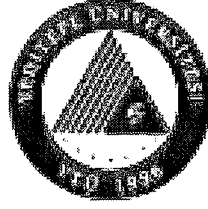


T.C.
YEDİTEPE UNIVERSITY
GRADUATE INSTITUTE OF SOCIAL SCIENCES

A COMPARISON of THE REINSURANCE PRACTICES IN TURKEY and EU COUNTRIES

by

Şahım BAŞAYAGÜL

Supervisor

Yrd. Doc. Dr Çağatay AKARÇAY

Submitted to the Graduate Institute of Social Sciences
In partial fulfillment of the requirements for the degree of
Master of
Business Administration

ISTANBUL, 2006

A COMPARISON of THE REINSURANCE PRACTICES IN TURKEY and EU COUNTRIES

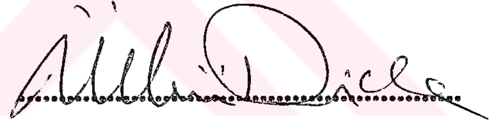
by

Şahım BAŞAYAGÜL

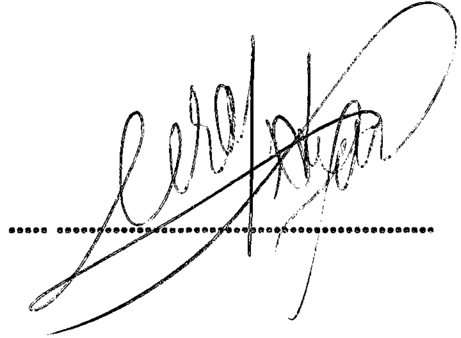
Approved by:

Yrd. Doc. Dr. Çağatay AKARÇAY (Supervisor) ....

Prof. Dr. Ülkü DİCLE ....



Yrd. Doc. Dr. Murat ERDOĞAN ....



Date of Approval by the Administrative Council of the Institute 01/02/2006

A COMPARISON of THE REINSURANCE PRACTICES IN TURKEY and EU COUNTRIES

1. INTRODUCTION 1

2. THE CONCEPT of REINSURANCE 2

2.1. Description of Reinsurance 2

2.2. History of Reinsurance 5

2.2.1. History of Marine Branch 5

2.2.2. History of Fire Branch 6

2.2.3. History of Life Branch 7

2.2.4. History of Accident Branch 8

2.3. General Principles of Reinsurance 8

2.3.1. Insurable Interest 8

2.3.2. Utmost Good Faith 9

2.3.3. Indemnity 10

2.3.4. Subrogation and Contribution 12

2.4. Functions of Reinsurance 12

2.4.1. Capacity 12

2.4.2. Catostrophe 13

2.4.2.1. The Retrocessional (Retro) Market 13

2.4.2.2. The Catasrophe Bond Market 14

2.4.2.3. Catasrophe Models 14

2.4.2.4. Casus Models 15

2.4.2.5. Flood 16

2.4.3. Control 16

2.4.4. Consolidation 17

2.4.5. Technical Role 17

3. METHODS OF REINSURANCE. 19

3.1. Facultative Reinsurance 19

3.2. Treaties 20

3.2.1. Proportional Reinsurance 20

3.2.1.1. Quato Share Reinsurance 21

3.2.1.2. Surplus Reinsurance 24

3.2.2. Non-Propotional Reinsurance..28

3.2.2.1. Excess of Loss Reinsurance..28

3.2.2.2. Stop Loss Reinsurance (Excess of Loss Ratio)........................30

3.3. Pools..32

4. REINSURANCE MARKET..43

4.1. Types of Markets..43

4.1.1. International Markets..44

4.1.2. National Markets..46

4.2. Actors of Markets (Role of Buyers – Sellers and Brokers in Reinsurance Market)..47

4.2.1. Buyers of Reinsurance..47

4.2.2. Sellers of Reinsurance..50

4.2.3. Brokers..52

4.3. International Practice and Problems in Reinsurance Market........................54

5. EFFECTS of SEPTEMBER 11, 2001 TERRORIST ATTACKS on REINSURANCE..63

6. REINSURANCE PRACTICE in EU Countries..68

6.1. Background of Reinsurance Practices in EU Countries..............................68

6.1.1. Market Capacity in EU Countries..70

6.1.2. Mergers and Acquisitions in EU Countries..70

6.2. Policies of Reinsurance in EU Countries..71

6.2.1. Reinsurance Directive..71

6.2.1.1. Purpose of Directive..71

6.2.1.2. Options for the Implementation of Directive..............................75

6.2.1.2.1. Oppose to the Directive..75

6.2.1.2.2. Support the Directive..76

6.2.1.2.3. Support the Directive subjectively..............................77

6.2.1.3. Benefits and Costs of Reinsurance Directive..............................78

6.2.1.3.1. Economic Benefits and Costs..78

6.2.1.3.1.1. Solvency Margins..79

6.2.1.3.1.2. Regulatory versus Economic Capital..............................80

6.2.1.3.1.3. Collateralisation..81

6.2.1.3.2. Environmental and Social Benefits and Costs....................82
6.3. Problems Affecting the EU Reinsurance Market....................................82
6.3.1. Uncertainty for Direct Insurance Undertakings (and Their Policyholders)82
6.3.2. Barriers to Trade...83
6.3.3. Administrative Burden...83
6.3.4. International Trade Negotiations..83
6.4. Projects of Reinsurance in EU Countries...87
6.4.1. Projects of the Directive..87
6.4.1.1. Consultation with Small Business...87
6.4.1.2. Competition Assessment...87
6.4.1.3. Monitoring and Review..89
6.4.1.4. Consultation..89
6.4.2. Reinsurance Supervision Project...91
6.4.2.1. Objectives of Reinsurance Supervision Project...................................91
6.4.2.1.1. Overall Approach of the Reinsurane Supervision Project......93
6.4.2.1.2. Fast-Track vs. Long-Term Comprehensive Project.............94
6.4.2.1.3. Alternatives for the Non-Life Solvency Requirements.........95
7. REINSURANCE PRACTICE in TURKEY...98
7.1. Past of Reinsurance in Turkey (Monopoly) 98
7.2. Policies of Reinsurance in Turkey...109
7.2.1. "Association of the Insurance and Reinsurance Companies of Turkey" (TSRSB) 109
7.2.2. Milli Reasürans T.A.Ş. (Milli Re) 111
7.2.2.1.POOL System in Reinsurance in Turkey.................................113
7.2.2.1.1. Facts about F.A.I.R. Reinsurance Pool..........................113
7.2.2.1.1.1. Background of F.A.I.R. Reinsurance Pool.................113
7.2.2.1.2. Turkish Catastrophe Insurance Pool (TCIP) 114
7.2.2.1.3. Turkish Reinsurance Pool...115
7.2.2.1.4. Economical Cooperation Organization (ECO) Pool..........115
8. COMPARISON OF REINSURANCE PRACTICES BETWEEN TURKEY and EU COUNTRIES..117
8.1. Comparison of Reinsurance Practices Between Turkey and EU Countries......117

8.2. Possible Effects of EU Membership of Turkey on Reinsurance........................120
9. CONCLUSION..122
10. APPENDIXES..123
Appendix 1: Increase in the Premium Income of Milli Reasürans T.A.Ş. 123
Appendix 2: Profit and Loss Account of Milli RE for 2004 125
Appendix 3: F.A.I.R. Pool's Premium and Membership – Wise Experiences 129
11. GLOSSARY..130
12. REFERENCES..137

LIST of TABLES

Table 1: Main Groups Who Are Likely to be Directly Affected by the Proposal.................. 74

Table 2: Some key differences between the current UK reinsurance regime and the Commission's proposal (as currently drafted).. 77

Table 3: Damaging Effects on Competition.. 88

Table 4: A List of Organisations the Treasury has been in Contact with................................90

ABSTRACT

Reinsurance is to insure again by transferring to another insurance company all or part of the risk. Reinsurance gives the insurance companies the possibility to insure the risks that they cannot afford financially. Some financial measurements show the responsibility of the ceding company, the parts that over that company are assigned to reinsurance companies. Insurance companies make reinsurance to avoid difficulties with paying the huge damage insurances. The ceding company reflects the premiums and the payments of the losses to the reinsurance company by some techniques. However, risk transfer progresses are not made by annual agreements between the ceding and reinsurance company; the ceding company can appeal to the reinsurance company for each risk.

Reinsurance is required for:

- Expansion of the risk to other companies
- Rise of the capacity of the insurer's job acceptance capacity
- Rise of the capacity of the insurer's job acceptance flexibility
- In supporting the insurance company's financial structure
- Technical information transfer from reinsurer to insurer

The past, the present and the applications of the reinsunre in the EU and Turkey has been studied in this thesis. The reinsurance system that is used in the EU covers the system in Turkey in some parts, but they have many differences. Both have guiding foundations (for Turkey: The commision selected by the Ministry of Treasury of Turkey, for the EU Countries: The commision selected by the EU Council); although the objectives, missions and the application of them show many differences. These differences have been explained in the thesis. Thus, the problems faced in Turkey are understood more clearly. The Turkish reinsurance sector will be effected positively if the system that have been checked, improved regularly by the EU.

The final part presents a comparison of EU and Turkish reinsurance systems.The EU and Turkey reinsurance juristictions, market capacities, projects over reinsurance are analyzed, Turkish and the EU reinsurance companies, sectors' locations, effects of the laws on EU and Turkish local and international companies have been discussed. How different is the EU and Turkish reinsurance markets is studied.

ÖZET

Reasürans, sigorta edilmiş riskin, belli bir kısmının veya tamamının yeniden sigorta edilmesidir. Reasürans, sigorta şirketlerine, tek başlarına kendi sermayeleri, ihtiyatları, özvarlıkları bakımından kısaca mali yönden mümkün olmayan riskleri, sigortalayabilme imkânı verir. Bir takım mali ölçüler esas alınarak, branş esasıyla tespit edilen saklama payları, sedan şirketin risk üzerindeki sorumluluk miktarını göstermekte, aşan kısımlar ise çeşitli reasürans anlaşmalarıyla, reasürans şirketlerine devredilmektedir. Sedan şirket, sigortalıdan toplamış olduğu primlerin ve sigortalıya ödemiş olduğu hasarların belli bir kısmını, değişik tekniklere göre yapılmış reasürans anlaşmaları vasıtasıyla, reasürans şirketine yansıtır. Ancak sedan şirket ile reasürör arasındaki risk transferi işlemi, yıllık anlaşmalar olmaksızın da yapılabilmekte; sedan şirket, her bir risk için, ihtiyari olarak, reasüröre müracaat edebilmektedir.

Reasüransa duyulan gereksinimin nedenleri:

- Rizikonun diğer sigorta (reasürans) şirketlerine yayılması,
- Sigortacının iş kabul kapasitesinin artması,
- Sigortacının iş kabul esnekliğinin artması,
- Sigorta şirketinin mali yapısının desteklenmesi,
- Reasürörden sigortacıya teknik bilgi aktarımıdır

AB ve Türkiye'de reasüransın geçmişi, günümüzdeki konumu ve uygulamaları hakkında bilgilere yer verilmiştir. AB'de uygulanan reasürans sistemi belirli hatlarıyla Türkiye'deki sistemle örtüşse de içerik olarak birbirinden oldukça farklıdır. Her ikisinde de yönlendirici kuruluşlar bulunurken bu kuruluşların misyonları, hedefleri ve uygulamaları farklılık göstermektedir. Bu farklılıklar tezde sıralanmış olup, bu farklılıklardan dolayı Türkiye'de yaşanan sorunların nedenleri daha iyi algılanmıştır. AB'deki düzenli, belirli süre aralıklarında yenilenen ve geliştirilen sistemin uygulanması halinde Türkiye Reasürans sektörü olumlu yönde etkilenecektir.

Son bölüm, AB ve Türkiye'de reasürans uygulamalarının karşılaştırılmasını içermektedir. AB ve Türk reasürans hukuku, pazar kapasiteleri, reasürans üzerine üretilen projeler, Türkiye ve AB'deki reasürans şirketleri ve sektördeki konumları, Türkiye ve

AB'deki yasaların yerel ve yabancı firmalar üzerindeki etkileri bu çalışmada ele alınmış ve buradan yola çıkılarak Türkiye ve AB'deki reasürans piyasalarının birbirlerinden ne denli farklı oldukları ortaya konmuştur.

1. INTRODUCTION

Insurance sector has developed and improved considerally from the beginning. Companies develop new projects with the goal of improving their portfolios in the most stabilized way, and taking their financial structures to the highest levels. As a result, they obtain ways to finance the risk of holders who don't have the possibility of holding in their portfolio by the reinsurance.

In modern days, reinsurance has been gaining importance because of showing an increase in the types and number of insurable values and measuring worth of these values in million of dollars. However, the financial structure of the professionally active insurance firms are strong, there is no possibility to take risks that is equal to lots of countries budget. Thus, reinsurance is a pushing power for the companies, and the function and the importance of it is an undeniable condition.

In this thesis, the process of reinsurance, which is defined as "insuring insurers" will be explored in terms of past as well as present in Turkey and EU countries. The EU and Turkish reasurance applications, projects of reinsurance that have been created in EU and Turkey, market capacities, companies and their role in reasurance sector, effects of the Turkish and EU laws on national and international companies will be discussed and the differences of the reasurance process in EU and Turkey is analyzed.

2. THE CONCEPT of REINSURANCE

2.1. Description of Reinsurance

Reinsurance is a structured risk transfer between an insurance undertaking (often called the "cedant") and a reinsurer. Reinsurance fulfils the following functions for an insurance undertaking:

- Reduction of technical risks
- Permanent transfer of technical help
- Increase of homogeneity of insurance
- Reduction of volatility of technical aspects
- Substitute for capital/own funds
- Supply of funds for financing purposes
- Supply of service provision

In spite of its obvious connection to direct insurance business, there are some characteristics of reinsurance that may be important to be highlighted[1]:

- There is no direct contractual relationship between the reinsurer and the original insured, and the policyholders have normally no priority to the assets of the reinsurer to cover their claims.
- Reinsurance is a business activity between professional parties.
- Reinsurers largely depend on information from the direct insurers to establish claims reserves. There are other significant delays in receiving claims information.
- Reinsurance business has higher degrees of diversity in regard to geography and combinations of insured lines than direct insurance business.
- Reinsurers have significant catastrophe exposure, and special retrocession and pooling techniques to cope with those unfavourable situations.

---

[1]Commission, 2002/83/EC, "Directive of the European Parliament and of the Council on Reinsurance and Amending Concil Directives"

[2].Ali Bayram, Birsen Çankaya, Ticari Terimler Sözlüğü, 2002

The Role of Reinsurance Sector in Economy

The ***reinsurance sector*** plays an equally key role in the economy by providing wholesale cover for the risks assumed by insurance companies on behalf of their clients. The transfer of risks to reinsurers reduces the fluctuations in the business performance of the primary insurers and also reduces their capital costs. While the average cession level in the EU is rather low (i.e. some 10% of all insurance premiums are reinsured), the cession level is relatively high for certain activities (i.e. 18% of non-life insurance premiums are reinsured, compared to 3% for life insurance premiums on average) [2]. Reinsurers may also serve the primary insurers as an equity substitute, provide additional underwriting capacity and are often part (or even the dominant business) of financial conglomerates. Besides insuring insurers, reinsurers are also major financial intermediaries and institutional investors and reinsurers' financial assets represented 1% of the global securities market in 2001. The stability of the reinsurance sector is not only vital to the stability of the insurance sector generally but also has important implications for the financial system as a whole.

Recent evidence of financial strain among reinsurers has focused the attention on the level and nature of risk assumed within the sector. Reinsurers face two risks in addition to those faced by primary insurers. First, they are exposed to greater volatility in their financial results because they protect the primary market against peak exposures. In consequence of this risk, they need to maintain relatively high levels of capitalisation. Second, they may be called upon to support ailing subsidiaries, as they are often the top trading company in a group structure. Despite these additional risks, reinsurers operate in a global market where their activities are often not subject to prudential oversight or to a lighter regime than that applying to primary insurers. Moreover, there is no global framework for reinsurance supervision. This situation has raised concern about potential risks in the reinsurance industry. One the other hand, reinsurers can benefit from significant geographical and sectoral diversification effects to a greater extent than direct companies.

---

[3] "Reinsurance – a systemic risk?"; Sigma 5/2003, Swiss Re.
[4] Cahit Nomer, Hüseyin Yunak, Reasürans, 1998

Reinsurance is a highly international industry with a limited number of large companies. In 2002, the total reinsurance premium of the 40 largest reinsurance groups amounted to USD 138 601 200 000, whereof USD 58 544 000 000 stemmed from EU reinsurers. In the EU, Germany has a dominant position with companies as Munich Re, Hannover Re and Allianz Re. Lloyd's is the largest in UK.[3]

Particularities of reinsurance

In spite of its obvious connection to direct insurance business, there are some characteristics of reinsurance that may be important to highlight before going into more specific supervisory issues:

- There is no direct contractual relationship between the originally insured and the reinsurer, and the policyholders have no priority to the assets of the reinsurer to cover their claims.
- Reinsurance is a business activity between professional parties.
- Reinsurers largely depend on information from the direct insurers to establish claims reserves. There are furthermore significant delays in receiving claims information.
- For reinsurers the volume of non-life operations significantly exceeds that of life operations.
- Reinsurance business has higher degrees of diversity in respect of geography and combinations of insured lines than direct insurance business.
- Reinsurers have significant catastrophe exposure, and special retrocession and pooling techniques to cope with those

---

[5]Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003.

2.2. History of Reinsurance

Reinsurance in one-form or another is hardly as old as insurance itself, if only because at the start insurers did not accept more liabilities than they could bear themselves. The first known references to reinsurance as understood to-day have been traced to the Continent of Europe. In 1370 a marine policy was issued in respect of a voyage from Genoa to Sluys and the part of the risk considered to be the most hazardous, i.e., from Cadiz to Sluys, was reinsured, while the voyage through the Mediterranean was retained wholly for the direct insurer's account.[4]

2.2.1. History of Marine Branch

The first account of a marine reinsurance is given by Gustav Cruciger relating to the issue in 1370 of a policy for a voyage from Genoa to Sluys, the original insurer then reinsuring the most hazardous part of the risk from Cadiz to Sluys. Clearly that was not the case of an original underwriter reinsuring a risk that he could not afford to carry himself, as evidenced by his retention of the full risk for the safer part of the voyage through the Mediterranean. Rather, he used reinsurance to avoid a hazardous risk which he preferred not to carry but which he had been obliged to accept in order to obtain the more desirable business, or perhaps to accommodate a valuable client. Thus it may be concluded that insurers soon learned how to put reinsurance to use to increase their own underwriting flexibility.

Marine reinsurance was made illegal (in England) by an Act of 1746, an exception was made if the original insurer became insolvent or bankrupt or should die, but, as Golding says[5]:

"That exception could only enable a fresh insurance to be taken out by the insured, since the first insurance had become valueless. So the effect of the ACT was to forbid the

[6] C.E Golding, A history of reinsurance p.19, 1931.
[7] C.E Golding, A history of reinsurance p.20, 1931.

practice of reinsurance using the world in its proper sense, but not to forbid insuring again in the circumstances mentioned."

Another reference to reinsurance is found in the "Law of Marine Insurance" by Park. It was published in London in 1800 which refers to an ordonnance of Louis XIV of France which declared that "it should be lawful to the insurers to make reassurance with other men of those effects which they had themselves previously insured". Park added that:

"It is not in France alone that this law prevails, for by the positive and express regulations and ordinances of Konisberg and Hamburg and Bilboa, reassurances are allowed to be effected and consequently are lawful contracts". The statute virtually suspended marine reinsurance in England for over a century, and when it was repealed in 1864, resumption of marine reinsurance was slow. Reinsurance of marine risk in mentioned specifically in the stamp Act, 1891[6]:

"The insurer under a contract of marine insurance has an insurable interest in his risk and may reinsure in respect of it."

