meet their contractual liabilities in full. The longer the period of potential recovery of reinsurers, the greater the risk of failure. Long tail liabilities stretch out 20 or more years in the future, and asbestos related claims have a latency period of 30-40 years.
- 2.8 Thus a model can be built showing expected full reinsurance recoveries in each future time period, and alongside a pattern of expected shortfalls in recovery. This would be able to be compared to actual performance in the most recent year, and may help validate the model, particularly if a consistent approach to bad debt write offs has been made.
- 2.9 Future expected new business could be built in, with its patterns of recoveries from its reinsurance programme. This might help to guard against undue future reliance on less than desirably secure reinsurers, and possibly lead to a review of the reinsurance

programme. It has been suggested that insurers reinsure significantly more than what may be theoretically justifiable. A model which allows for non-recoveries may help with rationalising the process.

3. Bad Debts

- 3.1 Bad debts, in this context, means provisions against failure of the reinsurer to meet its financial obligations to the insured. This includes both insolvency and disputed treaties.
- 3.2 Historically, the reserving process in a general insurance company has involved both gross and net data. In certain circumstances, only net data may be available. The triangles themselves contain a labyrinth of information that needs careful consideration. Firstly, what is meant by the word “net”? Set out below are some examples.
1. The gross claims less the full recoveries from reinsurers.
 2. The gross paid claims less the actual recovered reinsurance. (Note that this may lead to a timing issue).
 3. The gross claims less reinsurance recoveries, adjusted each year for bad debts on payments, but not outstanding claims.
 4. The gross claims less reinsurance recoveries, adjusted for bad debts on payments and on outstanding claims.

Further complications may arise because of commutations which will distort the picture.

- 3.3 In the net data provided by insurers, the information is usually provided by a net triangle with full recoveries, or a triangle with specific “bad debt” features. These triangles have the feature that they are “last years’ triangles” with an extra diagonal. This has the advantage that auditing the result is easy.
- 3.4 The allowance for irrecoverable reinsurance is then left to the accountants as a “bad debt provision”. Each year specific amounts are written off, and it is often difficult to relate these to the actual reinsurance contracts. There is therefore a potential

lack of uniformity in the approach. In addition, the writing off of bad debts could be due to contract disputes as opposed to known insolvency. There is the possibility of a future recovery and this needs to be factored into the provision. The actual treatment of bad debt is often made with a view to what the Inland Revenue will allow. Allowance for future bad debts on outstanding claims (or even IBNR) is not usually allowed unless there is a strong statistical justification for such an approach.

- 3.5 Faced with these issues, in certain respects, the actuary has a number of choices. They will depend on the instructions he has been given, and the purpose of the exercise. For establishing reserves for an insurance company, he will almost certainly be asked to review the pure gross and net data, without any provisions for bad debts, and the bad debts become part of the general considerations for the Board. For the purposes of RITC the net data may have been adjusted for bad debts (this is not unusual at Lloyd's) and accordingly the projected future claims will, themselves, contain an implicit allowance for bad debts. In any case, as RITC is a willing buyer/willing seller transaction, then the treatment of bad debts is a more fundamental issue. Finally in an appraisal value for the purpose of sale or purchase, the treatment of bad debts is also of considerable financial importance.

- 3.6 Let us assume that an actuary is required to assess the bad debt provision. To do this fully he would need the following:-

1. Details of the reinsurance programme for the years and business in question. This will include details of the coverage, (including number of reinstatements), the percentage placed, and the reinsurers with their specific percentages.
2. Details of known claims which have impacted the contract, both payments and outstanding claims, and the amounts recovered and recoverable.
3. The gross and net claims "triangles"
4. In respect of catastrophes, the claims development.

We will also suppose that he has calculated a gross provision (and possibly a pure net provision assuming that reinsurance is 100 per cent collectable).