Marine reinsurance on the continent of Europe was not subject to the restrictions in force in England. There is and indirect reference to reinsurance in an application by Danish Company to its government in 1775, reinsurance is known to have been transacted in Norway from 1840 onwards, and the Ordonnance of Louis XIV, which shows that reinsurance, was practiced in the second half of 17th century.

2.2.2. History of Fire Branch

In the early days of fire insurance, insurers would not accept more than they could retain; hence there was co-insurance rather than reinsurance. One of the oldest references to fire reinsurance is found in a royal concession granted to the Royal Chartered Fire Insurance Company of Copenhagen in 1778. The earliest authentic record of fire

---

[8] Victor Dover, a handbook to marine insurance, 1975.

reinsurance is dated August, 1813 and it was entered into by the Eagle Fire Insurance Company of New York. The earliest treaty of which there is a record is dated 1821.

The Royal Exchange Assurance directors fixed limits in 1826 and the first facultative reinsurance proposal was received in 1828 - an offer from the Guardian which was declined.

The Guardian began fire reinsurance as a deliberate policy in I856. In 1858 the precursor of the present-day Fire Offices' Committee was formed and a circular was issued in I863[7]:

"The guarantees be not given to or taken from any office which does not adhere to the tariff system as to any class of risks in London or elsewhere in the United Kingdom, whether tariff or non-tariff, and whether at tariff or non-tariff rates"

When the F.O.C. (Fire Offices' Committee) was finally constituted in 1868, this rule was amended and included in the general rules, and in 1871 the "Rules for the regulation of guarantee transactions in fire insurance business" became operative.

2.2.3. History of Life Branch

Early life assurances wore issued for one year only and, as in fire insurance, co assurance preceded reassurance. Sums assured wore small, but demands came for policies for larger amounts coincident with the growth of the business. A general system of life reassurance dates from 1844 and in 1854 the English and Scottish Life offices drew up an approved list of regulations.

There was a case heard in the Courts in 1864 between the Reliance Mutual and the Provident Clerks, in which the retention of the ceding company on a risk reinsured was concerned. Life reassurance in England is still mainly conducted on a facultative basis, but

[9] C.E.Golding, The Development of Fire Reinsurance in the United Kingdom, 1952.

on the Continent there is a record of a treaty in 1858 made with the Frankfurter Reinsurance Company, and in 1865 with the Swiss Reinsurance Company.

2.2.4. History of Accident Branch

Accident insurance is a development of the 19th century, and reinsurance began on the facultative basis. The earliest record of reinsurance that has been traced is the acceptance by the railway passengers in October 1872, from a life assurance company of the excess over £ 2000 in the aggregate in one vessel in respect of emigrants going to New Zealand.

The treaty method has found favour and the excess of loss treaty developed for liability insurance at the opening of the present century.

2.3. General Principles of Reinsurance

The legal principles applicable to an ordinary contract of insurance between insurers and insured are likewise applicable to a contract of a reinsurance between reinsurers and reinsured. A contract of reinsurance cannot exist unless there is already a contract of direct insurance in force – the one is dependent on the other.

2.3.1. Insurable Interest

Every contract of reinsurance must be supported by insurable interest, and it has been clearly established that the issue of a policy by the direct insurers gives them an insurable interest so that they can, if desired, reinsure. In Lower Rhine and Wurtemburg Insurance Association v. Sedgwiok (1899), the defendant reinsured certain risks with the plaintiffs and, of the two original policies covering these risks, one lapsed and the other was cancelled. The defendant (a marine underwriter) issued a fresh policy to the assured with different conditions, and the plaintiffs had no notice of these facts. The defendant paid a total loss and it was held that he was unable to recover from his reinsurers, the plaintiffs.

---

[10] Terry O'Neill and Jan Woloniecki Law of Reinsurance,2nd edition, 2004

The extent of the insurable interest is limited to the extent of the liability assumed under limit of indemnity and risks involved. As with direct insurance, insurable interest is closely linked with the principle of indemnity.

2.3.2. Utmost Good Faith

The principle of utmost good faith is as essential a feature of reinsurance as of direct insurance and it is.likewise strictly applied, subject to the modification that both parties to a reinsurance contract are insurance experts, .. hence the ceding company and the reinsurers have more knowledge than can be expected when a proposer and direct insurers both enter into a contract.

The operation of this principle is best illustrated in facultative reinsurance where each risk is submitted individually to reinsurers by means of a slip on which the material particulars of the direct insurance must be shown and the retention of the ceding insurers must also be disclosed.

The treaty method of reinsurance shows the high degree of confidence which exists in the markets in the sense that the principle of utmost good faith is taken for granted because very little information is disclosed by the insurers to the reinsurers and there is a tendency to give less and less details to the latter. Indeed, under a blind treaty system the reinsurers have no opportunity to know the risks that they shoulder.

Under the older forms of reinsurance the interests of the ceding insurers and the reinsurers were in direct proportion, that is to say, the direct office might hold one-half and the reinsurers the other half, for which the latter would receive half reinsurance there is not this same similarity of fortunes. The excess of loss reinsurers can conceivably make a profit on their treaty, while the direct insurers make a loss on underwriting the business. It is in accordance with this principle of utmost good faith that the direct insurers will often consult their reinsurers, with whom they have an excess of loss treaty, when dealing with an awkward claim. The direct insurers may feel that they are justified in maintaining a denial of liability, but this may mean that the case will go to Court, whereupon, if

judgment is entered against them, the reinsurers will probably be involved, whereas if a compromise settlement were made forthwith, the direct insurers alone would be concerned. If the treaty reinsurers agree that it would be desirable to resist the claim, in the knowledge that they may have to make a payment, then the direct insurers feel justified in adopting what appears to them to be the right attitude by denying liability.

Under the treaty system the direct insurers, as already noted, do not seek the prior approval by the reinsurers of each risk placed on the treaty; indeed, that would defeat the object of the treaty, which is to provide automatic reinsurance facilities. The effect of this, so far as the principle of utmost good faith is concerned, is that the duty to make full disclosure of all material facts does not cease when the treaty has been formally entered into, as it does under a contract of direct insurance once the negotiations have been completed and the contract has come into existence. The duty of utmost good faith under a treaty operates in respect of each risk placed on the treaty and if the direct insurers were guilty of a broach of utmost good faith in respect of any particular risk, the reinsurers would be entitled to deny liability, but that is a theoretical possibility only.

2.3.3. Indemnity

Certain contracts of direct insurance are not considered as contracts of indemnity, but all contracts of reinsurance are strict indemnities. The reinsurers contract to indemnify the direct insurers on the terms agreed, and the original insurers alone have rights under the reinsurance contract. In case of fail, the direct insurers are still liable to their own insured to the full amount stated in the policy, while if the direct insurers fail, the policyholder cannot claim direct against the reinsurers.

In accordance with the principle of indemnity, the ceding insurers must prove that the loss is one which falls within the terms of the reinsurance contract, although reinsurers will at times follow the direct insurers if the latter decide to make an ex gratia payment. They are in no way compelled to do this. In St. Paul Fire and Marine Company v. Morice (1906), a bull was Insured for a voyage from New York to Buenos Aires and for ten days

[11] Harvey W. Rubin, Dictionary of Insurance Terms, 2000.

after arrival. The risks insured Included “mortality, jettison, and washing overboard”. There was a clause "Warranted free of capture, seizure, or detention". On arrival, the bull was found to be suffering from foot and mouth disease and, in accordance with Argentine law, the bull was not allowed to be landed and the Argentine officials ordered it to be slaughtered on board ship. The action was brought to recover against the defendants, underwriters at Lloyd's, a loss under a policy of marine reinsurance. There was some doubt about whether the animal was suffering from foot and mouth disease, but the learned Judge said that the word "mortality" in the policy of reinsurance did not include the death of the animal in consequence of the action of the officials in Buenos Aires, and the loss which was due to the ordinary municipal law name within the clause "Warranted free of capture and seizure". Judgment was therefore entered for the defendants.

Another interesting case relevant to the application of the principle of indemnity to reinsurance contracts is Merchants Marine Insurance Co. v. Liverpool Marine & General Insurance Co. (1928)[10]. The plaintiffs, having undertaken the reinsurance of a risk under a marine policy reinsured their own risk with the defendants. The vessel concerned was badly damaged by the time she reached her first place of destination, and since there were no adequate facilities for repairs, it was decided to undertake temporary repairs to enable the vessel to proceed. This was done and she proceeded, but began to leak badly and had to be run ashore to prevent sinking. The vessel was subsequently sold as a wreck. The original insurers paid as for a total loss and the plaintiffs, having paid, then claimed against the defendants as reinsurers. It was held that the loss was an immediate consequence of the damage caused by the original stranding and as the risk continued until the vessel was repaired with no unnecessary delay, the plaintiffs were entitled to recover[11]. The facts were that by a policy of marine insurance a vessel was insured by her owner with the plaintiffs, who, by another policy, reinsured the vessel against the risks and for the period covered by the original policy for total loss only. A claim by the owner against the plaintiffs on the original policy failed, on the ground that the vessel had been scuttled. The plaintiffs obtained judgment against the owner for costs, but it was impossible to recover the costs. The plaintiffs then sued the present defendant, one of the underwriters of the

---

[12] C.E.Golding, Reinsurance Obligations .
[1]3 C.E.Golding, Reinsurance Obligations .

reinsurance company. There was no undertaking in the reinsurance policy to pay the costs in question. It was held that it was immaterial whether there was a practice among reinsurers to pay costs in such cases, and as there was no legal liability to pay them, the action failed. The modern treaty system of reinsurance usually provides, by means of a special clause, for the direct insurers to settle all claims at their discretion. The following clause is typical[12]:

"The ceding company have the sole right to settle claims either by way of compromise ex gratial payments, or otherwise, and all settlements are binding on the reinsurers. The reinsurers should be liable for their share of any costs incurred in resisting or defending any claim".

2.3.4. Subrogation and Contribution

These corollaries of the principle of indemnity do not directly concern the contract of reduced by the exercise of subrogation rights or because there are other insurances in force on the same subject-matter which contribute to the loss then naturally, the net sum paid by the direct insurers is less than it would otherwise be, and the reinsurers benefit accordingly.

2.4. Functions of Reinsurance

Reinsurance plays very important role in insurance sector. The reason for the need for reinsurance is as follows:

2.4.1. Capacity

Reinsurance provides capacity (competitive advantage) for insurance companies. Insurers have to accept risks for commercial reasons, larger than perhaps they wish. Reinsurance is used to reduce the risk to a suitable size for the insurer.

[14] C.E.Golding, Reinsurance Survey.

2.4.2. Catostrophe

Some countries, including many of the less developed ones, are particularly exposed to the risks of natural disasters such as earthquakes, floods and hurricanes which can severely damage a national economy. There is also the risk of man – made disasters like the many deaths and injuries caused by the escape toxic materials at Seveso (Italy) in 1976 and Bhopol (India) in 1984, the gas explotion at Pasadena, California in 1999 and terrorist attacks.

Terrorism has caused enormous losses, most notably in the Oklahoma City bombing of 1995 and the World Trade Center bombings of 1993 and September 11, 2001. The losses from the terrorist attacks of September 11 surpassed all insured catastrophic losses from the previous decade combined[13]. Reinsurance enables domestic insurers to spread such risks internationally.

2.4.2.1.The Retrocessional (Retro) Market

In terms of capacity, reinsurers will generally seek to manage to their l-in-250-year event, which in terms of U.S. industry loss would equate to about a US$ 50 billion industry event today. In present, the traditional retro market is unable to provide fully for such a loss within cost-effective parameters, and this often leads customers to seek additional benefits through structured, parametric or capital market transactions, where a significant amount of alternative capacity exists. These types of transactions are becoming increasingly popular with those wishing to spread their catastrophe volatility across a wider spectrum of the financial market.

For U.S. terrorism, retro providers have generally agreed that for 2004 they would cover "non-certified" terrorism exposures within the property product.

[15] Guy Carpenter, The World Catastrophe Reinsuırance Market 2004.

2.4.2.2.The Catasrophe Bond Market

The catastrophe bond market witnessed yet another record year in 2003, with total insurance of US$1.73 billion, an impressive 42-percent year-on-year increase over the 2002 record of US$1.22 billion. During the year, a total of eight were completed, with three originating from first-time issuers. Since 1997 when the market began in earnest, 54 catastrophe bond issues have been complete total risk limits of almost US$8 billion.

The trend toward large transactions continued in 2003, with the average issue size hitting a new high of US$217 million, up from US$174 million in 2002. In addition, shelf offerings - a registration of a new issue without selling the entire issue at once - are becoming more common. Following its first successful catastrophe shelf offering, Pioneer, Swiss Re obtained an additional US$293 million of catastrophe protection through the Arbor Program shelf offering. Shelf offerings are advantageous for issuers as they facilitate the fast and efficient offering of securities as needs or market conditions dictate.[14]

2.4.2.3.Catasrophe Models

Catastrophe models are constantly changing and improving as "bugs" are repaired, financial calculations are enhanced and updated exposure and experience information becomes available to the modeling company engineers. This additional information is incorporated into the models as needed, and model updates are released. In most cases, the new versions will affect the loss output.

RMS's hurricane model underwent a significant update in 2003, affecting the 2004 renewal season with the release of RiskLink 4.3[15]. Both the hazard and vulnerability components have been updated. In some cases, these updates have resulted in dramatic changes in loss estimates, most notably for the hurricane peril in the northeastern United States, causing some companies to buy additional cover. At the same time, other company

---

[16] Guy Carpenter, The World Catastrophe Reinsuırance Market: 2004.
[17]M.H. Atkins, Simulation Models in Risk Managament, 1992.

portfolios have shown a decrease in losses. The new model also incorporates a more accurately represented coastline, "transitioning" storms, as well as changes; in vulnerability curves. As always, the changes in losses are dependent on the line of business, location, construction and occupancy of a given company's book of business.

RMS's earthquake model was also updated. The regions included in the update are the western United States and Canada. The changes include updated USGS National Seismic Hazard Maps (2002), revised data on fault rates, new active faults, an expanded set of high magnitude events and revised attenuation rates[16]. By increasing the probability of very large earthquakes and at the same time decreasing the probability of moderate events, the losses in certain areas of California increased at the long return periods, while decreasing at the shorter return periods. The change in the seismic source model resulted in a significant loss decrease in Washington state, at the same time causing a significant increase in Oregon. The New Madrid area had been updated in 2000 and did not change in version 4.3. Updated RiskLink8 version 4.4 will be used for the 2005 renewal season. Although there are many enhancements and changes in this updated version, few, if any, will affect the losses.

AIR Classic™ version 5.5 changed very little overall from the prior year, with the exception of the land-use and land-cover data for the state of Florida. The updated data for Florida could result in significant loss increases, depending on the location of the portfolio. Similar changes will be incorporated for all states in the Classic™ version 6.0 to be used for the 2005 renewal season. In addition to the land-use and land-cover changes, version 6.0 will also update information on commercial vulnerabilities, which may cause an increase in projected commercial losses for the 2005 renewal season.

2.4.2.4.Casus Models

The CASUS model was developed to address the lack of capacity in the personal accident market due to excess losses and market changes following the World Trade Center attacks of September 11, 2001. The tragic losses from that event highlighted the lack

---

[18] Guy Carpenter, The World Catastrophe Reinsurance Market: 2004.

of quantitative methods for assessing workers compensation and personal accident catastrophic accumulations. This left reinsurers concerned about potential accumulations from possible future events, which in turn affected capacity and pricing. The problem was heightened by the fact that such catastrophes are especially difficult to model. Unlike property, people represent mobile exposures, and there have been few major insurance losses or other historical data with which to assess the frequency and severity of possible catastrophic losses.

The model currently covers the United States and the united kingdom. The accumulation component can be applied together European territories if the essential data requirements are met and if the diversity assumptions that apply to the United States and the United Kingdom are deemed appropriate for the country in question. Modeling regions outside of Europe would require further research and modification.

2.4.2.5.Flood

Major flood modeling initiatives are currently underway around the globe. In Taiwan, a flood modeling initiative is being funded by the government more comprehensive flood models.

In Europe, DACH Flood is being developed for Germany, Austria and Switzerland. The first stage of this model for the Rhine will be available at the end of September 2004. Another initiative is underway to model the flood risk in ease in Belgium and is due for release in the fall of 2004.

2.4.3. Control

Some insurances shared risk and claims. This ensures stabilization of result. For example obligatory (Treaty) reinsurance system reduce the fluctuations in the loss/premium ratio (quote share – stop/loss – reinsurance methods) (it is shown in Section 3, Methods of Reinsurance).

2.4.4. Consolidation

The other main functions of reinsurance are the financial aspect. Reinsurance can effect the net financial position:

- Balance sheet reasons
  - Solvency
  - Cash flow
- Tax reasons
  - Describing profits
  - Smoothing
- Profit

2.4.5. Technical Role

The technical role of reinsurance is to protect insurers against insolvency or financial strain by reducing the degree of variability in their retained costs. Expressed another way, an efficient reinsurance program should produce a greater stability in the underwriting result of a direct insurer.

Essentially insurers in buying reinsurance are seeking to improve their financial performance and security. The functions of reinsurance can be summarized as follows:

a. The primary functions are:

   I. To protect insurers from underwriting losses which may imperil their solvency;

   II. To stabilize underwriting results;

   III. To increase the flexibility of insurers in the size and types of risk and the volume of business they can safely underwrite; and,

IV. Further spread the risk of loss.

b. To assist in the financing of insurance operations, being used as an alternative to increasing an insurers' capitalization.
c. To defer tax liabilities, to spread claims costs over several years and to reduce exchange rate and investment risks.
d. To provide an insurer with access to a range of insurance underwriting claims handling, administrative and technical services.

3. METHODS OF REINSURANCE

3.1. Facultative Reinsurance

This is the oldest method of reinsurance and it is still practiced where, for one reason or another, the more convenient modern method of treaty reinsurance is either not practicable or where the treaties are already fully interested with a balance of the risk still to be placed.

Irrespective of the class of insurance concerned, the facultative method of reinsurance is one under which each risk proposed for reinsurance is dealt with individually and the reinsurer to whom the risk is offered can accept or decline as he may wish. In this respect facultative reinsurance is like direct insurance.

Advantages: The main advantage of facultative reinsurance is that it enables the reinsurer to differentiate, that is to say, he can underwrite the business offered to him, where as under treaty reinsurance (as will be seen later) he has no say in the acceptance of business because he undertakes to shoulder all risks which came within the treaty. Indeed, the direct insurer must interest the treaty before he goes outside for facultative reinsurance.

Another advantage is the way in which it preserves the essential community of interest which should always exist between the parties to an insurance or reinsurance contract.

Disadvantages: The outstanding disadvantage is the work involved in the operation of facultative reinsurance by reason of the necessity of dealing with each case individually. This means, too, that a direct insurer cannot give cover immediately for any risk which is beyond because he must first secure the consent of reinsurers, and there is, of course, no certainty that he will be able to place the whole of the amount of the risk that he wishes to reinsure. The facultative method is more costly to operate, as will be realized when the treaty method is described.

---

[19] John E. Tiller, FSA, Denise Fagerberg Tiller,
Life Health & Annuity Reinsurance, Chapter 4, 2005.

3.2. Treaties

This method of reinsurance has become very popular because of its convenience and the amount of clerical work that it saves. In the same way as facultative reinsurance is applicable to all classes of business, so the treaty method of reinsurance can apply to any type of cover, although it is specially favoured in certain fields.

Treaties vary in detail, but general principles are common. A treaty, then, is a one or more reinsurers under which the direct office agrees to cede and reinsurer(s) agrees to accept cessions within pre-arranged limits. The direct insurer is bound to interest the treaty first before going outside for cover (where the amount to be placed is greater than the treaty can absorb), while the reinsurer cannot refuse to accept any cessions placed under the treaty.

The modern treaty is thus virtually a blank cheque to the insurer or ceding company, since the reinsurer works more or less blindly; he trusts the ceding company implicitly. This was not so when treaty bordereaux advices were customary, although oven with the advantage of periodical declarations the reinsurer was still largely in the hands of the ceding company.

All documents, bordereaux, accounts, and the like, relating to the reinsurance agreement is to be regarded as strictly confidential and that is an obvious stipulation. The reinsurer has a contractual right to relating to any risk or claim falling under the treaty, although, obviously, this facility is rarely, if ever, used.

3.2.1. Proportional Reinsurance

A type of reinsurance where the ceding insurer cedes to its reinsurer a predetermined proportion of the liability and premium of those policies subject to the reinsurance agreement.

[20] R.L Carter,Reinsurance Essentials, 2003.

3.2.1.1.Quato Share Reinsurance

Simplest of all forms of treaty reinsurance is the quota share contract whereby the reinsurer agrees to reinsure a fixed proportion of every risk accepted by the ceding company, sharing proportionately in all losses and receiving in return the same proportion of all direct premiums (net of return premiums), less the agreed reinsurance commission. The treaty will specify, inter alia, the class(es) of insurance covered; the geographical limits and any other restrictions, such as any specific types of risk or perils excluded from the treaty; and whether a monetary limit applies to any one risk or loss accumulation. The treaty will provide that automatically the ceding company will cede and the reinsurer will accept the agreed share of every risk underwritten which falls within the contract.

Advantages: Perhaps the major advantage for a primary insurer offered by quota share reinsurance is its simplicity of operation. Once the treaty has been arranged, very little administration and accounting is required. Provided all of the risks accepted by the ceding company fall within the terms of the treaty no special effort need to be devoted to the reinsurance of any individual risk (that is, unless additional reinsurance protection is required), or to the apportionment of premiums and claims. Experienced staff therefore will be able to devote more time to other aspects of the business: in a small company, perhaps short of highly trained personnel (as is common in many developing countries) that may be a considerable benefit. Likewise quota share treaties require little administration by reinsurers.

There are, however, other advantages for both parties. The ceding company ran both safely accept larger risks than otherwise would be possible, knowing that reinsurance is available automatically to contain potential losses within an acceptable limit, and write a larger account than could be supported by its capital base. As for the reinsurer, by receiving a share of every risk written by the reinsured, it will obtain a more balanced portfolio of business than could be obtained by reinsuring the same account by any other form of reinsurance. Such participation in every risk creates an identity of interest between reinsured and reinsurer, often inducing the latter to provide for the ceding company

technical training facilities and other services which are of particular value to new companies, especially in developing countries.

Disadvantages: Quota share reinsurance does suffer, however, from substantial disadvantages. Notably the ceding company cannot select the risks it cedes so that the reinsurer will take a share of the premium for risks which lie well within the cedant's own financial capacity. Moreover, although the company will gain from being able to accept larger risks than Otherwise would be possible, by reinsuring the. same proportion of every risk underwritten the relative variability of expected losses on the retained portfolio will be the same as on the total portfolio. Therefore, judged in terms of its impact on the risk borne by the ceding company, quota share reinsurance fails to reduce[19]:

(1) The incurred loss ratio on the retained account; and
(2) The possible relative variation in actual retained losses incurred during any one year from the expected retained losses (i.e. it will not reduce the coefficient of variation of retained losses).

On the other hand, by reinsuring a fixed proportion of all insurances written, a company will reduce its probability of ruin because it will achieve a smaller absolute variation in retained losses relative to its capital and free reserves

Quota share reinsurances also do not adequately protect an insurer against the risks of either accumulations of losses from one event or an overall increase in the frequency and/or severity of losses in any one year.

Uses of quota share reinsurance

Normally, because of its disadvantages, insurers do not rely solely on quota share reinsurance for protecting any particular class of business. The main exceptions are new

[21] R.L. Carter, Reinsurance, 1995.
[22] Christoph Pfeiffer, Reinsurance, 1992.

companies and companies entering into a new class of business or new area of operation. Then the offer of a quota share treaty may entice a reinsurer to provide the essential reinsurance protection required. Although initially the portfolio of business may be small and limited in its spread, and the ceding company inexperienced in handling such business, the reinsurer can be certain of receiving a share of every risk, with no possibility of anti-selection by the reinsured. Depending upon the nature of the business to be transacted, even in such cases the reinsured may need to supplement the quota share reinsurance with a non proportional cover to provide protection against accumulation risks.

Quota share reinsurance may also form an appropriate part of a reinsurance programme for other reasons, such as:

(1) Where the ceding company wishes to arrange reciprocal exchanges of business.
(2) For classes of business where it is difficult to define a single risk, e.g. crop hail insurances.
(3) For reducing a ceding company's exposure under policies covering natural perils.
(4) For classes of insurance where, although there may be policy limits, the incidence and size of losses are uncertain, e.g. liability insurances.

Despite its disadvantages, quota share reinsurance documents possess the great merit of simplicity and thus ease and cheapness of administration. At times of financial difficulty, or perhaps following the implementation of more stringent solvency regulations, it also provides an easy and effective means whereby a company can reduce quickly its retained premium income so that it can continue to meet a prescribed ratio of net income to capital and free reserves.

Finally, quota share arrangements may also form part of a group-underwriting practice whereby all members of a group, instead of participating directly in an insurance written by one member, share it by means of quota share reinsurance up to agreed limits before interesting outside reinsurers.

.

[23] Eser,Kıymet, Reasürans anlaşmalarında kullanılan teknikler ve Türkiye uygulamaları, 1999.

Surplus Reinsurance

When reinsurance is arranged on a surplus basis, the ceding office reinsures only those amounts which it does not wish to hold for its own account. May of the risks accepted by the direct office can be wholly retained, hence there is no giving away of premium to reinsurers under each and every policy, as is done when reinsurance is arranged on a quota share basis.

Surplus treaties have none of the disadvantages of quota share treaties, and they provide for the direct insurer all the advantages of automatic reinsurance protection with adaptability as between one risk and the next.

A surplus treaty is usually arranged in a number of lines or retentions e.g. there may be a ten –or twenty – line treaty, which means that the ceding company can cover ten or twenty times its own retained line, and one of the features of automatic in its function.

There may be a first, second or even third surplus treaty. The reinsurer participating in a first surplus treaty has the knowledge that it will be interested in every risk of the nature covered by the treaty, once the ceding company's retention is exceeded it is thus assured in the ordinary way of a good spread of business and there is no selection or risks against its interest, except that selection which is inevitable by reason of the fact that the ceding company has first choice and will be retaining far more on the good risks than it will be on the bad ones. There is nevertheless sometimes provision made allowing the ceding company to arrange in special circumstances prior local reinsurances, and to that extent the interests of the reinsurer are sacrificed. If the treaty experience should in any given instance suffer as a result, there would need to be a review of the arrangement.

Advantages: Surplus reinsurance is the most common form of treaty reinsurance. Like quota share, it is a form of proportional reinsurance whereby the reinsurer accepts a certain share of a risk, receiving an equivalent proportion of the gross premium (less reinsurance

commission) and paying the same portion of all claims. The basic differences between the two are that under surplus treaties the reinsured only reinsures that portion of any risk which exceeds its own retention limit, and whereas quota share reinsurance can be used for any class of insurance, surplus treaties can only operate for property and those other classes of insurance where the insurer's potential maximum liability is expressed as a sum insured.

Normally under a surplus treaty the ceding company will adopt varying retention limits directly related to the degree of risk associated with different types of exposure units. For example, a property underwriter may fix a higher retention for, say, engineering factories of fire resistant construction than for timber-built woodworking shops because not only will the probability of a fire loss occurring be lower in the former type of premises but the extent of any loss relative to value at risk will probably be smaller too. In other words, in fixing its retention limits an insurer will pay regard to the same factors as are taken into account in fixing premium rates, and some companies draw up their tables of retentions on the basis of the premium rates applied to the original insurances.

Thus surplus treaties overcome one of the main disadvantages of quota share. The ceding company is able to keep for its own account all of the premium for risks underwritten which fall within the scope of its own retention, differentiating for some portfolios between classes of risk.

Also, by ceding amounts in excess of its retention limits, but retaining for itself 100% of risks falling below those limits, the ceding company reduces the range of possible losses on its retained portfolio, thereby reducing the potential relative variability of its aggregate claims costs.

Reinarz's[21] argument is subject to the important qualification that there is no change in the distribution of the reinsured's retained portfolio by size of risk. If the company used its surplus reinsurance facilities to enable it to write a larger proportion of large risks it

---

[24] Robert C. Reinarz, A reference book of Property and Liability Reinsurance Management, 1968.

would tend to counterbalance the favourable impact of surplus reinsurance arrangements on the loss variance of the retained portfolio.

In particular it enables a direct company to handle larger risks and to write a larger portfolio of business than otherwise would be possible given the constraints imposed by its financial resources. By providing the company with a more stable portfolio of retained business, it reduces the probability of suffering random large losses which may badly strain the company's finances, Moreover, like quota share, provided the company can provide its reinsurers with a profitable portfolio of business, by reinsuring it may be able to increase its own profits relative to retained premium income and thus over time build up its free reserves and underwriting capacity.

Disadvantages: There are, however, substantial disadvantages associated with surplus reinsurance which have encouraged the swing towards the use of non-proportional reinsurances for the reinsurance of individual risks. Some of the disadvantages apply equally to the reinsured and the reinsurer, others represent a disadvantage to one party but an advantage to the other.

For example, the advantages discussed above which the ceding company obtains from being able to reinsure only the larger risks it accepts conversely present several disadvantages for the reinsurer. Inevitably the ceding company will tend to retain for its own account a large part of the less hazardous class(es) of the business it writes so that, ceteris paribus, a disproportionate amount of the heavier-risk business will be ceded to the reinsurer(s). It does not follow, however, that this practice leaves the reinsurer carrying a disproportionate share of the poor business written by the ceding company. Such a result only holds true if original premium rates are unfairly discriminatory in the sense that the premiums charged on the low-risk business are sufficient to yield profits over the long term while those for the more hazardous risks are inadequate. The unavoidable disadvantage to the reinsurer (and conversely the advantage to the ceding company) lies in the imbalance of the portfolio ceded which[22]:

---

[25] Robert C. Reinarz, A reference book of Property and Liability Reinsurance Management, p. 29 ,1968.

(l) will contain a narrower spread of business, so that if the loss experience of a high-risk group or of the larger risks deteriorates as compared with the other business, the reinsurer will probably suffer more than the ceding company because of a higher concentration of such business being included in the reinsured portfolio; and

(2) the distribution of the reinsured business by size of risk will tend to be wider, so exposing the loss experience to greater variability. The costs incurred by both ceding companies and reinsurers in administering surplus treaties tend to be higher than for other forms of reinsurance.

A ceding company must compare the sum insured on each risk it proposes to underwrite with its retention limit for that class of risk to determine the amount, if any, to be ceded. Then an entry has to be made in the reinsurance register both at inception and when any alteration is made to the sum(s) insured or premium rate(s), and the correct portions of all premium receipts or refunds and claims payments have to be included in the quarterly reinsurance accounts. The use of computers has reduced the administrative burden for both ceding companies and reinsurers, but work still has to be done which is not required for other forms of reinsurance.

Generally very little information is now supplied by ceding companies to their reinsurers regarding individual risks ceded so reducing costs for both parties. On the other hand the reinsurer suffers the disadvantage of not being able to exercise the same watch over the business ceded and thus its own acceptances, as in the days when the submission of detailed bordereaux was common practice. However, following the increase in the size of industrial, commercial and transport risks with the consequent need to spread them amongst a larger number of insurers, which increases the possibility of a reinsurer picking up a share from several cedants; increasingly reinsurers are requiring cedants to submit bordereaux, at least for very large 'target' risks.

Finally, like quota share reinsurance, although surplus treaties provide some protection against the accumulation of losses from one event, the extent of the risk transferred to the reinsurer is unlikely to provide adequate protection for a ceding company however carefully it monitors its business and sets its retention limits. For example, even a

well controlled property insurance account covering fire and special perils will always be exposed in some degree to major conflagrations or wide-ranging natural disasters. Therefore, in view of the increase in the number and size of natural disasters in recent years, reinsurers are increasingly wary of accepting an unlimited liability under surplus reinsurance treaties for loss accumulations due to natural perils.

Mixed Quota And Surplus Treaty

The object of the treaty is to enable the direct insurer to give off by way of reinsurance a quota and also a surplus. By way of illustration, direct insurers may agree upon a quota share of every risk subject to a maximum, so that it holds a port and gives off the balance under the quota share treaty to a number of quota reinsurers. The remainder of the amount involved where it exceeds the agreed figure is then dealt with as a surplus.

3.2.2. Non-Propotional Reinsurance

A form of reinsurance where the Reinsurer makes loss payments to the Insurer only when the Insurer's loss exceeds a pre-determined limit. It is excess reinsurance.

3.2.2.1.Excess of Loss Reinsurance

An excess of loss reinsurance is arranged on an individual risk or occurrence basis the fundamental principle is the same. He reinsurer, instead of assuming liability for an agreed share of all losses occurring an individual risks ceded by the reinsured as with proportional reinsurances, undertakes to indemnify the reinsured against losses occurring on the reinsured portfolio of business in excess of an agreed amount, subject normally to an upper limit.

Advantages: It can be deduced from the above that from the stand point of a ceding company excess of loss reinsurances have three major advantages over proportional reinsurances:

[26] Robert Hammesfahr, Reinsurance Claims, 1st edition August 2004.
[27] Robert W. Strain, Reinsurance, 1997.

1. The ceding company obtains protection only against the large losses which could strain its financial capacity but within the excess limits the company has 100% protection. Thus it can cut off its liability at the chosen monetary limit. The variability of retained losses should be smaller on a portfolio protected by surplus reinsurance which transferred the same aggregate annual expected loss to the reinsurer.
2. Because of the reinsurer has no liability for the more frequent small losses costing less than the excess of loss reinsurance lower limit, the ceding company retains for its own account a higher proportion of its gross premium income.
3. Administration costs are for lower for both parties. The ceding company no longer needs to classify each risk it underwrites to fix its retention arrange reinsurance for any balance, apportion premiums and losses. After arranging the excess of loss cover, the reinsurance administration will be confirmed to paying the initial premium calculating and paying any adjustment premium, and notifying and setting with the reinsurers any losses which fall within the treaty limits. At the same time it will be able to carry on its business in the knowledge that it has automatic protection against any losses falling within the reinsurance excess limits, though that should not lead to any change in its underwritten policy. Most excess of loss treaties are subject to exclusion clauses and limits which effectively require the ceding company to maintain the same underwriting standards.

Disadvantages: A major problem with non – proportional reinsurances is that of calculating premiums that fairly reflect the risk transferred to the reinsurer. Unlike proportional reinsurances where original premiums normally can be taken as a firm base for the reinsurance premium with the reinsurance commission allowed being adjusted according to the loss experience and balance of the reinsured portfolio, the relationship between the original and reinsurance premiums cannot be so direct with non – proportional reinsurances.

[28] Şakarcan, R.Can, Non-Proportional Reinsurance, 1991.

Normally excess of loss reinsurances provide a ceding company with protection mainly against severity of loss: the company has to bear itself and increase in the frequency of losses below its chosen retention limit.

If a company seeks to protect itself against an increase in the expected frequency of losses by selecting a low retention limit, more losses will have to be processed by the reinsurer so that both parties will incur higher administration costs, thereby negating one of the advantages of excess of loss reinsurance.

Special arrangements often have to be made for target and peak risks because their inclusion in an excess of loss treaty will tend to increase the variance of its results to degree which may be unacceptable to the reinsurer and the ceding company alike.

Under property and marine excess of loss treaties subject to reinstatement clauses the ceding company is faced with the possibility of having to pay an additional premium if any losses occur during the year should experience be particularly bad the reinsured may be faced with having to pay two or three premiums during the year under the terms of an automatic reinstatement clause, and even then may run out of cover.

3.2.2.2.Stop Loss Reinsurance (Excess of Loss Ratio)

One of the methods of reinsurance is by way of stop loss, or excess of loss ratio, and covers of this description vary considerably in hazard. Each, therefore, has to be individually scrutinised and rated. There is no rule of thumb method of rating, and it is not necessarily possible to apply the terms and conditions which are acceptable to the reinsurer in one set of circumstances to another entirely different set.

Although by means of surplus reinsurance the ceding company can reduce its net liability on individual risks to a figure well within its compass, yet by reason of the incidence of claims it may well find itself with a high claims ratio at the end of the year,

and stop loss reinsurance is the form of protection which in those circumstances makes it possible to limit such loss ratio to an agreed percentage.

As the name implies, the loss ratio of the ceding company is stopped at an agreed percentage, and if in any one calendar year the loss ratio exceeds that percentage, then the reinsurer takes care of the difference. In that way the ceding company should be left with a loss ratio comparable to that of earlier years, although that naturally depends on the point at which it is stopped. These covers are necessarily given only to first-class companies, since the reinsurer is obliged to rely even more than normally on the bona fides of the ceding company, especially as with such cover available an underwriter could easily take advantage of the reinsurer by expanding his underwriting practices without due caution, in the knowledge that the reinsurer would pay in the event of his being unfortunate.

It is not easy to decide on the rating and, in the early stages that must be largely guesswork, although reinsurers seem to acquire an intuitive idea of what is a reasonable charge to be made. A reinsurer who specialises in this kind of reinsurance business must obtain a "spread" over as wide an area as possible; otherwise, there is the obvious danger of heavy losses under several covers arising out of a set of circumstances which may involve many companies operating in the same area, e.g., the North American hurricane of 1950 and 1954[25].

The reinsurer will not give "unlimited" cover, and will restrict liability to an agreed percentage of the net retained premium income, or, alternatively, to a specified amount, but both limits are frequently inserted, the lesser to in the event of need.

This type of cover may be arranged in addition to the normal surplus treaty so as to operate on the net retained lines of the ceding company, although in some instances it may be possible to work on the gross business, without— there being any protecting surplus covers except possibly in special instances where the sum insured is very high and facultative reinsurance is necessary.

[29] R.L. Carter, Reinsurance, 1995.

There is a tendency to make more use of the facilities of this type which are now available, especially for hail business where it is now considered to be the easiest form of protection. A stop loss contract may cover 90% of the amount in excess of a 70% loss ratio up to a further 50%, thus reinsurers are liable for 90% of all losses after the loss ratio of the company has reached 70% and until the loss ratio of the company has reached 120%.

It is frequently stipulated that the reinsurers' liability is also limited to a fixed amount for the reason that any substantial increase in the premium income of the company can greatly increase reinsurers' liability under the cover. Thus, in the example given, reinsurers will be liable for 90% of all losses in excess of 70% until the loss ratio of the company has reached 120% or a fixed amount of, say, 90% of £50,000, whichever was the less[26].

It is frequently stipulated that the ceding company shall retain for its own account a proportion of the cover (usually 10%) and the reinsurers will only be liable for 90%, as shown in the example. This safeguards the reinsurer against alteration in the normal underwriting practice of the direct company.

3.3. Pools

In addition to the forms of reinsurance already mentioned there has developed, particularly in foreign markets, a system of reinsuring by various forms of pooling arrangement, which in effect constitute a system of quota and/or surplus reinsurance between participating members of the Pool.

Such an arrangement may be either privately agreed upon between member companies for their mutual benefit or imposed by Government intervention in one form or another, ranging from the inauguration of a national pool administered by a Government authority to a pool of private companies created at the suggestion of the Government in the interests of the community.

---

[30] R.L. Carter, Reinsurance, 1995.

Pool reinsurance systems may either be in respect of:

(a) a particular class of risks of a hazardous nature, e.g., workmen's compensation insurance in the coal mining industry, particularly in the Far East, the object being to obtain an improved spread of risk, or

(b) All business of a particular class, e.g., fire and miscellaneous perils, so as to enable the market or participating group of companies to absorb the business. This is particularly true where the member companies are not financially strong enough to absorb the risks independently without placing an undue strain on their financial resources by incurring excessive liabilities.