- 3.7 For simplicity's sake, it is assumed that the reinsurance programme is graded. For those reinsurers known to be in financial difficulty, often considerable background work has been done to establish the known exposure in terms of payments and reported outstanding claims, and a view is taken as to the percentage recoverable, taking into account the time value of money. In respect of other insurers, they can be placed within broad bands as to their security status (see section 5, for example).
- 3.8 For certain types of contracts the assessment of the bad debt provisions is simple. In respect of quota share reinsurance it is just the proportion of the gross risk insured multiplied by the appropriate bad debt factor. As the full gross reserves are known, then this can readily include IBNR.
- 3.9 In respect of short tail catastrophes, the ultimate loss is calculated, and the appropriate reinsurance recoverable can be ascertained against this loss. The bad debt provision can again be readily estimated.
- 3.10 In respect of other "short tail business" the IBNR and outstanding claims reserves are usually small, and assessment of bad debt provision is again a simple exercise.
- 3.11 In respect of "long tail business" the situation is much more complex. A typical example is those insureds with considerable asbestos and pollution liabilities, going back 30 years. The assessment of the ultimate gross costs of these claims, in themselves, is difficult, and the application of reinsurance programmes is often done in an approximate manner. There are liability disputes as to whether there has been one or several losses. Whereas such disputes may make less difference to the total gross claims, they will impact on the reinsurance recoverable. Often the reinsurer is not known, or if they are known, the percentage is uncertain (it may vary from risk to risk).

Records have been lost or destroyed, and the brokers who originally placed the business are of limited help. Reinsurers have changed name, been sold, amalgamated and so on.

- 3.12 The process is further complicated by the fact that triangulation methods are often inappropriate for determining the liability of such latent claims, and alternative approaches (for example, top down exposure analysis) are of limited help. Triangles may be of use in determining approximately the percentage of the gross loss that was reinsured. Furthermore, if it is possible to produce triangles before and after the bad debt provisions, it may be possible to ascertain a pattern of such provisions which may be of value. These provisions may also fluctuate with profit in that when profits are low there is often an unwillingness to move bad debt provisions upwards, and catching up is made when profits are high.

4. Bad Debt Provisioning in Other Businesses.

4.1 The banking industry's approach to bad debts

Whilst the treatment of actual and potential bad debts arising from reinsurance programmes is of interest to the insurance industry, the banking industry has similar issues in respect of its lending activities.

4.2 Provisions for bad and doubtful loans in banking traditionally fall into two categories:

"Specific" provisions - which relate to loans identified as bad or doubtful

"General" provisions - which relate to the fact that bad and doubtful loans which have not been identified can reasonably be expected to exist. In principle, these two provisions should total to the amount by which management should write down the value of its loan portfolio to an amount which represents its net realisable value in the normal course of events.

4.3 The *specific* provision for a given loan takes into account the nature of the exposure and the extent to which the borrower may be able to honour its commitments. Consideration is paid to, inter alia, the total lending to the particular debtor, the written down value of any security associated with the lending, the cost of enforcing the lender's rights and the value of any accrued income in the accounts,

4.4 The *general* provision is normally established by applying an overall percentage to outstanding balances within defined groups of loans. These defined groups comprise lending which is expected to exhibit consistent features. Groupings can be at the level of mortgages, credit cards, personal loans, overdrafts and corporate/commercial lending but may go further than this to allow for, for example, geographic or industry effects. The lender may have an established system of "*grading*" loans according to some sort of score, and this grading can be used to group loans. For example, on a scale of 1 to 10, loans to debtors with the

highest financial standing would score 1 whilst those with the weakest financial standing would score 10.

- 4.5 The percentage to be applied to the outstanding balances for each group will be based upon past experience of the group and other factors such as economic conditions.

- 4.6 Where a bank has international exposures to countries and governments it will need to assess the macroeconomic and political conditions prevailing in these areas. Such 'Country' and 'Sovereign' risks need to be considered in the context of both general and specific provisions.

4.7 Comparison with the insurance industry

In reserving for future claim payments insurance companies hold unearned premium reserves, outstanding claim reserves and IBNR reserves. Reinsurance recoveries were allowed for either implicitly or explicitly, but typically assumed that full recovery is achieved. Now that the insurance accounts directive is in force, reinsurance recoveries have to be allowed for explicitly.