A Pool is administered by an organisation created by the member companies for this purpose, all business within the scope of the arrangement being passed to the Pool by the ceding company. The business after being pooled is then retroceded to members:

(a) In an agreed ratio, or

(b) Proportionately to the volume of business ceded, the usual method of measuring the volume of business being on a premium income basis

If it is so agreed between the member companies, the Pool may keep for it fixed retention of all business received by it, thus becoming a reinsurer in it own right.

It will be realised that a pooling arrangement can take a number of forms, all being evolved from the basic principles of quota and surplus reinsurance, each form in itself being open to considerable minor variation.

The following notes are designed to embody the main variations in the method of handling pool business.

.

[31] Robert C Reinarz, A reference book of property and liability reinsurance management , 1968.

An Insurer's Acceptance

A member company, when accepting a particular risk falling within the pooling arrangement may:

(a) Pass the entire risk to the Pool

(b) In accordance with its underwriting policy, retain a portion of the risk, i.e., a net retention, passing the excess or surplus to the Pool,

(c) or retain a quota share of its acceptance, say 10%, ceding the remainder, i.e., 90% to the Pool.

Pool Acceptance and Retrocession

The business thus received by the Pool is divided and retroceded to the participating companies either:

(a) without a retention on the part of the Pool,
(b) after a retention in accordance with a table of limits, or
(c) with the Pool participating in the business ceded to it on a quota basis in conjunction with the member companies.

It will be seen, therefore, that the retrocession by the Pool to the member companies will under (a) and (c) be on a pure quota basis, whereas under (b) it is a quota share of the surplus after the Pool retention.

In respect of any one loss, in excess of the maximum group retention of the whole Pool, it becomes necessary to enter into a further arrangement with additional reinsurers to enable the Pool to fulfil its object, namely, the ability to absorb all acceptable; risks presented to it. These additional reinsurers, who may be direct companies, but are more often professional reinsurance companies or members of Lloyd's, will be interested in the reinsurances of the Pool by way of an obligatory treaty with the Pool organisation.

[32] C.E. Golding, Reinsurance Survey.

According to the arrangement made, this treaty will take the form of:- a quota participation of the Pool reinsurances: thus, all the reinsurers will be on an equal footing; on a surplus basis, either pari passu; with the Pool members or only after the Pool members have received their maximum share (thus becoming in fact a 2nd Surplus); in certain instances in order that the additional reinsurers receive a more balanced portfolio the treaty may embody arrangements for both quota and surplus retrocession.

As a further safeguard against unforeseen excessive accumulations and possibly as an alternative to the introduction of additional reinsurers, the Pool organisation may arrange an Excess of Loss or an Excess of Loss Ratio treaty designed to protect the over-all Pool.

The administration costs of the control- ling body may be made by a levy on member companies either by a specific periodic charge or by way of an overriding commission on the business handled. It is customary for premiums for business ceded to the Pool to-be net premiums, i.e., less agency commission

Losses are advised to the Pool Organisation who arrange for payment. Premium and Loss bordereaux would be rendered to members by the Pool but may be dispensed with either altogether or in part. Accounts are as a general rule rendered by the Pool administrative organisation on a quarterly basis (particularly to the outside reinsurers). A cash loss limit may be imposed between participating members in order, to make ready funds available to the Pool for handling large claims. Where member companies are not receiving from the Pool an equal volume of business (by premium comparison) to that ceded, they will require on their own cessions, as with normal quota and surplus treaties, a reinsurance commission as a contribution to acquisition costs.

Where outside reinsurers are concerned, the reinsurance commission is usually higher than that paid by and to the member companies, in addition to which there may well be a, profit commission, the calculation of which follows the principles laid down in the earlier part of the lesson. These additional commissions may either be used to offset the

costs of administration in the organisation or either partly or in their entirety be divided among members on an agreed basis.

Advantages of Pools

(l) Companies participating obtain a quota share (and possibly a surplus share in addition) of a wider selection of business, thus obtaining improved spread and balance to their portfolio.

(II) Large blocks of business constituting a single hazard can more easily be absorbed within the existing insurance framework

(III)In the less developed insurance markets of the world where, by reason of the infancy of insurance, there is a degree of instability, Pool Reinsurance not only co-ordinates the resources of insurance to meet the demands made upon by the community, but also utilised to assist in fixing premium with the hazards involved. This is made possible by the availability from the Pool records of premium and loss statistics over a far wider range of business than would otherwise be readily available.

Disadvantages of Pools

(I) Any efficient reinsurance administrative body involves, of necessity, a fair amount of expense which must in one way or another directly or indirectly be paid for out of premiums. Pool reinsurance involves further expense which arises from the introduction of an additional intermediate stage in the reinsurance procedure with the attendant records and staff. (2) In spite of limits tables being utilised, if the Pool is to achieve it's fully there are strong theoretical purpose there are possibilities of accumulations. This is particularly true in fire insurance overseas in congested areas where a number of member companies may all cede business from an area which is physically one conflagration hazard.

There is every possibility also of a company having declined direct acceptance of a particular risk becoming interested by way of the Pool from another company. This is true

[33] Robert C Reinarz, A reference book of property and liability reinsurance management , 1968.

of any reinsurance treaty between two direct insurers, but the risk is enhanced in proportion to the number of companies participating in the Pool.

Reinsurance can be said to be a form of underwriting the underwriter, and while this can be done with a fair degree of accuracy in a normal quota or surplus treaty with the assistance of bordereau and personal knowledge, this control is obviously weakened where a number of underwriters are all contributing to Pool business. On the other hand, in all likelihood the underwriter of any company participating in a Pool would have a sound idea of the capabilities and character of the underwriters of other member companies, especially when the Pool covers a small territory

Finally, there have been developed new forms of reinsurances contracts, often referred to as " Financial Reinsurance", which provide insurers and reinsurers with additional tools for managing their financial affairs.

Financial Reinsurance

A steady growth of earnings is a desirable objective for any trading enterprise. Wide swings in annual operating results between heavy losses and large profits can jeopardise a firm's financial stability, its ability to maintain dividends for its owners, the timing and amount of its tax liabilities and, in extremis, its exposure to hostile takeover and/or its solvency. Earnings instability poses additional problems for insurers. They have to calculate their solvency according to supervisory rules relating to the valuation of assets and liabilities, and informed buyers and intermediaries attach considerable importance to financial security when deciding where to place business.

Both life and non-life insurers are exposed to the adverse effects of the infrequent, random timing of major catastrophes, and of interest rate, stock market and exchange rate movements on earnings and asset values. Additionally non-life insurers' annual results are exposed to the destabilising effects of very large individual losses, greater uncertainty regarding the timing of claims payments, the cyclical nature of their business, and the shortcomings of one year accounting conventions in dealing with such phenomena.

Traditionally, well-managed companies have sought to limit the size of the fluctuations in trading results and asset values by establishing reserves, spreading their funds over a range of low-risk investments diversified by type, currencies and maturity dates to match their liabilities, and by purchasing reinsurance.

Since the 1970s, however, a variety of new instruments have been developed to enable individuals and organisations to better manage financial risks. They include currency and security futures and options, interest rate and equity swaps, and other financial derivative products. Increasingly they are used by insurers and reinsurers in the management of their risks. In addition new types of contracts, known as 'financial' or 'finite risk' reinsurance, have been developed to address the specific financial needs of insurers. The large losses incurred in the traditional reinsurance markets, with consequent withdrawals of capacity, have been major factors in the growth of financial reinsurance, with many new companies being formed, some by traditional reinsurers, to write such business.

Traditional v. financial reinsurance

Although 'financial reinsurance' differs in certain distinct respects from traditional reinsurance products, there are many points of similarity and, as will be seen, they are moving closer together. Traditional reinsurance contracts could, of course, also is described as 'financial' in that they too provide financial benefits, notably:

(l) They improve a ceding company's earnings stability by affording some relief against adverse fluctuations in annual results by providing protection primarily against what may be termed 'underwriting risk'; that is, the random incidence of adverse claims experience. Catastrophe and top layer excess of loss reinsurances in particular enable a ceding company to spread the cost of infrequent, very large losses over several years.

(2) They help to strengthen ceding company's balance sheet in so far as credit can be taken for liabilities transferred to a reinsurer when calculating a company's solvency. Also, not infrequently traditional proportional reinsurance contracts are used to reduce the

strain on surplus caused by gross reserving regulations, or to maintain solvency margins intact following a surge of gross premiums and/or a fall in asset values.

(3) Although in the past reinsurance was not generally seen as a tax planning device[30], traditional reinsurance contracts can be tax advantageous as compared with other means of smoothing out the impact of infrequent disasters on an insurer's annual trading results. Many countries, including the United States, do not allow insurers when aggregate claims costs are below average to deduct from taxable profits any transfer of funds to catastrophe and/or claims equalisation reserves established to meet potential future large losses. Tax authorities argue that to do so would put insurers in an advantageous tax position as compare with other trading enterprises, enabling them to roll-forward a part of their otherwise taxable income. However, premiums paid for reinsurance designed to achieve the same long-term smoothing of results are tax deductible.

One of the ways, however, in which traditional reinsurance contracts differ from financial reinsurance, is that the former do not expressly address potential sources of loss other than those arising from adverse claims experience. Any protection afforded against losses due either to investment and foreign exchange risks, or the timing of the settlement of long-tail claims tends to be incidental to the main purpose of the reinsurance. Financial reinsurers, on the other hand, have developed a wide, evolving range of contracts that may handle either existing or prospective claims liabilities and may have one or more of the following objectives:

— enabling an insurer to reduce the risk of economic loss due to reserve deterioration and to strengthen its balance sheet by the difference between its claims reserves and the premium paid to the reinsurer;

— providing surplus relief by effectively discounting claims reserves;

— protecting surplus by insuring claims reserves against adverse development, including the effects of investment and/or exchange rate risks and the earlier than anticipated payment of claims;

— helping to smooth insurers' annual results by spreading over several years the cost of large/catastrophe losses, and so insurers' tax liabilities.

[34] Andrew J. Barile & Peter R. Barker, Reinsurance and Reinsurance Management, 1968.

Of course, the first two benefits can be achieved without the aid of financial reinsurance if an insurer is permitted by its regulatory authority to discount claims reserves. Even then, however, it may be more profitable to do so through the purchase of financial reinsurance, as will be explained below.

Characteristics of Financial Reinsurance

There is no universally accepted definition of 'financial reinsurance'. Not least this is because in a relatively new dynamic market, new forms of contract, and variations thereon, are continuously being developed. Also, after a careful analysis of each potential cedant's portfolio of business and often its business plan too, contracts are tailored to meet individual needs and circumstances. Therefore, there is no complete set of standard contracts that could provide a basis for a definition of the whole, growing family of contracts. However, there are certain aspects of the business that distinguish financial from traditional reinsurance, notably:

"Financial reinsurance ... aims to directly address the financial outcome of the insurance process. Financial reinsurance can be defined as a transaction in which financial considerations dominate the buyers' motivation."[31]

"... they seek to achieve financial goals as their primary purpose, rather than insurance underwriting goals ... the transfer of insurance risk to the reinsurer is limited or non-existent." "... a transaction where asset, credit and timing risks are transferred by the ceding company with the reinsurer's liability subject to an aggregate limit."[32]

"... a contract where a single premium is paid that is largely derived from the net present value of future known or expected losses."[33]

The first two statements emphasise the financial objectives of financial reinsurance contracts.

---

35 Heidi E Huller, 'Financial Reinsurance: Answering the Critics', *Best's Review,* March 1991.
36 Alistair Johnston. 'Accounting for Financial Reinsurance', a paper presented to the 1994 Annual Conference of The Association of Insurance and Risk Managers.

The second and third statements focus on the limited transfer of risk: invariably the reinsurer's liability is capped at a level well below that would normally occur under conventional reinsurance contracts, the limit being usually related directly to the premium(s) payable by the cedant. It is a feature of financial reinsurance that has led to regulatory, accounting and taxation problems.

The third and fourth definitions highlight the formal recognition by both parties of the time value of money. It allows a ceding company to 'reinsure' existing or prospective liabilities for a consideration that is less than the expected settlement value of the liabilities transferred because the reinsurer can earn an additional income from the investment of the premium. Although the expected investment earnings obtainable on the funds held to cover liabilities to cedants enter explicitly or implicitly into the pricing of traditional reinsurance contracts, particularly for long-tail classes of business, they are not specifically recognised in the contract. However, with financial reinsurance such earnings are central to the pricing and the cover, so providing three possible advantages for a cedant[34]:

(1) If an insurer is not allowed by solvency regulations to calculate claims reserves based on the present discounted values of its outstanding, including IBNR, claims, a financial reinsurance can be used to achieve the same objective. That was why in the 1970s Lloyd's syndicates began to purchase 'time and distance' policies to limit their liabilities in respect of past underwriting years of account and to liberate profits tied-up in reserves.

(2) Even when the discounting of claims reserves is allowed, a financial reinsurer may be able to agree to a premium which is less than the amount which the insurer otherwise would have to set aside to fund the liability transferred. It can do so because of its ability to earn a higher net of tax field on the funds it holds.

(3) Generally the reinsurance will provide some surplus relief because the liability transferred to the reinsurer is greater than the premium paid. Because the size of the investment earnings that a financial reinsurer can earn, and thus give credit for in the premium, is directly related to the length of the delay between the

---

[37] Graham C. Pewter. 'Step by step'. *The Review.* March 1991.
[38] R.L.Carter, Reinsurance, p. 646, 1995.

receipt of the premium and the timing of payments under the contract, financial reinsurance is particularly suited to: (a) the long-tail classes of insurance business; and (b) low frequency catastrophe risks for which the reinsurance is arranged on a multi-year basis.

The other main characteristics of financial reinsurance contracts are:

(l) A recognition by financial reinsurers that, for a ceding company, reinsurance is a substitute for additional capital, so that to justify any transaction both parties need to look at the cost of capital;

(2) An almost certain obligation on the reinsurer to make some payment to its cedant; and

(3) The sharing of profits. In return for accepting a limit on losses recoverable from the reinsurer, the ceding company is given the right to share in ultimate profits, either through premium rebates or higher commissions, or through enhancements of the cover provided as lower deductibles and/or higher limits.

Invariably financial reinsurance companies are located in tax havens (notably Bermuda, though increasingly Barbados, Dublin and Luxembourg too). There they can value provisions for outstanding, including IBNR, claims on a net present value basis, and being under no legal obligation to distribute earnings, they can, with zero or low corporate tax rates, rapidly build up surplus.

[39] Kenneth C. Froewiss, A Practical Guide to Finite Risk Insurance and Reinsurance, 1998.

4. REINSURANCE MARKET

4.1. Types of Market

Whenever the buyers of any commodity are in contact with its sellers a market can be said to exist. Although physical contact between the two parties at some recognised place may be normal, it is not a necessary condition for the existence of a market. The essential requirement is that there exists some method of communication between potential buyers and sellers either directly, e.g. by telephone, letter, FAX or a computer network, or indirectly through an intermediary.

The development of reinsurance companies throughout the world has led to active and sometimes highly competitive markets operating in many cities where local direct insurers can place their reinsurances. In addition, there are a few places recognised as international reinsurance centres where much of the business transacted originates from abroad. Contact between insurers and reinsurers in some markets are direct, whereas in other countries much of the business is dealt with through the agency of reinsurance brokers. The latter play a particularly important role in the placing of reinsurances internationally, especially on the London market where all of the business placed at Lloyd's and over 80 per cent of the reinsurance business placed on the company market passes through the hands of brokers. A feature of reinsurance markets is that because of the ways in which insurers and reinsurers operate, a company may be trading simultaneously as both a buyer and a seller of reinsurance.

So the organisation of reinsurance markets ranges from a group of local insurers placing all of their reinsurances with a local monopoly reinsurance corporation to something as complex as the London reinsurance market. Indeed the multiplicity of organisations operating in the London market and their different ways of doing business led one observer to suggest that "London would be more accurately described as consisting of a number of overlapping markets loosely linked by practice and tradition".

[40] R.L Carter,Reinsurance Essentials, 2003.

4.1.1. International Markets

In the case of London the development throughout the 19th century of overseas underwriting agencies and later of branches and subsidiaries by the major UK direct insurance companies gave their London head-office officials a unique knowledge of insurance practice and conditions throughout the world. As local markets developed, the same companies through their old connections were able to attract reinsurance business to London in place of the insurances they previously wrote direct. London too was able to offer to potential buyers of insurance and reinsurance a variety of different types of insurers and reinsurers – major composite groups and specialist independent companies; the so-called fringe companies consisting of smaller companies writing overseas business often through underwriting agencies; branches and subsidiaries of major foreign insurance and reinsurance companies; the marine Protection and Indemnity mutual associations; and most notably the individual underwriters forming the Lloyd's market with its highly developed broker system. At the time of its early development London possessed the additional advantages of a strong international currency, no restrictions on the movement of funds abroad, and the backing of bankers, other financial experts, lawyers, and loss adjusters experienced in overseas business. Finally, there was considerable freedom from government interference in the conduct of insurance business, so encouraging flexibility in rating and wordings and the establishment in London of foreign companies. Thus London possessed all of the attributes which Neave has listed as the prerequisites of an international insurance centre, i.e.[37]:

"A sound financial background and a thorough technical expertise....a currency freely negotiable and exchange control regulations favourable to the free transaction of reinsurance business internationally... flexibility, implying a certain size and variety of technical opinion, and with it a willingness to consider all types of cover so that competitive quotations can be obtained."

Central to the operations of the London market is Lloyd's with its 179 or so underwriting syndicates and 222 accredited Lloyd's brokers (at January 1994) which,

---

[41] J.A.S. Neave, Reinsurance Today: A General Survey.

through their international connections, are able to bring to the market business from around the world[38].

An important feature of both the Lloyd's and company markets is the practice of spreading large risks amongst a number of syndicates and/or companies. Not only does this enable brokers to tap the underwriting capacity of the whole market but it also enables individual insurers to acquire a well diversified portfolio of business and minimise the risk of being over-exposed on any one risk, which helps to foster an innovative approach to the insurance of unusual risks. When placing a large risk the broker will approach one or more underwriters recognised in the market as being leaders in the class of business concerned in order to obtain a quotation which, hopefully, will receive the support of a sufficient number of 'following' insurers to enable the risk to be fully insured. Although the commencement in 1993 of the electronic placing of business through LIMNET (the London Insurance Market Network) will eventually change brokers' procedures for the placing of risks within the Lloyd's and company markets, it will not affect the fundamental principle of spreading-large risks amongst two or more insurers (or reinsurers).

In contrast to London, the growth of the New York, Tokyo, Zurich and other European reinsurance markets has stemmed mainly from the enterprise and growth of a few large companies specialising in reinsurance business. Bermuda's status as a low tax offshore financial centre enabled it to develop over a period of two decades from being in the 1970s a location for captive insurance companies, to an international market specialising in financial reinsurance and high level, notably catastrophe, reinsurances.

It is perhaps unfortunate that the specialist reinsurers have come to be known as professional reinsurance companies. The implication that companies whose main business is direct insurance are amateurs when it comes to dealing with inwards reinsurance business is often far from the truth, as is evidenced by the volume of inwards reinsurance business' which they write. However, what the major professional reinsurance companies can offer (and here must be included reinsurers that deal either mainly direct or through brokers, and the reinsurance subsidiaries of large direct insurers) are the services of

---

[42] R.L. Carter and P. Falush, The Londan Insurance Market: Issues and Responses.

specialist underwriters. Thus they can handle all of the main classes of business, and they possess a thorough knowledge of conditions throughout the world gained from years of experience and extensive travel. The development of some specialist reinsurers has been based principally on the size and growth of their domestic markets, e.g. the American companies, but the Swiss and Scandinavian reinsurance companies have demonstrated that an international business can be built on a small domestic base.

4.1.2. National Markets

By definition, national reinsurance markets are narrower in the scope of business transacted than their international counterparts. Usually the same is true of their structures too, though they display widely differing patterns.

Amongst the Communist regimes that came to power after 1945 it was standard practice for all insurance business to be nationalised and for the state insurance organisations of the larger nations to seek reinsurance protection mainly, if not solely, to provide protection only against potential losses with high foreign currency commitments. Several African and Arab countries, and the states of the Indian subcontinent, followed the Communist example, but because of the more limited size of their domestic markets they have tended to have a greater recourse to international reinsurance. Now many countries in Eastern Europe and elsewhere have either already privatised their state corporations, or are in the process of doing so, and are becoming more involved with international reinsurance.