- 4.8 The establishment of bad debt provisions in respect of reinsurers which have been identified as being in financial difficulty is not normally the responsibility of an actuary. The provisions are usually determined on a case by case basis which takes account the nature of the exposure to the reinsurer and the extent to which the reinsurer may be able to honour its commitments. In this respect the banking and insurance industries are believed to follow similar approaches. Insurance companies tend also to restrict the provision to outstanding case reserves.

- 4.9 The question arises as to whether allowance should be made for potential default by reinsurers which have not been specifically identified as being in financial difficulty. If such an allowance is made the question then arises as to how such allowances should be determined.

- 4.10 This is an area where bank *general* provisioning principles and methodology may be of use to the insurance industry. In this respect the methods used for corporate/commercial loan

portfolios may be most useful in that these portfolios comprise large exposures, and multiple small exposures, of different types to a single debtor. These features are arguably present in reinsurance programmes. Methods which involve portfolio groupings and percentages, as described above, could form the basis for development by the actuarial profession.

- 4.11 Particular areas where research may be fruitful are
- ☐ Development of reinsurance security 'grading' factors
 - ☐ How information from external rating agencies, such as Standard & Poors can be used.
 - ☐ Research into past insurance/reinsurance insolvencies in order to identify particular features or trends for future use.
 - ☐ Consideration of the impact of different reinsurance markets and associated regulatory constraints.
 - ☐ Consideration of accounting and disclosure requirements in different domiciles
- 4.12 The value of bank commercial/corporate *general* provisioning methodology as a model for reinsurance bad debt provisioning has already been commented upon. It is worthwhile noting that bank *general* provisions on bulk consumer lending, such as personal loans, are broadly analogous to insurance IBNR claims reserves. A comparison of techniques would be valuable.

5 The Role of the Reinsurance Committee.

- 5.1 Many insurance companies have Reinsurance Security Committees which meet on a regular basis. Typically the Committee's membership consists of the Chief Underwriter, Finance Director, Actuary and others. There may be a team working under the Committee.
- 5.2 Typical duties of this Committee are
1. To grade all Reinsurance Security, both in respect of companies currently used and those being considered to be used.
 2. To monitor developments in reinsurance, specifically news that could lead to an immediate downgrade of a company.
 3. To check that underwriters are following grading restrictions, such as not using a company which has been ~~graded~~ as "Unacceptable" or not even graded. In certain companies, the Committee can only advise and can in theory be overruled by the underwriters. In other companies the list is mandatory, and the reinsurance security used is scrutinised both by the Committee and internal audit.
 4. To monitor exposures to each company. Each underwriter may have an acceptable level of exposure which, when aggregated over all underwriters, results in an accumulated exposure could be considered excessive.
- 5.3 The review process may consist of a formal document, prepared by the Reinsurance Security team, setting out in a standard way the various financial statements, together with some key indicators (for example, solvency margin, reserve to premium ratios and so on) which will help in assessing the grade. These may be circulated before with a recommendation, and only those with a dissident point of view are discussed fully at the meeting.
- 5.4 The information used may be in a standard form (for example S&P/ISI basis). The Report and Accounts are used in unconsolidated format where possible, so that the value attributed to subsidiaries is stated. Shareholders' funds are adjusted to

exclude intergroup debt owed to the company, fixed assets, the value attributed to subsidiaries, and assets of 'questionable' value, for example tax losses.

The ratios used include:

- ☐ Gross Premium to adjusted shareholders' funds (and changes therein over the last three years);
 - ☐ Technical Reserves to adjusted shareholders' funds (and changes therein over the last three years);
 - ☐ Debtors to total balance sheet returns;
 - ☐ Net Premium to Gross Premium (and changes therein over the last three years);
- and so on.

These and other considerations were discussed in the Rating Agencies paper discussed at GISG in 1995.