Other countries have allowed private direct insurance companies to continue operating (e.g. Nigeria), but have formed state owned reinsurance corporations to which all companies are required to cede part of their business. Some state reinsurance corporations, notably in South America, have a monopoly of domestic reinsurance, and alone are permitted to place reinsurance abroad. Elsewhere, the state reinsurer is entitled to only limited compulsory cessions, leaving direct insurers free to place any balance with other reinsurers.

Lastly there are countries with competitive reinsurance markets catering principally for domestic direct insurance companies, though, as in Scandinavia, they may contain one or more professional reinsurance companies very active in world markets.
The uniqueness of London is that it encompasses within the market as buyers and sellers of reinsurance all of the types of insurance and reinsurance enterprise that can be found throughout the world.

4.2. Actors of Markets (Role of Buyers – Sellers and Brokers in Reinsurance Market)

4.2.1. Buyers of Reinsurance

Direct insurers: The main buyers of reinsurance are the direct writing companies.

Captive Insurance Companies: A captive insurance company is one that has been established primarily to insure (or reinsure) all or part of the risks of its parent company or organization. It's the final stage in a risk retention (self – insurance) programme. The idea is not new: some of today's leading insurance groups were established originally to provide insurance for their founders on better and more consistent terms then were available in the market at the time.

Reinsurers: Although, reinsurers are principally suppliers of reinsurance, they also operate as buyers whenever they retrocede part of any business they have accepted.

Technically a reinsurer will retrocede business for the same reasons as a direct insurer buys reinsurance; there is mainly because it does not retain wholly for its own account some of business it has accepted.

[43] Paul Walther, Buyers perspectives on the Reinsurance Market, 2003.
[44] John Jennings, Reinsurance industry underreserved, S&P warns. (Standard & Poor's Insurance Rating Services Group), 1993.

The Buyer's Needs

The buyer's needs for financial protection:

Reinsurers are in business because they have customers that meet their product and services. The prime function of reinsurance is to protect the assets of the insurer from those insurance risks that have the potential to impair its solvency. The risk arises from the underwriting operations and particularly relates to the volume of premium income and the cost of claims that occur.

The Buyer's Need for Service

The reinsurance product is often described as a financial "commodity" with a price that fluctuates according to the laws of supply and demand. The price of excess of loss reinsurance does fluctuate relative to the amount of cover required and the amount of capacity available. It is hardly a day-to-day fluctuation; rate changes are discerned at the main renewal seasons of which 1 January is the most influential. Reinsurance derivatives are financial commodities and are significantly different from the standard reinsurance products. A reinsurance derivative is described as a "contract of margin" whilst a standard reinsurance contract is one of indemnity. It is because reinsurance contracts are ones of indemnity that they are more than a financial commodity. Insurers as the customer look for the added value that reinsurance should bring to their business. We have already spoken about reinsurance security, and the quality of the security offered is an issue of added value. This is particularly true for the smaller insurer that obtains reinsurance cover from a reinsurer that has a balance sheet stronger than its own. Added value is the commitment by the reinsurer of financial strength and the commitment of technical strength with expertise. Reinsurers provide a technical service based upon their own expertise gained from reinsurance underwriting and claims handling. Insurers expect that expertise to be available to them as part of the business relationship. The three key technical areas are:

---

[45] Paul Walther, Buyers perspectives on the Reinsurance Market, 2003.

(1) Risk underwriting, in particular for the higher hazard or unusual risk that requires a particular underwriting expertise not within the insurer's own expertise. Many reinsurers engage in specialist underwriting and are able to advice on appropriate rates, terms and conditions for a particular risk. Some employ surveyors and engineers and make their services available. Those that underwrite facultative reinsurance provide those services both as marketing and an underwriting tool.

(2) *Technical Research* that is made available by reinsurers to their clients. Different reinsurers have taken the initiative to publish the results of their research on many technical methods. Some are specific to a class of insurance business; some deal with claims issues, particularly those relating to third party liability; some relate to natural catastrophes and their impact upon insurance and reinsurance. Those publications, often draw from the reinsurers own experience; benefit both parties by contributing to the further understanding and evaluation of risks.

The buyer's need for cost-effective reinsurance cover

Reinsurance is a cost to the insurer. Insurers are under pressure to reduce costs in a competitive underwriting environment. Insurers understand the need for reinsurance and why it is at the cost that will secure for reinsurers the appropriate return that continues to provide the security demanded by customers and shareholders. Arguably, the measure to determine the cost – effectiveness of the reinsurance cover is to compare with the cost of raising and satisfying the capital otherwise necessary to replace reinsurance cover.

Many insurers engage reinsurance brokers to advice on their programme needs and place reinsurance treaties on their behalf. The role of reinsurance brokers is changing from one whose main function has been to place business at the most economic terms to that of an advisor on the management of business risks and the reinsurance solutions possible. However, the role of identifying reinsurance market and negotiating terms and conditions on behalf of clients is still the insurance broker's prime function. The role of advisor to the insurer's own financial strategists is to identify most – effective the insurance programme and negotiate accordingly with reinsurers. Reinsurers have their own financial objectives to meet but it is important for them to be aware that insurers have to make financial decisions

with regard to risk retention balanced against reinsurance cost. Right decisions can mean an insurer achieves a financial return superior to its competitors. Wrong decisions can mean the reserve.

To summarize, an insurer meets the transfer risk to the reinsurer at a competitive cost but requires a service from its reinsurers that enhances the value of the insurer's own business. Security is the prime requirement but of importance is the service that responds promptly to the payment of valid claims.

4.2.2. Sellers of Reinsurance

Professional Reinsurance Companies

Since the foundation in 1842 of the first insurance company specialising in supplying reinsurance, professional reinsurance companies have been established in most countries.

Direct Insurance Companies

Reinsurance business commenced with the ceding of reinsurances between direct insurers and for many years they continued to handle a far larger volume of inwards reinsurance business then the professional reinsurance companies.

The participation and organization of direct insurance companies as sellers of reinsurance follows 10 uniform patterns. In some groups reinsurance is conducted as an autonomous class of business by a separate subsidiary with little direct interference from the parent management. At the other extreme, inwards reinsurance may be little more than an appendage of the direct – writing operation, the inwards reinsurance activities being limited to the acceptance of facultative reinsurance. It is reasonable to conclude that the attitudes and policies of direct – writing companies to reinsure business likewise display wide differences and any generalisations about their behaviours must be treated with

caution. Perhaps some are more concerned that their professional reinsurance counterparts with short term profitability than with establishing long term relationships with their ceding companies. On the other hand, any company that wishes to write a successful treaty account must gear its organisation and objectives to dealing with that type of business.

Likewise, although direct insurance compares normally tend to acquire all or most of their reinsurance business through brokers, companies that wish to develop their reinsurance accounts must create the right conditions to do so. They need to build up professional staffs with specialist reinsurance knowledge and expertise, and must work hard to establish strong relationships with the brokers who act as their sales force.

And the others;

Underwriting agencies: the transaction of reinsurance business internationally has the obvious advantage of enabling even direct insurance companies whose business is confined to their home market to obtain a geographically distributed portfolio of business. The transaction of international business is highly concentrated on a few recognised centres so that a company wishing to participate on any scale in such business needs to be represented locally.

State insurance and reinsurance corporations

State insurance and reinsurance corporations vary considerably in both their operational methods and in their positions in their domestic insurance markets.

Insurance and reinsurance pools

Under a pooling arrangement a group of insurers form a joint organisation to handle the insurances of particular risks.

[46] R.L Carter,Reinsurance Essentials, 2003.

4.2.3. Brokers

A discussion of reinsurance brokers is hampered by two difficulties: first there is no universally accepted definition of a reinsurance broker, and secondly whatever definition one adopts there is no information available about the numbers of firms involved or the amount of business they handle. Partly these problems arise from the fact that even in countries where insurance business is closely supervised and where agents and brokers operating in the direct insurance markets must be licensed, intermediaries handling only reinsurance business are generally free from regulation.

If the title reinsurance broker is used to describe all of the firms and individuals (including employees engaged in a broking role) who act as intermediaries in the arranging of reinsurance contracts, whether acting principally as agent of the ceding company or of the reinsurer, then it embraces a wide diversity of firms operating in a variety of ways. Moreover, as noted above, some brokers do not merely engage in arranging reinsurances for their clients but also accept reinsurance business for reinsurers too. In some cases a broker may hold a binding authority from a reinsurer to commit it to a specified form of automatic reinsurance for a specific class of insurance and/or type of risk. Some brokers act as underwriting agents, undertaking the acceptance and underwriting of reinsurances on behalf of one or more reinsurer principals. Most brokers also become involved on behalf of one or other party to the reinsurance contract in many administrative activities of reinsurance such as the preparation of contract documents and the preparation of statements of account in markets where this is not handled centrally by a recognised bureau. Whenever brokers find themselves acting for two principals there can be a potential conflict of interests.

The types of organisations acting as reinsurance brokers throughout the world vary considerably in size, location and types of business handled. They range from purely domestic to multinational enterprises with offices scattered around the world; from small partnerships to companies employing perhaps hundreds of staff; and from specialists in particular classes of business (e.g. oil or aviation risks) to organisations handling all classes of reinsurance. In the larger firms, the directors and employees engaged in the role of

broker will be supported by, inter alia, specialist claims brokers, accountants, legal advisers and research staff engaged in the collection of market information and various forms of technical data and other information required for the advising of clients regarding their needs and the most appropriate forms of reinsurance and markets.

Role of the reinsurance broker has been described as[42]:

> "... to professionally advise their client concerning the best type of reinsurance programme, proper retentions and adequate capacity based upon their experience and knowledge of market availability and then place the resultant programme for the client with secure markets at competitive price or terms."

Thus brokers are more than just introductory agents. They hold themselves out as being experts who can be expected to bring to their duties. A detailed knowledge of insurance law, supervisory regulations, market practice and conditions applying in all of the countries in which they deal, and therein lays one of the major differences between reinsurance brokers and the majority of brokers operating in direct insurance markets. Whereas most direct brokers confine their activities to their own domestic markets, the nature of treaty reinsurance business is such that a reinsurance broker must arrange business internationally. Furthermore, unlike the direct broker who will normally be advising a layman in relation to insurance, the reinsurance broker acts as an intermediary between expert professionals, though in many cases a reinsurance broker may be expected to assist clients in identifying their exposures, including potential loss accumulations, and advising on appropriate reinsurance programmes. Faced with the increasing complexity of loss exposures, reinsurance products and markets, reinsurance brokers must endeavour to understand each client's business and needs in order to be able to provide such advice. They will offer advice too on the expertise of individual reinsurers in relation to particular classes of business and types of reinsurance.

Sudekum's reference to the selection of 'secure markets' is of particular relevance at a time when there is increasing concern regarding the soundness of some of the companies

[47] Lothar Sudekum, The Intermediary in International Reinsurance.

that are operating as reinsurers, Most, if not all, large reinsurance brokers have security committees to vet the financial standing of the companies they deal with, and to advise their clients accordingly when placing business for them[43]. Most, if not all, will also subscribe to the various insurance/reinsurance security rating services that are available.

The role of the broker does not end, however, with the placing of the client's reinsurance(s). From the standpoint of a reinsured it will extend to assisting with:

- the preparation of the reinsurance contract wording or, when it is - prepared by the reinsurer, the examination of the contract;
- the administration of the business, including the collection and payment of premiums;
- Claims negotiation and collection.

Also for many clients, especially in developing countries, the broker may be involved in seeking and arranging reciprocal exchanges of business and in the training of staff. Finally, Irukwu comments that[44]:

> "None of the new international reinsurance institutions now taking off in Third World countries can afford to do serious international business without the support of one or two of these international reinsurance brokers."

4.3. International Practice and Problems in Reinsurance Market

A robust economic case can be made for spreading the insurances of certain risks amongst insurers drawn from more than one country. The benefits of doing so are self-evident for: large risks where a single loss may account for a substantial proportion (and in the case of some small developing countries, more than) the premium income of all domestic insurers; catastrophe risks, notably where a country is so exposed to natural perils that a single event may destroy a significant part of its productive and other resources.

[48] UNCTAD Secretariat, "Reinsurance Security", 2004.
[49] J.O. Irukwu, Company, the Shareholder, the Director, and the Law, 1995.

The international spreading of such risks relieves the local insurance of either being unable to meet in full the demand for cover, so depriving the community of the benefits that flow from insurance, or of assuming the risk of incurring losses beyond its financial capacity. Also it the country against random large foreign exchange losses in that payments received from abroad will help to finance the loss of and/or the cost of higher imports caused by the occurrence of the insured event, though premiums payable abroad will be a regular cost to the balance of payments.

This is not the place to debate the respective merits of direct insurance reinsurance as the best means of spreading risks internationally, but either case the benefits are not restricted only to those cases cited above. An exceptional accumulation of smaller losses involving a large exchange cost (such as the loss of imported or exported goods, or a liability to make large payments to foreign third parties) may place a strain on a country's balance of payments which it might be protecting by regular premium payments. There may be competitive advantages too from reinsuring abroad. International reinsurers able to offer lower premiums or a better service than can be obtained locally, or they may spur local companies into improving performance. Finally, major companies and brokers often considerable technical services, advice and training assistance ceding companies and clients. Frequently they take ceding companies employees into their own offices for training, or second their own staff to work with them.

Yet despite those advantages, many restrictions have been placed on international direct insurance transactions, particularly (though not exclusively) by the governments of developing countries. Throughout the thirty years after 1945 when many barriers to trade were being against direct insurers, reinsurance remained relatively less restricted than direct insurance, and indeed benefited from the exclusion of foreign direct insurers from national markets, which usually led to more business] placed abroad with foreign reinsurers. Paradoxically, now that some movement towards liberalising insurance trade, concerns regarding reinsurance security are subjecting international reinsurance transactions to closer scrutiny by governments.

[50] R.L.Carter, Reinsurance, 4th Edition, 2005.

The restrictions on international trade in reinsurance take two forms:

1. Direct restrictions on the placing of reinsurances with foreign reinsurers
2. Indirect restrictions which put foreign reinsurers at a disadvantage in competing against local reinsurers.

Reasons for trade restrictions

Before considering the nature of the various types of restriction, help to try to understand the underlying reasons.

The barriers encountered by reinsurers are not generally erected by local companies anxious to protect themselves from foreign competition (though they may lobby vigorously for such protection), but by governments and supervisory authorities. Their motives fall main headings:

l) To protect local policyholders from the consequences of the insolvency of foreign reinsurers not under the direct control of the local supervisory authority.
2) To build up a local insurance and reinsurance market, possibly as part of the planned growth and diversification of the economy.
(3)To protect the balance of payments and foreign exchange reserves from outflows of premiums and capital funds.
4) To retain funds generated by insurance operations for local investment.
5) To protect national security; i.e. to reduce the dependence of the economy on foreign suppliers of insurance/reinsurance services.

There is some merit in all of the objectives, and indeed the local Mention of a larger volume of business may sometimes serve the best interests of all parties. In earlier chapters considerable emphasis has been placed on the desirability of ceding companies retaining a reasonable of the risks they accept, in that if a company is substantially involved in the results of its business it is more likely to strive to maintain its underwriting standards. Also unnecessary fragmentation of business through coinsurance and reinsurance adds to total administrative costs.

It must be recognised too that developing countries have special needs which warrant special treatment. So it might be justifiable to accept the additional costs of short-term protective measures designed to facilitate the development of local companies, provided they will eventually be capable of withstanding competition unaided on the other hand, the interests of policyholders are not always best served by measures adopted in pursuit of wider economic objectives and, indeed, it may be that their interests are of minor importance when the regulation of overseas reinsurance is under review. Moreover, there are sound reasons for believing that often the indirect economic costs of restrictions on international reinsurance transactions may outweigh the apparent benefits, as will be explained later. First, however, the various of discriminatory measures employed against foreign reinsurers need to be explained.

Direct Restrictions

Reinsurance services may be supplied internationally by a reinsurer either: (a) writing business in a particular country through a local established branch office, subsidiary company, or underwriting agent ('establishment' business); or (b) selling its services from its head office across national frontiers to insurers located in other counties (cross-frontier or 'services' business). Direct restrictions, therefore, take two forms:

(1) Those excluding foreign insurers and reinsurers from establishing in a country, or at best restricting them to taking only a (in minority) share in locally incorporated companies.

(2) Regulations prohibiting local insurers wholly or practically reinsuring abroad.

Particularly from 1945 to the mid-1980s many countries expelled foreign-incorporated or foreign-owned companies as part of the general domestication/nationalisation of their economies, often following the ending of colonial rule. When foreign insurers were permitted to retain share in locally incorporated companies often they were restricted to a minority interest, in some cases as low as 20%, with national interests holding the majority of the, shares and exercising management

[51] I.J Bourke and Jeanette Leitch, Trade Restrictions and Their Impact on International Trade in Forest Products, 1998.

control Although joint-venture arrangements may help to provide access to more sources of business than a foreign insurer may otherwise be able to acquire, they may also create problems, especially if the employment of expatriate staff is forbidden or severely curtailed.

South America led the way in placing restrictions on local companies reinsuring abroad. The state monopoly reinsurance institutions of Argentina and Brazil, for example, were alone given the right retrocede risks to foreign reinsurers. Elsewhere (e.g. Mexico regulations were enacted requiring a certain proportion of all reinsurances to be placed locally before any business could be reinsured abroad. By the end of the 1970s such restrictions had become already feature of the international reinsurance scene, particularly among the developing countries, but today some countries either have already privatised, or are beginning to dismantle their state-owned monopoly corporations, and are generally making their markets more accessible for foreign reinsurers. Regulations requiring local companies to make compulsory reinsurance cessions to state and/or regional reinsurers, and in some cases to offer any balance of their reinsurance needs to the state reinsurer before seeking to place it on the international market, also deprive international reinsurers of business which ceding companies would prefer to place with them.

There are many ways in which international reinsurance transactions, whether on an establishment or cross-frontier basis, can be made more difficult or less profitable to either the reinsurer or ceding company. The following methods are the most common.

Localisation of reserves:

Generally Requests-deposits arise from the regulations of supervisory authorities ostensibly acting to protect the interests of local policyholders. Sometimes reinsurers, whether established in the country or otherwise, compelled to maintain sufficient funds within the country to cover their liabilities to ceding companies. The regulations may also specify the types of securities (usually government fixed interest securities) in which the funds shall be held.

Alternatively the pressure to deposit funds locally may be exercised indirectly through the solvency regulations applying to ceding companies. example, whereas direct insurers may be permitted- to deduct from - premium and loss reserves an allowance for liabilities transferred to local reinsurers, that concession may be withheld for reinsurances placed with non-admitted' foreign reinsurers located abroad. Consequently foreign reinsurers are obliged to deposit premium reserves, and perhaps loss "reserves too, with their ceding companies.

One result of such policies is to fragment international reinsurers' reserve funds. Therefore, in order to provide the same global standard of security to all ceding companies, they must maintain larger capital funds than otherwise would be needed. The servicing of that capital adds to the cost of reinsurance and thus the price of direct insurance.

Local Incorporation:

If establishment is only through local permitted only through local incorporation, capital costs may be increased because a relatively larger capital may be required for a small local company than for a larger group. Again that cost, plus any additional administrative costs, must be reflected premiums or lower profit margins.

Taxation:

Foreign reinsurers, particularly when operating on a cross- frontier basis, are exposed to discriminatory taxation in various, often ex, and frequently changing ways. In many instances the aim may direct more towards reducing the loss of tax revenues than deliberately trying to reduce reinsurance imports.

Sometimes fiscal measures may deter ceding companies from placing business with foreign reinsurers, Some countries have allowed the deduction of reinsurance premiums from taxable income if either they are included in a ret the revenue authority by the non-resident reinsurer and taxed accord, or ceding companies act as agents for non-resident

---

[52] Robert C Reinarz, A reference book of property and liability reinsurance management , 1968.

reinsurers in collecting a withholding tax based on an assumed profit from the reinsurance. Premiums ceded. At least, under the latter arrangement the reinsurer is able to claim double-taxation relief from its own revenue authority.

Elsewhere special taxes are levied on foreign suppliers of reinsurance. In some countries subsidiary companies and particularly branch of foreign insurers and reinsurers are subject to effectively higher rates of corporate tax than domestic companies. Some governments attempt to. Reach out through the use of withholding taxes to tax non resident reinsurers on income which they claim originates in their countries.

Exchange control regulations:

Many countries impose exchange controls on the remittance of funds abroad for current trading transactions, usually even more stringent controls on capital movements, such regulations can seriously impede the settlement of accounts for overseas reinsurances, to the detriment of both ceding companies and reinsurers.

If ceding companies cannot remit balances to their reinsurers, overseas reinsurers effectively face a one-way bet - if losses exceed premiums they will be expected to pay the balance, but without hope of receiving early payment if premiums happen to exceed losses. Restrictions on the investment of foreign balances may further exacerbate the position if reinsurers are thereby prevented from earning a reason return on their funds. However good may be the technical results treaty, it cannot be regarded as a financial success if the reinsurer is unable to obtain control of favourable balances. The problem can be particularly acute if for some reason the contract is retroceded so that the reinsurer is responsible for the payment to retrocesssionaires of premiums it itself obtain from its own cedants.

Even when no official exchange controls are imposed on the remittance of premiums, claims payments or reinsurance balances, inordinate administrative delays in obtaining authorisation from a central bank to remit funds can have much the same effect.

In such circumstances, reinsurers may be unwilling to supply over, and if ceding companies cannot obtain speedy settlement of claims they will be equally reluctant to purchase reinsurance from abroad. Some countries have imp exchange control regulations which, by officially delaying the remit abroad of reinsurance premiums, operate like deposit regulations.

Exchange control restrictions on capital movements may also adversely affect the profitability of overseas reinsurances. Restrictions have mainly been imposed by governments with weak currencies. However, during the 1970s countries with strong currencies, notably Germany and Switzerland fried to protect themselves from capital inflows by placing restrictions on the types of securities foreigners could purchase and by charging negative rates of interest on bank deposits. Though designed to deter inflows of 'hot money' from speculators, reinsurance transactions were also caught by the same restrictions, so putting foreign reinsurers accepting business from those countries at a disadvantage compared with domestic reinsurers[48].

Barriers to international trade are not erected solely by governments of importing countries, but by exporting countries too. This point is particularly important in relation to exchange control regulations. If reinsurers or brokers are required to surrender all premiums received in foreign currencies and hold balances in their domestic currency, then they lose the opportunity to match foreign liabilities with assets in the same currency. Such an interference with commercial judgment may not matter if the reinsurer's domestic currency is strong on the foreign exchange markets, but the consequences can be near disastrous if the reinsurer is forced to hold a weak currency.

Solvency regulations:

Obstacles to overseas reinsurance transactions on a cross-frontier basis may also be erected by the governments of exporting countries through their own insurance solvency regulations. If foreign assets are deemed inadmissible for the purpose of establishing solvency, a reinsurer that accepts business from abroad must either maintain a higher level

---

[53] R.L.Carter, Reinsurance, p. 756 1995.

of free reserves or convert all foreign premiums into its own currency, in so far as that is possible.

Trends in trade policy:

As noted above, the political climate during the first three decades after the end of the Second World War generally became less favourable wards international insurance operations. Although reinsurers did not fare as badly as direct insurers, and indeed sometimes gained at their expense, nevertheless the tendency was for an increasing number of restrictions to be placed on reinsurance transactions.

First, in the late 1940s the Central and Eastern European countries that id been seized by Communist regimes followed the example set by the Soviet Union in the 1920s of expropriating all private insurance companies. China, India and arts of Latin America followed suit in the 1950s, as did large numbers of ex-colonial territories, particularly in Africa and the Middle East. As the latter gained their political independence, so they sought to establish their economic independence too. Many therefore sought to foster the development of indigenous insurance markets, often in the process expelling foreign direct insurers from, or at least reducing their interest in, their local markets, and establishing state-owned monopoly reinsurance corporations. Throughout the developing world attitudes towards insurance business during the 1950s to 1970s increasingly became inwards looking, though UNCTAD did encourage countries to co operate at a regional level. Although such measures, including those relating to reinsurance, were aimed at reducing a country's dependence upon foreign suppliers, not infrequently resulted in larger imports of foreign reinsurance services in lieu of direct insurance supplied by foreign or foreign owned insurers. Eventually by the end of the 1970s there were signs that attitudes were beginning to change.

[54]UNCTAD Secretariat, "Reinsurance Security", 2004.

5. EFFECTS of SEPTEMBER 11, 2001 TERRORIST ATTACKS on REINSURANCE

The phenomenon of terrorism is difficult to define in unambiguous terms. However, 11 September has brought to light a new dimension of international terrorism, with a staggering, previously inconceivable scale of threat scenarios and loss potentials

Terrorism risk in many ways closely parallels natural catastrophe risks such as earthquakes, storms and floods. In both cases, enormous inherent loss potentials make diversification difficult to achieve; individual events can affect entire economies and many different insurance lines of business.

And yet, there are also significant differences: unlike terrorist attacks, natural hazards occur randomly and without intent, and their probabilities and consequences can be modelled with scientific data and methods.

Terrorism risk insurance before 11 September

Historically, fire insurance covered fire and explosion damage regardless of its cause, with the exception of damage caused by war, civil war or civil commotion

Since terrorism in most countries was not part of the war exclusion clause, fire or explosion damage resulting from a terrorist attack was covered. Special regulations or pool solutions with state support are in place to cover terrorism risk but only for a few particularly exposed countries: UK, Spain, South Africa and Israel.

---

[55] Douglas Holtz-Eakin, "Federal Terrorism Reinsurance",CBO Testimony, 2005.

The new challenge after 11 September 2001

In December 2001, Swiss Re issued a preliminary sigma review of the year 2001 catastrophes[51]. Total insurance losses of the September 11, attack on the World Trade Center are still difficult to quantify. The resulting loss total is certainly much higher than the amount incurred by Hurricane Andrew, now the second largest insurance event in history, which hit Florida in 1992 and amounted to some USD 21 bn in 2001 values.

Before 2001, the largest man-made property insurance loss was the Piper Alpha oil platform explosion in 1989 with a loss amount of USD 3.0 bn in 2001 values, which in terms of the loss triggered by the World Trade Center event was more than 10 times less. These dimensions illustrate that both the severity and frequency of loss exposure have become virtually immeasurable. The potential extent of fatal and disruptive effects is compounded by various factors. Modern technology and extremely effective and lethal weapons are available to terrorists.

Further, terrorists will be ready to sacrifice their own lives to maximise damage, disruption, horror and the number of fatalities. The size, complexity and vulnerability of certain targets – such as densely overbuilt downtown areas or financial centres – enable perpetrators to achieve staggering consequences with relatively simple concentrated attacks.

New terrorism and insurability

Before September 11, terrorism loss potentials appeared to be manageable for the private insurance industry. Accordingly, terrorism risk was largely covered on a private basis.

Since that date, new dimensions of terrorism have prompted a surge in demand for insurance protection against this type of threat. At the same time, the insurance industry is

[56] Schmitter, H, Setting Optimal Reinsurance Retentions, Swiss RE Publishing, Zurich, 2001.

compelled to fundamentally review its risk acceptance position, and to reduce and limit coverages granted to avoid unmanageable exposures in the future.

The question whether terrorism risk is insurable at all must be fundamentally reviewed. The necessary criteria for the insurability of risks in general need to be examined first:

Assessibility: The probability and severity of losses must be quantifiable.

Randomness: The time at which the insured event occurs must be unpredictable, and the occurrence itself must be independent of the will of the insured.

Mutuality: Numerous persons exposed to a given hazard must join together to form a risk community in which the risk is shared and diversified.

Economic feasibility: Private insurers must be able to charge a premium which is commensurate with the risk.

Obviously, terrorism risk does not readily meet all of these criteria. Available data from past events reveals little about the future risk. Although terrorists do not act randomly, but strike by surprise and purposefully maximise effects, their attacks are random for their victims. Mutuality is difficult to achieve given the major differences in terrorist hazard exposure between landmark risks and most other buildings. The tremendous loss potentials and the risk of co-ordinated terrorist actions throughout the world hamper diversification. And finally, with the apparent uncertainties regarding the risk quantification, the economic feasibility of the business is extremely doubtful.

---

[57] Schmitter, H, Setting Optimal Reinsurance Retentions, Swiss RE Publishing, Zurich., 2001.

State involvement

Some major hurdles to insurability can be overcome through state involvement.

The state as the insurer of the last resort is in a better position to deal with extreme loss potentials than private insurance companies with their limited capital and capacity. Government can declare terrorism insurance mandatory and spread the risk throughout an entire society. Pricing uncertainty can be overcome by adjustment based on loss experience. This approach generates significant funds permitting even large future losses to be covered.

Terrorism risk can be insured to a certain extent without state involvement. However, accumulating the necessary private insurance capacity takes time. We expect the private insurance industry in the US to develop – over the next three to four years – the means to cover terrorism, using an approach similar to that for natural catastrophe risks.

In the case of acute incompatibility between supply and demand for terrorism insurance – as is currently the case in the US market – temporary solutions permitting an efficient combination of private and public resources are appropriate, based on the following principles:

- Automatic terrorism cover for all property risks.
- Levy on current property premiums.
- Sharing the loss burden among all parties involved, ie insured parties, direct insurers, reinsurers and government.

In this situation, the government would be in the dual function of establishing rules to impose a certain degree of solidarity to overcome insurance capacity shortage, and acting as an insurer of the last resort by providing financial capacity for very large loss events exceeding private insurance capacity. Government involvement can be significantly reduced or gradually phased out in response to the accumulation of private insurance capacity.

Consequences for insurers and reinsurers

Regardless of the degree of state involvement, the challenge of terrorism calls for an appropriate response by the insurance and reinsurance sector. Terrorism risk must be treated on the basis of established principles of risk assessment and management.
Terrorism cover can be offered only on a limited, selective basis against payment of an additional premium which reflects the individual risk. Unless solidarity is imposed through some form of state involvement, landmark risks will inevitably be subject to high premium rates. Cover conditions must ensure that risk sharing among the insured, direct insurers and reinsurers is well-balanced, and that overall exposures are kept within predefined limits.

Terrorism – dealing with the new spectre

The days since September 11, have been ones of re-evaluation on different levels – personal, societal, political and industrial. New core issues are now emerging for the insurance industry.

The devastating attacks on the World Trade Center and Pentagon have shown that terrorism threat has become virtually immeasurable in terms of both the severity and frequency of exposure – making it difficult for the private insurance industry to adequately cover this risk. While international terrorism is hardly a new phenomenon, these attacks have brought to light a staggering, previously inconceivable scale of threat scenarios and loss potentials.

6. REINSURANCE PRACTICE in EU COUNTRIES

6.1. Background of Reinsurance in EU Countries

Direct insurance activities in the EU are regulated and supervised in accordance with directives[53]. These have been in force for 10-25 years and have been reasonably successful in assuring harmonised establishment and supervision rules, being the absolute prerequisites for the creation of a single market in insurance. The rules are comprehensive and have over time been changed several times, and a long awaited codification of rules for life and non-life insurance is now under way.

Insurance groups are supervised in accordance with Directive 98/78/CEE and further work is going on for insurance undertakings and banks belonging to financial conglomerates.

There are currently no prudential directives dealing with reinsurance. The only directive directly dealing with reinsurance is 64/225/EEC5 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession. The issue of creating a single licence or a passport for reinsurers is not dealt with in this Directive.

Concerning the actual supervision of reinsurers, a Commission questionnaire showed that all but one Member State supervise reinsurers either directly or indirectly. There appears to be a movement towards direct supervision. However, direct supervision does not exclude indirect supervision and it may be difficult to draw a sharp boundary between the two.

With regard to direct supervision, domestic reinsurers are supervised more stringently than non-domestic reinsurers. This may appear paradoxical but it also perhaps reflects the greater difficulty of supervising effectively non-domestic reinsurers. For domestic reinsurers, all Member States require the submission of annual accounts and have

[58] Council of the European Union, Commission Staff Working Paper: "Extended Impact Assessment", 2002.

the power to carry out on-site inspections. Other important supervisory powers are the ability to: impose fines, examine the sufficiency of technical provisions and require managers to be fit and proper.

With regard to indirect supervision, domestic reinsurers are again more strictly supervised than non-domestic reinsurers. Important supervisory functions are to examine: the financial solidity of the reinsurer, the spread of reinsurance business and assessments carried out by rating agencies.

Obstacles to reinsurance cross-border business

Although reinsurance is probably one of the most international service industries, there are still obstacles to cross-border business. The CEA and the OECD have identified certain types of obstacles to be found to cross-border business in the EU as well as internationally.

In the EU, the CEA and the OECD identify administrative impediments like requirement for an auditor's confirmation of balances as well as the obligation for branches to issue financial statements according to local GAAP (generally accepted accounting principles) for the whole group. Certain EU countries also use systems where assets of the reinsurer must be pledged in order to cover outstanding claims provisions.

Internationally also other impediments can be found. Certain countries still have monopolistic situations in reinsurance through one privileged (often state-owned) company. Other countries require compulsory cessions in certain line of business to a state company or to identified national reinsurers. Furthermore there are supervisory restrictions like requirements to register in the country in the host country, or limits to cessions (cross-border reinsurance can not make up more than a certain percentage of total cessions, or that it can only be used when national capacity is exhausted). Other jurisdictions also require excise taxes or withholding taxes from foreign reinsurers.

[59] Pfeiffer, Christoph, Reinsurance, 1992.

6.1.1. Market Capacity

With no major catastrophe losses affecting the world wide market in 1996, capacity should remain plentiful and relatively in expensive. Further price reductions are still possible, but they are unlikely to dublicate the reductions enjoyed to date simply because the market cannot fall much farther given the narrow spread between investment gains and underwriting losses.

Increaded capacity can be attributed to a number of converging factors, among them;

- An evolutionary change in the traditional relationship between insurers and reinsurers. Large reinsurers are becoming more aggressive competitors by directly soliciting large accounts and circumventing traditional primary markets.
- A concentration of large risk underwriting, creating larger blocks of available capacity.
- Consolidation among reinsurers, such as Munich Re/British Mercantile, and General Re/Employers Re.
- New capacity from non – European insurers and reinsurers.
- Stronger overall market capitalization.

In this era of worrisome budgetory deficits, governments (e.g., Italy and France) are moving to privatize the relatively low – return business of assest protection. In addition, privatized companies will be under pressure to increase profiability through cost – cutting, reorganization, the use cost – effective technology and partnerships with other insurers.

6.1.2. Mergers and Acquisitions

The trend toward greater M&A activity in the insurance industry is part and parcel of a general business trend. As both investment banks and venture capital firms enhence their presence on the continent, the M&A activity witnessed in the UK during the past several

years will expand in to the rest of Europe. Take over targets include companies being privatized, as well as the underperforming subsidiares and divisions of major European conglomerates being pressured by shareholders to increase profitability.

The amount of capital available in Europe for both M&A and new ventures is unprecedented. This activity will require risk managers to become active members of the companies' due diligence teams. Risk managers are critical to retask of identifying and quantifying potential pollution liabilities, hidden liabilities (e.g., long term, non-cancable contract), and severance cost related to restructurings and relocations.

Megamergers will continue to come under the scrutiny of EU commisioners, creating delays in final approvals which, in turn, will cause significant added cost. Moreover, they may result in business strategies becoming part of the public record and, thus, easily accessible to competitors.

6.2. Policies of Reinsurance

6.2.1. Reinsurance Directive

6.2.1.1. Purpose of Directive

The purpose of the proposed Directive is to harmonize the supervision of reinsurance business in the EU. A reinsurer is an insurance company that assumes liability for some part of a policy written by another insurance company. Using reinsurance helps spread out risk and limits the possible maximum loss faced by the company that wrote the original policy.

The Commission has three specific objectives in harmonising EU reinsurance supervision[55].

[60] Reinsurance Directive, "Regulatory Impact Assestment", 2005.

Objective 1: Establish a sound and prudent regime in the interest of policyholders. Strong and well-supervised reinsurers contribute to a stronger internal market and international financial stability. This objective addresses uncertainty for direct policyholders, barriers to trade and administrative burdens. As the UK already applies a similar approach to the proposals, they should bring the EU more in line with UK practice and will therefore reduce regulatory arbitrage and benefit UK-based reinsurers.

Reinsurers also benefit by not having to implement different regulatory regimes in different countries. Greater financial stability should benefit direct insurance companies and their policyholders.

Objective 2: Allow mutual recognition of licensed companies so they can conduct reinsurance business all over the European Community under freedom of establishment and the freedom to provide services. This also addresses uncertainty for direct policyholders, barriers to trade and administrative burdens, but in addition it should also be beneficial for the EU position in international trade negotiations. Like objective 1, the main beneficiaries should be reinsurers, direct insurers and their policyholders.

Objective 3: Abolish systems, which require the pledging of assets to cover outstanding claims provision. This primarily addresses barriers to trade and will help improve the EU position in international trade negotiations.

This is likely to raise the level of reinsurance underwritten from the UK. For instance, UK-based reinsurers do not generally underwrite French insurers, because they will be subject to UK solvency requirements plus French collateral requirements. However with collateralisation removed it may be more efficient for reinsurers to underwrite such business from the UK. Therefore the primary beneficiaries from this are reinsurers, direct insurers and their policyholders (reaping the benefits of a more efficient reinsurance market).

In order to facilitate a 'fast track' approach to adoption and implementation of the Directive, the Commission is proposing that the regime for pure reinsurers is based on the

existing regime for direct insurers, and uses similar solvency parameters (mixed insurers – i.e. firms which write both insurance and reinsurance business – are already covered by the regime for direct insurers).

Thus the Directive proposals will in particular[56]*:*

Introduce a mandatory licensing system, under which an EU reinsurer would be able to write business anywhere in the EU under the authorisation and supervision of its home state supervisors.

Remove collateral requirements that currently exist in some Member States and prevent new ones being imposed.

Set minimum non-life reinsurance solvency margins in line with those already applying in the EU to direct non-life insurance; and set minimum life reinsurance solvency margins in line with those already applying in the EU to direct life insurance.
The following table provides a summary of the main groups who are likely to be directly affected by the proposal.

[61] Reinsurance Directive, "Regulatory Impact Assestment", 2005.

Group	Reason
Reinsurance firms	Pure reinsurance firms across the EU will have to apply a new regulatory regime for their business. The proposals are very similar to the regime currently applied in the UK. The licensing system will also provide easier access to other markets and could also lead to competitive efficiencies.
Insurance firms	It should become easier for direct insurance companies to evaluate the financial soundness of different reinsurers. Life insurance firms may experience increased reinsurance costs on the basis of the Commission's proposals for life reinsurance solvency margins.
Policy holders of insurance firms	One of the objectives of the Directive is to establish a sound and prudent regime in the interest of policyholders. However, customers of life insurance firms may experience an increase in premiums.
Financial Services Authority	The FSA will have to make a number of modest adjustments to the current UK supervision of reinsurers to align it with the new Directive.

Table 1: main groups who are likely to be directly affected by the proposal.

6.2.1.2. Options for the Implementation of Directive

The UK faces three broad options; either to oppose the Directive, to support it, or to support it subject to seeking specific amendments on life reinsurance solvency requirements. The Commission's proposals will also introduce a single passport system, and remove collateral requirements. The cost and benefits of each of these elements are considered in the analysis below.