- 5.5 Rating agencies such as S&P/ISI for non-USA companies and Best's for USA companies are of help. The rating agencies tend to review the companies in depth and are good indicators. In the work done on Risk Based Capital in the United States, it is clear that Best's Grade is a good indicator for short term solvency. A good indicator of insolvency in US is NOT having a Best's Grade.
- 5.6 Market rumours or news are useful sources of information. Examples include takeovers, writing unusual business, raising fresh capital and so on.
- 5.7 The underwriters often reinsure the outwards business of the company being reviewed. They therefore have a good feeling for the type and quality of the business of the company, and also the quality and soundness of their underwriters. Where

the company itself writes some reinsurance business, the relevant underwriters often have the added perspective of competing against the reinsurers under review.

- 5.8 Allowance needs to be made for the class of business being reinsured. For long tail liability business, it is possible that a claim will not be settled for many years, so that more caution is needed to allow for the risk of insolvency before payment is made. Many reinsureds are seeking reinsurance recoveries on asbestos and pollution risks first placed in the 1950's. Although modern 'claims made' contracts may mitigate this being repeated, there are still classes (for example Employer's Liability) which are still on an occurrence basis.
- 5.9 The companies are split into Grades. Different companies have different grading structures. The various grades usually have a minimum adjusted shareholders' fund, which is a minimum requirement for the grade. A typical example is

Grade	Fund	Type	Exposure
A+	£100 m	Long Tail	£10 m
A	£100m	Short Tail	£5 m
B	£50 m	Short Tail	£1 m
C	£25m	Short Tail	£0.25m

All other companies are ungraded and require a committee agreement before approval. Certain companies do not have the necessary capital, but are upgraded for special circumstances, for example Pool Re - the Reinsurance Pool to cover terrorist risks.

- 5.9 Reinsurance Pools are usually graded by their weakest member, although again special considerations are needed.

- 5.10 The grade list is often reviewed by the auditors, who have their own list and will obviously comment if there is some discrepancy resulting in an insurer getting, in their opinion, too high a grade.
- 5.11 Special considerations are often applied to certain reinsurers. Some have the highest quality balance sheet, but it has proved historically difficult to get payment for claims. Others are in parts of the world where there is political instability, and all insurers from certain countries are not graded for that reason. With regards to reinsurers in some countries, accounting standards may be too poor to properly assess the company. Certain jurisdictions are also known for having few, if any, reinsurance regulations, and many insolvencies (sometimes due to allegedly fraudulent management) have occurred in these countries. Lloyd's is itself, interesting. Whereas it is given the top security grade, there are those who think that certain Syndicates are of lower quality than others due to potential differences in the speed of settlement. Standard & Poors have started to rate Lloyd's Syndicates on the basis of crowns (from 1 to 5). Historically Lloyd's syndicates have not met 100% of all bona fide claims.
- 5.12 In addition to the Reinsurance Security Committee, insurance companies also place reliance on broker lists. These may give a more complete picture and may help in assessing the recovery potential from reinsurers on past treaties, which is needed to assess the bad debt provision.
- 5.13 Often a reinsurer is the subsidiary of a larger company. Until recently it was thought that the larger insurers would support their subsidiaries should they get into financial difficulty. This is no longer the case. The rating agencies will rate insurance

subsidiaries on a stand alone basis only, unless there is a concrete parental guarantee. Only then will they rate the group together. Standard & Poors make allowance for implicit guarantees, such as a subsidiary having a close relationship with the parent, substantial retrocessions from the subsidiary to the parent, or even having the same name as the parent. Care must be taken when rating subsidiaries, and the existence or otherwise of some form of parental guarantee is an important consideration. However, guarantees are only given in respect of business transacted up to a certain date. The subsidiary may be sold, floated off and so on, in which case the guarantee will no longer apply.

5.14 A final consideration is “exposure”. There are three issues here

- 1. The exposure in the current year to an individual company across all lines of business reinsured.**
- 2. The exposure in the current year to companies within a Group across all lines of business reinsured. Certain companies within a Group may all be top rated due, for example, to parental support.**
- 3. The exposure over all past years.**

This last item would include known outstanding claims and IBNR in respect of short tail claims, and also an estimate of the exposure to the long tail claims, including asbestos and pollution liabilities.