6.2.1.2.1. Oppose to the Directive

- The EU will continue to have inconsistent supervision of reinsurers. Some countries will continue to not subject their reinsurance organisations to comprehensive supervision, while others (including the UK) will[57].
- Current UK solvency requirements will continue to apply to UK-based reinsurers.
- The reinsurance reduction factor will remain at 50%. UK reinsurers who transfer part of the risk on their books to another reinsurance company (this is known as 'retrocession') or to their parent company or another part of the group, will be allowed continue to reduce solvency requirements by up to 50%.
- The current UK minimum guarantee fund (the minimum capital required to do business) will remain at €3 million for UK-based reinsurers.
- While the UK does not have collateral requirements, UK-based reinsurers will continue to be subject to collateral requirements when doing business in some other Member States.

[62] Reinsurance Directive,"Regulatory Impact Assestment", 2005.

6.2.1.2.2. Support the Directive

- The mandatory licensing system will provide easier access to other EU markets for UK reinsurers.
- Solvency requirements for non-life reinsurance will mirror the EU requirements for non-life insurance. This means they will remain unchanged from their current levels in the UK. (However, through comitology, the non-life solvency margin on non-liability business could be raised by up to 50%, if further analysis of risks of different business lines suggested that was appropriate5).
- Solvency requirements for life reinsurance will mirror the EU requirements for life insurance. This means pure life reinsurance in the UK will potentially face significantly higher solvency requirements, as FSA solvency requirements for pure life reinsurers are currently considerably lighter than the Commission's proposal. The Association of British Insurers (ABI) estimate solvency requirements will increase by an average of 140 per cent.
- For life reinsurance business, reinsurers will be only allowed to reduce solvency requirements by 15% under retrocession, rather than by 50% as now.
- The minimum guarantee fund will be set to €3 million (for an industrial or commercial captive reinsurance firm - an autonomous and licensed subsidiary established to cover part or all of the risks of its parent – the requirement will be €1 million). Currently there is no EU-wide minimum guarantee requirement but some Member States do currently set a minimum requirement of €2 million.
- The proposals will remove collateral requirements (the UK has no collateral requirements). Some Member States require reinsurers to pledge assets to over outstanding claims provisions.

6.2.1.2.3. Support the Directive Subjectively

	Do nothing (Directive not implemented)	Apply Commission's proposal
Life solvency requirements	About 33% of net in force premiums.	About 79% of net in force premiums.
Non- life solvency requirements	About 25% of gross premium written for all business (ignoring the retrocession reduction)	Under the proposals it would be 25%, rising to 30% if CEIOPS exercised all the options to increase requirements.
Collateral requirements	Collateral requirements vary between countries. UK does not have collateral requirements but some other Member States do.	Removes the collateral requirements existing in some Member States and prevents new ones being imposed.
Reinsurance reduction factor	Under retrocession all reinsurers are allowed to reduce solvency requirements by up to 50%.	The Commission's proposal will only permit life reinsurers to benefit by up to 15%. (Non-life reinsurers will continue to benefit from a 50% reduction.)
Minimum guarantee Fund MGF)	The current MGF level varies with the type of business. It is €3 million for life reinsurance, €2 million for non life reinsurance, rising to €3 million if any part of the non life reinsurance is liability or credit (there are reductions for mutuals)	€3 million for all reinsurance.
Licensing	The license to do reinsurance business has to be obtained from each Member State in which a firm wants to do business in.	Once a license has been obtained from one Member State, a firm is free to do business in other Member States.

Table 2 Some key differences between the current UK reinsurance regime and the Commission's proposal (as currently drafted).

6.2.1.3.Benefits and Costs of Reinsurance Directive

6.2.1.3.1. Economic Benefits and Costs

- Compliance costs: The Commission's proposals are similar to current UK supervision of reinsurers by the FSA. Therefore additional compliance and administrative costs are likely to be marginal.
- A new EU-wide regime: The introduction of a new EU-wide mandatory licensing system under the Commission's proposal will provide easier access for UK-based reinsurers to other Member State markets under the Single Market "passport". Increased market access should feed through to higher profits for UK-based reinsurers if they are competitive.
- The proposals will lead to more consistent and effective supervision of reinsurers in other EU Member States, and reduce the administrative burden of compliance for those firms doing business in more than one Member State. This should lead to increased competition within the EU and pressure on prices to fall. Furthermore, greater certainty for direct insurance companies will put pressure on premiums to fall. Both of these outcomes will benefit policyholders.
- The proposals should strengthen the EU's hand in trade negotiations with third countries. It may lead to a more competitive position in relation to the US, where collateralisation applies.
- It will also help to complete a single market in financial services as set in the Financial Services Action Plan (FSAP). Since current UK supervision of reinsurers is similar to the proposals, the UK is unlikely to benefit from the Directive to the same extent as other Member States that do not currently have as comprehensive supervision of their reinsurance industry. However, the adjustment costs to the new proposals for the UK are likely to be proportionately less than for other countries.
- Capital requirements: Changes in capital requirements are one of the drivers of firms' costs and benefits. There are three key issues regarding capital requirements and the Directive proposals – solvency margins, regulatory versus economic capital and collateralisation.

6.2.1.3.1.1.Solvency Margins

Solvency margins are set to reduce the risk of reinsurance failures. They help to reduce systemic risk and provide a buffer against unexpected shocks. Their aim is to create greater stability in the market place. Solvency margins should be set having regard to probability of default. Setting requirements too low could introduce instability, but setting them too high will impose higher costs, such as the opportunity cost of holding additional capital and lead to a lower supply of reinsurance.

The solvency requirements for non-life reinsurance under the proposals are to remain similar to current UK requirements. However, the margins for life reinsurance are raised under the proposals. The current UK solvency margin for life reinsurance is 1 per mille (0.1%) of the capital at risk8. The Commission's proposal raises it to 3 per mille (0.3%)[58].

Rating agency assessments of the credit worthiness are important factors for insurers to take into account when selecting reinsurers.

The rise in solvency margins for life reinsurance proposed by the Commission does not appear justified.

The Directive also needs to set solvency margins with an eye to the global nature of reinsurance business, otherwise there is a risk that business will simply be driven out of the EU. Furthermore, life reinsurance capital requirements should be different from direct life capital requirements. Requirements for the latter were set about 30 years ago. Improvements in health since then have meant changes in mortality rates and hence the risk firms are exposed to.

---

[63] Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003.

Under the Commission's proposals the reinsurance reduction factor for retrocession will also be reduced from 50% to 15% for life reinsurance. Industry estimates that with increased solvency margins for life reinsurers and reduced reduction factor, there would be a requirement to hold approximately an additional £700 million9 of capital. The opportunity cost of this extra capital adds about a further £24.5 million10 to total costs (these are ongoing costs but will depend on factors such as level of risk and quantity of business underwritten). With most life reinsurers underwriting life reinsurance only, this is likely to exclusively impact the life reinsurance market. The changes that we are seeking to make to the Commission's proposals will bring the Directive in line with current UK requirements for life reinsurance so that the increase in capital requirements and the associated costs are minimal.

However, firms are likely to restructure their organization to minimise the additional cost imposed on them. This figure is therefore likely to be an upper estimate of the additional burden, even before the impact on economic, as opposed to regulatory, capital is considered.

6.2.1.3.1.2.Regulatory versus Economic Capital

The amount of capital that a firm assesses is prudent to hold, to meet regulatory and other business needs, is referred to as economic capital. In terms of impact on reinsurance premia and price what matters is the change in economic rather than regulatory capital. Regulators typically expect reinsurance companies to hold a level of additional capital in excess of the total required solvency margin. In the UK this is broadly of the order 150%+ of the required solvency margin. If life reinsurers did have to hold an additional £700 million capital, as suggested, then it would reduce this margin to around 4% unless they raised their total (economic) capital to compensate. However for reasons explained below we would expect economic capital to rise but perhaps not enough to maintain the 150%+ margin.

Reinsurers may hold significant amounts of economic capital to avoid costs related to market discipline and supervisory intervention. In addition, they can hold economic

capital to: avoid the risk of losing market confidence; as insurance against difficulties in raising new capital; for strategic and reputational reasons, such as to finance mergers and acquisitions, or to satisfy rating agencies prior to expansion into other markets; and to allow flexibility in decision making. Institutions will typically also hold economic capital to accommodate fluctuations in market risk requirements, which may be volatile.

Some studies have shown that there is a positive but non-linear relationship between economic and regulatory capital in the banking sector. We believe this is also likely to be the case for reinsurers. Thus, some of any increase in regulatory capital is likely to be absorbed. But there would still nevertheless be an increase in economic capital, creating, as already illustrated, pressure for a rise in premiums and prices. To some extent, this can be mitigated by the gains made from removing collateralised systems in other Member States. However this depends on how the firm will decide to spread the gains to different business lines and the impact of any pressure to restructure due to higher solvency margins.

The changes that we are seeking to make to the Commission's proposals will bring the Directive in line with current UK requirements therefore minimizing the impact on economic capital.

6.2.1.3.1.3.Collateralisation

The proposals would remove all collateral requirements within the EU. This will benefit UK reinsurers by reducing barriers to trade and therefore provide greater access to some markets for reinsurance. Currently UK-based reinsurers generally do not do business in collateralised markets. This is because they will be subject to both UK solvency margins as well as foreign collateral requirements.

The removal of collateral could lead to more efficient risk sharing, thus improving profitability and supporting greater financial stability. However, a reinsurer's decision to provide insurance cover is not solely based on collateralisation issues but will also depend on other factors (competition, market size, etc). This, along with current UK-based

reinsurers practice of not doing business in markets requiring collateral, makes it difficult to estimate the likely benefits from the removal of collateral. But there could potentially be considerable benefits from increased access.

6.2.1.3.2. Environmental and Social Benefits and Costs

There are no significant environmental and social benefits or costs.

In conclusion the cost/benefits analysis (including analysis in annex 1) suggests that the Commission's proposal to set life reinsurance solvency margins at 3 per mille will not provide a net gain to the UK. The Directive does offer a potential net benefit if the solvency margins are set at levels similar to those currently used in the UK as in the third option.

6.3. Problems Affecting the EU Reinsurance Market

There are currently no harmonised reinsurance supervision rules in the EU. The lack of an EU regulatory framework for reinsurance has resulted in significant differences in the level of supervision of reinsurance undertakings in the EU. The different national rules have created uncertainty for direct insurance companies (and their policyholders); barriers to trade within the internal market, administrative burden and cost as well as weakening the EU position in international trade negotiations:

6.3.1. Uncertainty for Direct Insurance Undertakings (and Their Policyholders)

The different reinsurance supervision regimes in the EU have resulted in increased difficulties for direct insurance undertakings to choose their reinsurers in a prudent and cost-efficient way. The selection of reinsurers is of decisive importance for an insurance company, and could also affect the company's ability to pay claims towards policyholders.

[64] Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003

6.3.2. Barriers to Trade

Certain EU countries use systems where assets of the reinsurer must be pledged (collateralised) in order to cover outstanding claims provisions. This makes optimal investment management more difficult and thus results in higher operational costs for reinsurance undertakings. This could in fact increase the price the reinsurer charges for taking over risks from direct insurance companies, and this pattern has been seen in certain Member States. Reinsurance companies may also decide not to be active in markets where the posting of collaterals is required, and consequently the availability of reinsurance protection will be more restricted.

6.3.3. Administrative Burden

In the EU, the CEA and the OECD have identified administrative impediments for cross border reinsurance services. The lack of mutual recognition between EU supervisory authorities in reinsurance in certain cases means that reinsurance undertakings are subject to different supervisory rules in several Member States. For reinsurance companies this could lead to significant double work and increased administrative burdens. Examples of burdensome administrative measures are the multiple fit and proper checks of the group's highest management, double requirement for auditors' confirmation of balances as well as the obligation for branches to issue financial statements according to local GAAP (generally accepted accounting principles) for the whole group.

6.3.4. International Trade Negotiations

It is argued that the lack of a harmonised EU system makes international mutual recognition agreements more difficult. The absence of such agreements means that European reinsurers are confronted with important barriers to entry into foreign markets, such as the requirement of posting collateral for the value of their commitments in the foreign market where the reinsurer intends to conduct business.

[65] Reinsurance Directive,"Regulatory Impact Assestment", 2005.

Underlying drivers internationally to the process

There are several underlying international drivers to this process:

• ***G7*** and the ***IMF*** have expressed concern that lack of reinsurance regulation could impede international financial stability. In fact, at recent Financial Sector Assessment

Programme (FSAP) reviews in Member States, IMF has reiterated the need for legislation in this field.

• The ***FSF*** (Financial Stability Forum) has repeatedly expressed concerns about the transparency of the reinsurance market and has therefore created a task force to address the issue[61].

• The ***OECD*** has ongoing work in the reinsurance field, particularly as concerns exchange of reinsurance company information between supervisors.

• The ***IAIS*** (International Association of Insurance Supervisors) reinsurance work is closely coordinated with the EU fast-track project. A set of principles for minimum requirements for supervision of reinsurers as well as a standard on reinsurance supervision have been adopted.

Regulatory assessment – subsidiarity and proportionality

Before the formal initiation of the reinsurance supervision project, the Commission Services ordered a large study on general background issues13. One specific part of the study related to arguments for and against reinsurance supervision in general, and in the EU in particular.

---

[66] Available on site http://www.fsforum.org/home/home.html

The consultant[62] identified the following arguments in favour of reinsurance supervision in the EU:

- Harmonised reinsurance supervision would contribute to financial stability through more transparent supervision and reduced regulatory arbitrage. This fact has been highlighted by several international organisations (see above).
- Streamlining of supervisory requirements that today vary substantially between Member States would reduce internationally active companies' compliance costs and reduce their administrative burden.
- Through the removal of barriers to entry, harmonised reinsurance supervision will lead to a more efficient internal market for reinsurance services.
- Reduced costs to market participants due to the disappearance of market barriers.
- Indirect additional protection for policyholders as insurance companies would be more able to make a prudent and cost-efficient choice of reinsurers.
- Improved transparency of the European reinsurance market as EU reinsurers will be subject to a harmonised supervisory framework.
- A supervisory system could give a quality mark to the EU reinsurance sector and increase its competitive situation world-wide. This is particularly important as the EU is the world's largest provider of reinsurance services.
- Reduction in insolvency risk for EU reinsurance companies due to the introduction of harmonised quantitative and qualitative solvency requirements.
- Increased bargaining power in trade negotiations with non-EU countries. The lack of a harmonised EU reinsurance framework has been an issue in recent discussions with US regulators and the US insurance/reinsurance industry.
- Cost savings for supervisors as duplication of work between control authorities in different countries can be avoided. This is important also for the insurance industry that directly or indirectly normally finances the supervisory authorities.

[67]Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004.

The consultant found the following arguments against reinsurance supervision in the EU:

- Reinsurance is an activity between professional buyers and sellers. As there is normally no direct link between the reinsurer and the policyholders, the need for supervision is less than in direct insurance. In addition strong market practice has been developed over many years.
- The global nature of reinsurance makes it less suitable to national supervision schemes, which could in fact become be barriers to trade. Many direct supervisory schemes tend to have a domestic focus that is less relevant to reinsurance.
- The wide range of activities and business lines of a reinsurer may be difficult to capture in a supervisory system. It is a tall order for a national supervisor to be knowledgeable in such a wide field.
- A more severe EU reinsurance supervision system could disadvantage EU reinsurance companies, and some may leave the EU for an off-shore location.
- Reinsurance solvency requirements could increase reinsurance undertakings cost of capital. Particularly after the 9/11 terrorist attacks, the cost of capital for reinsurance undertakings has increased. The introduction of high solvency margin requirements would increase the capital costs further.
- Additional cost for supervisors as well as difficulties to find experienced reinsurance staff. Already today it is difficult for supervisory authorities to find and keep experienced reinsurance staff.
- Reinsurance is an insurance activity and therefore direct insurance rules should apply, and not specific reinsurance regulations. Different rules between insurance and reinsurance could make it increasingly difficult to create a level playing-field.

6.4. Projects of Reinsurance in EU Countries

6.4.1. Projects of Directive

6.4.1.1.Consultation with Small Business

Having consulted small firm associations and groups, it is unclear how small firms will be impacted. The reinsurance industry in the UK is composed large organisations, and because they base prices on economic capital it difficult to assess the impact a change in regulatory capital will have on premiums and prices.

The Commission's proposal is expected to have only a small impact on non-life reinsurers and, on insurers and their customers. This is because the new European regime is little different to the regime currently in operation in the UK.

However, the proposals for life reinsurers will have a significant impact not only on life reinsurers themselves, but possibly also on direct life insurers and their customers. Life reinsurers will need to carry more capital than they currently do and it could lead to increased prices charged to direct insurers which could be passed on to retail customers. With smaller insurance firms tending to purchase more reinsurance cover, because they have lower amounts of capital and seek to protect it, this may mean they are relatively more vulnerable. However as explained these effects are hard to quantify.

6.4.1.2.Competition Assessment

The following table highlights the competitive changes that are likely to occur due to the Commission's proposal. The first column highlights key areas that are likely to reduce competitive pressures within the UK reinsurance market, the second column covers areas that are likely to lead to no change, and the last column covers areas that are likely to improve competition.

[68] Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004.

Damaging competition	The minimum guarantee fund (the minimum business) will be set at €3 million. This may smaller firms who have relatively less resources competitors. Higher solvency margins for life reinsurance lower volumes of life business. Some firms could potentially decide to outside the scope of the Directive to avoid solvency requirements.
No change to competition	A few firms dominate the Reinsurance market. However, no one firm has more than 20 percent of the market share, with the three largest firms accounting for 44 per cent of the total. The proposal is unlikely to change this structure. With the UK currently applying a similar regime to the proposal there is unlikely to be significant changes to the market structure, higher ongoing or set up costs for new or potential firms. Furthermore the change in the burden of implementation should be small for all firms. With new developments in products (such as securitisation) and advancement in risk management techniques, the reinsurance market is characterised by fairly rapid technological change. The proposals should not have an impact on a firm's ability to choose the price, quality, range or location of its products. It sets the adequate level of capital a firm would be required to hold for doing reinsurance business (with requirements changing according to product – life or non life) and lets the market determine price.
Improve competition	The proposals set solvency requirements proportional to the size of the business underwritten according to risk. This should prevent a disproportionate impact on smaller firms. The proposals may also lead to a competitive advantage for Europe over other regions. For instance, the US also has collateral requirements and firms are supervised by each state leading to inconsistencies in the application of rules and regulations.

Table 3: damaging effects on competition

Two of the three damaging effects on competition mentioned in the Table will not materialise under the third option that we are seeking to negotiate.

6.4.1.3.Monitoring and Review

The Reinsurance Directive will be succeeded by Solvency II, which will update the whole system of solvency requirements for the insurance industry, including reinsurance, taking account of changes in the financial market, such as the use of derivatives, new insurance products and risk management techniques. We expect Solvency II to be implemented by 2008 at the very earliest.

6.4.1.4.Consultation

The Treasury has worked closely with the FSA and has consulted on the poposed Directive with representatives of the financial services industry, in prticular through a series of roundtable meetings. The following table povides a list of organisations the Treasury has been in contact with.

[69] Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004.

Companies	Swiss Re, General Re, Munich Re, Revios Reinsurance, Lloyds of London, Pool Re, Wellington Re, Equitas, Groupama, Fortis, Royal & SunAlliance, Royal London, Cornhill, Aegon, BUPA, Sabre Insurance
Trade Associations	Association of British Insurers, London Market Insurance Brokers' Committee, International Underwriting Association, Federation of Small Businesses
Government	Financial Services Authority, Small Business Services, Small Business Practitioners Panel (FSA), Trade Partners UK, Office of Fair Trading

Table 4: a list of organisations the Treasury has been in contact with.

The Government will continue to consult interested parties on the proposed directive and has set up a series of drafting groups to advice on detailed issues. These groups draw extensively on the expertise of experienced City practitioners.

UK industry supports our third option, i.e. the introduction of a Reinsurance Directive that will bring other Member States reinsurance supervision more in line with the UK and also remove collateral requirements, which currently exist in some EU Member States. There are two key concerns for industry over the Commision's proposal. Firstly, solvency margins for life reinsurance will be raised.