Some of the results of the exposure analysis may give some surprising results! Most insurers have no idea of their exposure to their reinsurers.

6. Special Issues

6.1 Commutations

A Commutation takes place for a number of reasons. These include the obligations under the contract. Two of the most important areas are where the security of the reinsurer is in doubt, and where the insured itself is in financial difficulty and wishes to capitalise the future reinsurance recoveries so that a dividend can be paid to its debtors. One thing is clear, if a company requests a commutation then it needs to be reassessed for reinsurance security and any bad debt provision that may be necessary. Even if the commutation is not completed, it is an appropriate indication of possible problems.

Once a commutation has taken place, then it needs to be treated carefully in both the data and the accounts. This is a large one-off transaction that may find its way into the triangles. In any case, development patterns before and after commutation may differ. One approach is to remove the commuted business from the development entirely, as this gives the clearest picture.

Commutations should generally be made against all business reinsured. If a selective approach is made (other than a clear contractual obligation), then the implications on the remaining transactions need to be carefully considered.

6.2 Offshore/Non Regulated Insurers

Recently, many reinsurers with large capital bases have been established in countries where regulation is somewhat limited. Besides having a large capital base, these operations also run large risks. They also have no track record on their ability to

survive a series of catastrophes, and, although backed by strong parents, there is no guarantee that additional support will be forthcoming in the event of severe financial problems. Although the business is primarily short tail, some of these reinsurers have been moving into long tail risks to get a more balanced book. Monoline companies are more vulnerable to solvency problems than multiline cases.

One of the problems of assessing the reinsurance security of these companies is the absence of any meaningful financial information. A lot has to be taken on faith. There is good professional management, but other companies who are now insolvent, also had good professional management. There is also the fear that when one company goes insolvent, the domino effect will trigger other insolvencies.

One final consideration is the lack of regulation has meant, in some instances, that companies have been able to salt away profitable business to other operations, and have then let the subsidiary be separated from the parent and eventually go insolvent. The lack of any regulation makes such undesirable transactions a real possibility.

6.3 Letters of Credit

Letters of credit are clearly useful instruments, effectively giving a guarantee from a third party. This introduces a further issue, namely will the third party (usually a large bank) perform in the event of financial difficulties. This depends on the extent and wording of the letter of credit, the amounts being guaranteed, the period of the guarantee, and the events to which the guarantee attaches. In assessing solvency issues and bad debts LOC's tend not to be taken into account, but are viewed as additional security in the same manner as financial loans seek additional security.

6.4 Charter Re v Fagan

One of the most important decisions of recent times was the House of Lords in May of this year. This involved the ability of an insolvent insurer to recover from his reinsurer, despite the fact that the insolvent insurer had not actually paid the claims. The questions decided were

(i) Does “actually paid” mean “actually paid”

(ii) or, does the context of LMX reinsurance require that it means something different, such as “liable to pay”.

The answers to these questions are No and Yes

Lord Mustill stated “*the words must be set in the landscape of the instrument as a whole*”. He then concluded in these contracts that the word “actually” meant “*in the event when finally ascertained*”. The word “paid” meant “*exposed to liability as a result of the loss insured*”. Charter Re were entitled to recover.

“These are far from the ordinary meanings of the words, and may be far from the meanings which they would have had in other policies, and particularly in first-tier policies of reinsurance. But we are called upon to interpret them in a very specialised form of reinsurance”.

“To force upon the words a meaning which they cannot fairly bear is to substitute for the bargain actually made, one which the court believes could better have been made. This is an illegitimate role for a court”.

This means that the insolvent company will have more assets from the LMX business, and that this is now determined at the highest level. Recovery rates should increase. What is of concern is what is a ‘first-tier policy of reinsurance’ and why did Lord Mustill expressly distinguish such contracts?

6.5 Disclosure of non collection of reinsurance recoveries.

In the US the recent statutory returns have disclosure of non collection of reinsurance recoveries by period. These can be used in ascertaining the solvency position by placing a probability factor on the amounts. This is done regardless of the quality of the reinsurer, and also the reason for the non payment (insolvency or policy dispute). In the UK, for instance, certain reinsurers are disputing payment of asbestos related claims for various technical reasons, and these disputes are in arbitration or in court. Different insurers have different "bad debt" provisions against these cases, some considering them as no provision, but other putting up provisions based on win scenarios and the time value of money. The disclosure of these amounts will certainly help the regulator, as they can treat all cases uniformly and ask further questions in respect of unusual cases, or where the recovery position is deteriorating. It will certainly be of use to security analysts for the same reason.

7. Wishful Thinking

7.1 In 1990, a report by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the U.S. House of Representatives (the Dingell Committee) was published. Its title was “Failed Promises”, and gave a descriptive account of how a few individuals had plundered the wealth of a number of insurance companies, leaving behind many bankruptcies. This report was followed in 1994 by the sequel, entitled “Wishful Thinking, A World View of Insurance Solvency Regulation”. It is this title that also possibly best summarises the position of Reinsurance Security today in many companies. In the framework we have set out above we give indications of some of the issues that need to be taken into account in assessing reinsurance security for the variety of reasons set out above. There is no perfect solution, and no Committee is ever going to get its reinsurance security assessment correct.

7.2 Set out below are a series of quotations from the 1994 report which summaries many of the issues

On US Regulators

“The goal of preventing insolvencies is very unlikely to be achieved through the present regulatory apparatus”.

“Normal confusion in the regulatory network is greatly aggravated by naive and overly idealistic attitudes displayed by many of its participants”

“State Regulation: Too many Cooks Without a Recipe”

On London

"Many Americans, even some in a position to know better, erroneously believed that any insurance coverage purchased in London is somehow associated with Lloyd's, and that all insurance placed with Lloyd's is guaranteed not to fail".

"For many years, easy capacity and generous income bred complacency, loose management, hands-off regulation and a pervasive attitude that the London Market was immune to serious failure. These negative trends were fuelled by popular myths and unchecked rumors that infected the judgments of insurance buyers, market insiders and investors".

One particular example that the Committee focused was the LUI Group of Companies, Kwelm and the Weavers Stamp. The Committee was very damning (with hindsight). Although to pick on one company may be unfortunate, it does illustrate clearly the weaknesses of any system that is aimed at assessing the security of its reinsurers.

"Officials at DTI told the subcommittee that the KWELM companies had inadequate records and internal controls, yet those known deficiencies went unreported and uncorrected. Despite DTI's monitoring system, the unregulated Weavers Underwriting Agency was given management control over the Kwelm companies through an agreement that was said to be only one-half page long.

Reports filed with DTI by the Kwelm companies disclosed their premiums and claims payments, but did not reveal the underlying high-risk business strategy concocted by Weavers".

The report concludes: -

"The subcommittee has found that the regulatory systems work best when they operate with the presumption that

clever men will try to either avoid or fool them. Regulators can then target their limited resources to enforcement against troublemakers, rather than issuing a continual stream of general application directives on the presumption that they will be uniformly obeyed. The certainty that there will be rascality and incompetence in the insurance industry is all the more reason to make finding them the regulator's priority"

- 7.3 This gives an indication of the issues facing the assessment of reinsurance security. To a large extent the Reinsurance Security Committee is the regulatory supervisor, and needs the necessary power to stop business being written with companies it feels unsafe with. The concentration on the "clever men" should mean that no business is placed with such reinsurers, and that the committee can then concentrate on those insurers where business is placed. The Kwelm illustration indicates that accounting information, by itself, is inadequate to give a judgement, and a good idea of the volume and type of business being written, and the exposure, is also necessary. In case of doubt, do not use.
- 7.4 Reinsurance security is a balance between the wishful thinking of a sound monitoring system and the practical realities of deficiency in any such system.