The second related concern is the reduced incentive for life insurers' risk diversification by transferring some the risks that they take (retrocession). At the moment, these risk transfers are compensated with a reduction in solvency requirements of up to 50%. Under the Commission's proposals this reduction will be limited to up to 15% of the

solvency margin. This may limit the availability of capacity for life re-insurance and in turn affect direct insurers that are increasingly relying on re-insurance.

Industry estimates suggest that solvency margins under the Directive would be 140% higher than the current UK solvency margin for life reinsurance, as a result of both the above concerns, and would require industry to hold an additional £700 million of capital (although, as noted above, this figure is likely to be an upper estimate).

6.4.2. Reinsurance Supervision Project

Having considered the current problems affecting the EU reinsurance market and after wide-ranging consultations with Member States and interested parties, the Commission Services decided to launch the work on a reinsurance supervision directive in 2001. Member States, the insurance industry and other specialists broadly supported the initiation of reinsurance supervision work at EU level.

6.4.2.1.Objectives of Reinsurance Supervision Project

Together with Member States, the Commission Services formulated three guiding objectives for the reinsurance supervision work[65]:

Objective 1

The system should establish a sound and prudent regime in the interest of policyholders. Strong and well-supervised reinsurers contribute to a stronger internal market and international financial stability.

Problem areas addressed by the formulated objective

The objective addresses problem areas 1 (uncertainty for insurance companies and their policyholders), 2 (barriers to trade), and 3 (administrative burdens).

---

[70] Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004.

Objective 2

The system should build on essential coordination of Member States' legislation and mutual recognition of the supervision in the Member State where the reinsurance undertaking is licensed. Once licensed a company should automatically be allowed to conduct reinsurance business all over the European Community under the freedom of establishment and the freedom to provide services. No additional supervision of or checks on the reinsurance undertaking should be performed by supervisors in host Member States. This approach has shown its suitability during many years in the direct insurance field.

Problem areas addressed by the formulated objective

The objective addresses problem areas 1 (uncertainty for insurance companies and their policyholders), 2 (barriers to trade), and 3 (administrative burdens). The existence of a reinsurance supervisory system based on this principle will also be beneficial for the EU position in international trade negotiations

Objective 3

The introduction of a harmonised system for reinsurance supervision should lead to the abolition of systems with pledging of assets to cover outstanding claims provisions.
Problem areas addressed by the formulated objective

The objective primarily addresses problem areas 2 (barriers to trade) and 4 (the EU position in international trade negotiations).

Discussion

The collateralisation issue could be dealt with in two ways:

1. Abolish collateralisation requirements within the EU
2. Maintain the possibility for collateralisation

One major driving force for the reinsurance work – in the EU as well as internationally – is to reduce trade barriers and make the market more efficient. In this light, the collateralisation requirements used by some Member States and other jurisdictions could be seen as an obstacle. Other commentators argue that it is a necessary tool for prudential supervision.

Abolishing the collateralisation requirement was a key element in the CEA passport proposal, and it is widely supported by the EU insurance sector. A clear majority of Member States do not use collaterals and consider them as obstacles to an efficient internal reinsurance market. Certain Member States argue that the situation concerning collaterals is different in life and non-life reinsurance. A new reinsurance supervision regime should provide clear and forceful rules that remove the need for collateral requirements. The EU reinsurance work should clearly build on alternative 1. Indeed, in a regime founded on harmonisation of prudential rules and mutual recognition of regulatory/supervisory regimes by Member States, a requirement such as collateralisation of outstanding claims provisions is not longer necessary since the reinsurer is subject to specific supervision according to mutually agreed standards aimed at ensuring its financial position.

6.4.2.1.1. Overall Approach of the Reinsurane Supervision Project

Alternatives of Overall Approach

1. Status quo – no changes necessary to the current situation
2. Market mechanism solution/voluntary disclosure of reinsurance related information, alternatively recommendation concerning indirect supervision practice
3. Supervisory solutions

Discussion and reasons for the Commission proposal

The Commission Services agree with most commentators that there are problems in the internal market for reinsurance that must be addressed. A status quo solution does

therefore not seem applicable. Virtually no commentators have given their support for a "do-nothing" alternative.

Concerning the issue of market mechanism, voluntary approaches vs. supervisory solutions, the Services believe that a comparison with the direct insurance field is relevant and instructive. The Services believe that, as in the direct insurance field, reinsurance legislation at EU level would be necessary, as significant differences in approaches today between Member States is at the core of the problem. Insurance supervision is a public concern and requires public regulation. A voluntary, disclosurebased approach would not provide sufficient trust in the supervisory system. The lack of tangible sanctions in such a disclosure-based approach could make the system less efficient when addressing potential problems in reinsurance undertakings.

A majority of Member States and industry organisations believe that there is a need for supervisory action in the field. The Services therefore propose that such an approach is chosen for the EU reinsurance project.

Self-regulation within the insurance industry would not suffice to meet the objectives as insurance supervision is a regulatory function in all jurisdictions world-wide. The Services also consider it difficult to address objectives 3 and 4 through voluntary measures as amendments to legislation would be needed in several Member States.

6.4.2.1.2. Fast-Track vs. Long-Term Comprehensive Project

Different models for reinsurance supervisory systems have been discussed and/or proposed by several organisations. The proposals differ particularly on the comprehensiveness of the proposed systems and on the applicable time frame. Two broad approaches can be identified:

[71] Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004.

Alternatives of Fast – track and Long – term projectes

- Fast-track solution for a reinsurance supervision framework
- Long-term comprehensive project for a reinsurance supervision framework

Discussion and reasons for the Commission proposal

A majority of Member States and industry organisations believe that there is a need for expedient action to achieve tangible results in a short to medium-term perspective. Such a "fast-track" solution would take its starting point in current direct supervision rules and business practice, when appropriate with adjustments. A long-term project, linked to Solvency II, could to a fairly large extent build on the achievements in a fast-track project, but such a project will also have to take other long-term developments into account (such as profound changes in insurance accounting or in solvency rules). Against this background, the Commission Services have proposed that the reinsurance work should be based on a "fast-track" approach. Furthermore, developments in the reinsurance industry during last years (post September 11, impact from declining stock markets, etc.) call for a rapid introduction of a harmonised supervisory system. A number of reinsurance companies have ceased writing new business, and a number of new entrants have appeared. The level of premium has increased with over 30% between 2001 and 2002 according to Standards & Poor's14.

However, as there is a clear need for swift action, a preference is given to a fast-track solution. As stated above, a fast-track solution can be seen as a first block towards a comprehensive Solvency II solution.

6.4.2.1.3. Alternatives for the Non-Life Solvency Requirements

The different solvency alternatives outlined in chapter 5 in fact represent a continuum between basically identical requirements as in direct insurance to alternatives with higher requirements, both in terms of solvency and size of the guarantee fund.

The reinsurance companies are directly concerned by the requirements under the different alternatives, and the impact on them are outlined in the sub-chapter below containing the summary results from the simulations. As discussed above, the Services believe that all the outlined solvency alternatives would bring advantages to insurance companies and their policyholders. High requirements could be said to lead to stronger, more solvent reinsurance undertakings, which would be in the interest of direct companies. However, if the requirements are set too high, the price of reinsurance cover may increase, which would affect direct insurance companies.

It is important to remember that many direct insurance companies also accept inwards reinsurance business, and may therefore be subject to some of the new reinsurance rules.

This issue is analysed below in connection with the fourth simulation.

Insurance supervisors have different views on the impact of the different solvency alternatives. Some supervisors believe that higher solvency requirements are motivated from a prudential point of view, whereas others stress the importance of similar requirements between insurance and reinsurance.

Results from simulations

A number of the most important alternatives outlined above have been the subject of three simulation exercises performed between August 2002 and October 2003[67]. The simulations performed related to the following quantitative parameters in different combinations:

- Solvency margin requirements as percentages of claims and premiums
- Size of the minimum guarantee fund
- Size of the reinsurance reduction factor

[72] Council of the European Union, "Commission Staff Working Paper: Extended Impact Assessment", 2004

- The application of reinsurance solvency margins (and minimum guarantee fund requirements) for the inward reinsurance business of direct insurance undertakings

The parameters were combined into scenarios which were subsequently simulated using data available at national insurance supervisors. The samples used differ somewhat between the simulations. For certain computations life reinsurance business have been included in the samples, and simulations been done according to the non-life requirements. The extent of life reinsurance business is normally small in reinsurance companies.

7. REINSURANCE PRACTICE in TURKEY

7.1. History of Reinsurance in Turkey (Monopoly)

Reinsurance Monopoly in Turkey

The national insurance market which began with the establishment of the Republic, witnessed the foundation of national insurance and reinsurance companies. Evolution of the national insurance sector and the structure of the market have been reshaped by regulating the reinsurance transactions of the companies by introducing a reinsurance monopoly and effective control over the insurance companies. For this purpose, a new insurance law, Law on Inspection and Supervision of Insurance Companies (Sigorta Sirketlerinin Teftis. ve Murakabesi Hakkinda Kanun) has been enacted in 1927. Since the reinsurance monopoly continued until 2001, it is very important to analyze the system of the monopoly, the establishment and the operation of the administrators' company, Milli Re and discuss the renewal of the monopoly and its effects on the market.

During the Republican period, developments in the reinsurance monopoly paralleled the developments in the insurance sector, since the reinsurance monopoly entailed all the characteristics of the insurance market in Turkey as far as the total premium production, loss payments and retention for transport, fire, life and accident branches were considered.

Establishing the Reinsurance Monopoly in Turkey

The insurance sector witnessed fierce competition between the two major groups of companies: the Union Group[68] and the Generali Group before the introduction of the monopoly in the market. This competition was concentrated mainly around the bidding offers for the large insurance business of the State. The Union Group had two main advantages over the Generali Group: Having a popular agent Iş Bankasi which had 50 branches throughout the country and Anadolu Sigorta had a privileged access in the

[73] Savaşçı, Sevim, "Türkiye'de sigorta ve Reasürans şirketlerinin yatırımları için ekonometrik model çalışması", 1997

biddings of the State institutions' insurance business. Competition was resulted in huge reductions in the premium rates, increasing the cost of business for the insurance companies.

In 1926, however, because of the discounts on premium rates, the Generali Group was successful in getting two important insurance businesses from the State. The Union's advantages mentioned above were not enough for the expansion of its market share in Turkey. So, the system of reinsurance monopoly gave a new chance to the Union Group to reach the goal which it realized through Milli Re[69].

Following the adoption of these Laws, General Conditions for Fire Insurance were approved by the Ministry of Commerce. According to the Law, Government acted a contract with İş Bankasi to administer reinsurance Monopoly. Then, Is Bankasi as a requirement of the contract founded a new national joint stock company with 1 million TL initial capital on March 26, 1929. It was named Milli Reasürans Turk Anonim Şirketi...

General features of the reinsurance monopoly caused some important debates concerning the system as accepted by the Law. Some of the issues of concern were in connection to the period of reinsurance monopoly, preferential rights of Milli Re and the control over the insurance companies. So, it will be helpful to extract related items for future evaluation of the operation of the reinsurance monopoly in Turkey.

According to the Law on Reinsurance Monopoly, the Government was authorized to establish a Reinsurance Fund for the purpose of monopolizing the reinsurance business, totally or in part, or of sections which were required to be reinsured under the relevant Law, on any amount of insurance business transacted by national or foreign insurance companies (including branches or general agents of the foreign companies) operating in Turkey.

[74]Baydar, Vedat, Türkiye'de Reasürans inhisarı, 1965.

[75] Ekener, Türkiye'de Mükerrer Sigorta Sorunu ve Bütün Vesaiki ile Reasürans İnhisar Davası, 1974, p.25.

Establishment and operation of the reinsurance monopoly could be transferred by a Decree of the Council of Ministers to a Turkish company under the following terms[70]:

- The period of transfer shall not exceed 25 years,
- At least 60% of shares shall completely belong to the Turkish nationals,
- The minimum paid-in capital shall be 1,000,000 TL,
- The sole scope of operation shall be reinsurance business.

The Law on Reinsurance Monopoly empowered the government to establish total or partial monopoly on all insurance business on the Turkish territory. Insurance companies operating; in Turkey (both domestic and foreign) were required to cede to Milli Re 50% of all insurance business transacted in Turkey.

One of the important features of the insurance is the claim settlement and loss payments. For this purpose, according to the related items, Milli Re has the power to depute its assistants: to be present at the time of inspection by experts in case of any loss, it supervises the assessment and payment of the indemnity amount in accordance with the terms of cover included in the insurance contract. The company also may take necessary measures to prevent unjustified profits and proceeds under the directives given.

Aims of Reinsurance Monopoly

The aims and the purposes of establishing the reinsurance monopoly listed in the annex of the Law are as follows: Supervision of insurance companies, collection of statistical data, reduction in the amount of premium transferred abroad through the reinsurance transaction of the companies, generation of income to Treasury and the encouragement of the nationalization of the market Supervision of Insurance Activities.

[76]Baydar, Özgen, Reasürans işlemleri ve Türkiye'de reasürans tekeli uygulaması, 1988.
[77] RCD "Insurance Manual", 1967, p. 151.

The insurance companies operating in Turkey have not been subject to any supervision and the relevant Law did not require formation of such an institution. But, according to the Law on Reinsurance Monopoly reinsurance tariff could not exceed the basic insurance tariff approved by the Government. Both tariffs and reinsurance conditions were evenly applied to all insurance companies operating in Turkey. The duty of supervision must be undertaken by the Government; it can not be transferred to private companies. At that time, it was impossible to control insurance sector with a limited number of officials and with the existing institutional structure of the Ministry of Commerce. So, the supervision of insurance companies was performed by the Milli Re for a long time. The Insurance Supervisory Board was established in 1959. Then, Milli Re's supervision power was limited to the reinsurance business of the companies. The contents of the supervision were the application of a uniform tariff and the control over the claim settlements and loss payments.

Local Retention Capacity

One of the important purposes of the establishment of the reinsurance monopoly was to reduce the foreign exchange outflow. Although, increasing the premium retention was one of the major reasons stated in the Law, it could be possible only within the framework of reciprocity reinsurance agreements. It was a type of reinsurance business exchange. This method was used in reinsurance agreements between the Union Group and Anadolu Sigorta before the establishment of the reinsurance monopoly.

The reasons for the foreign exchange outflow and the need for the reinsurance cover are as follows:

- Low retention rates of the insurance companies,
- Impossibility of risk selection,
- Very high premium rates,
- Higher reinsurance commissions received,
- Shortage of educated staff in technical departments.

State intervention with the reinsurance market reduced outflow of the insurance premiums One of the important regulations was the cession of the mathematical reserves to the Milli Re. Life assurances were very profitable due to the lower loss ratios. In addition, mathematical reserves of the life assurances were invested and company had investment returns. Hence, 50% of the compulsory cession of life insurance premiums to the Milli Re reduced the technical and financial profits of the foreign companies. One of the impacts on the market was the reduction in life insurance business and the number of the foreign insurance companies operating in life assurance branch.

The insurance companies and the general agents operating in Turkey were transferring of their premiums except a small share reserved for meeting the claims and covering the operational expenses. They were receiving high reinsurance commissions. On the other hand, foreign insurance companies were also transferring their profits abroad. Because of the compulsory cession of %50 of all direct insurance transacted in Turkey to the Milli, the volume and number of the reinsurance business of similar risk increased. Milli Re had gained important bargaining power in the retroceding of the compulsory reinsurance business of insurance companies. The reinsurance commissions in the reinsurance transactions between Milli Re and foreign reinsurance companies were higher than the transactions between individual insurance companies in Turkey.

Revenues of Treasury

According to the agreement on management of the reinsurance monopoly, Milli re was obliged to pay 200,000 TL fixed fee per year and %58 percent of net profits. The amount of fee increased with the renewement of the Agreement. During the establishment of the reinsurance monopoly, the amount of the fees and the profit shares of the companies provided the Government authority with a substantial amount of income for the treasury.

Incomes obtained from transferring the management of the reinsurance monopoly to a private reinsurance company were similar to the late period of the Ottoman Empire

where the Government authority was giving up some of its administrative power. But, the Republican Government assumed Milli Re as a publicly owned company.

Nationalizing the Market

There was a fierce competition in the market. Discounts on premium rates were diminishing the technical profits. New companies entering the market had to compete both with the major group of foreign companies and deal with the difficulties arising from the structure of the markets. Since foreign companies had a small organizational structure and most of their activities were evaluated in the general management office, their administrative expenses were also less than the other companies established in Turkey. So, the chances of the new comers in competing for market share were very slim.

On the other hand, the concept of the reinsurance itself explains the importance of the strong reinsurance relations both in the early and during the operational years. Since, at the beginning of the operation of the company, own statistics are very scarce to determine the effective premium rate for the risks. Moreover, the own capital of the company is not enough to cover big fluctuations in the loss ratios. AJ1 insurance companies are required to get reinsurance coverage to limit and control their loss ratios. At this point, it becomes obvious that it was very difficult to form a national insurance company without any foreign support.

Compulsory cessions to the Milli Re were reducing the insurance companies' risks. According to the "Quota Share", a system assumed for the reinsurance monopoly, half of the risks undertaken by the companies were reinsured by the Milli Re without any anti selection. It is assumed this encouraged the national companies to get into the insurance business. Within this framework, the system of the reinsurance monopoly provided effective reinsurance coverage for the companies.

Establishment of the reinsurance monopoly reduced the foreign control over the insurance market. On the other hand, the supervision on the claims and, the control of the premium rates of the companies increased the popularity of the insurance business.

Increase in the market shares and the demand from Turkish nationalities and Muslims for insurance coverage had positive effects on the foundation of the new companies.

Impacts of the Reinsurance Monopoly

In early years of the reinsurance monopoly, total premium generation was nearly 6.3 million TL, 7.2 million TL and 7.1 million TL in 1927, 1928 and 1929, respectively. The number of the insurance companies was 52 in 1929[71]. The share of the Turkish companies was around 30%. Most of the companies were operating in the fire and transport sub-sectors. Share of the fire branch in the premium generation was more than 40%.

On the other hand, there were 7 Turkish and 8 foreign insurance companies operating in the life insurance branch. The life insurance premium collected in 1929 was 2,656,270. TL. The share of the Turkish companies was 22% which was very low compared to the other branches. The life insurance premium was mostly consisted of mathematical reserves. Companies were investing mathematical reserves freely. But, after the reinsurance monopoly, mathematical reserves for life insurance branch would be held in Turkey and half of these reserves would be transferred to Milli Re. So, some of the foreign companies operating in the life insurance branches ended their insurance business in Turkey or reduced their activities in that branch.

One of the important characteristics of the market in 1929 was high "Loss Ratios" in fire and transport branches which were around 46% and 56%. So, the overall retention ratio of the insurance companies was misleading since it was the major reasons for introducing the reinsurance monopoly to the market.

Intervention with the reinsurance market in developing countries started with the Turkish experience in the development of the insurance markets, the need for reinsurance business was essential and it increased the volume of the reinsurance business of the developed reinsurance markets (i.e. London). The Turkish experience was inversely

[78] Baydar, Özgen, Reasürans işlemleri ve Türkiye'de reasürans tekeli uygulaması, 1988.
[79] Ekener, Türkiye'de Mükerrer Sigorta Sorunu ve Bütün Vesaiki ile Reasürans İnhisar Davası, 1974.

affecting the volume of the reinsurance business. It would be an example for the other developing countries. That is why, London market and some other European markets refused to deal with the Turkish insurance markets and Milli Re. Milli Re was undertaking half of the all insurance business written in Turkey. Half of the risk undertaken were above the limits that may be covered by the companies own resources. Therefore, the problem arising from the necessity for international reinsurance coverage was solved through the transfer of 10% of companies' shares to the Swiss Re and making Quota Share treaties with the Swiss Re, Assicurazioni Group and the Union Group. The share of Is Bankasi was 80%. The Swiss Re and Ittihadi Milli was holding 20%.

The management of the reinsurance monopoly by the Milli Re caused a reduction in the commissions being paid to the intermediaries. Since, the insurance companies were functioning as intermediaries to the Milli Re (reinsuring half of the direct insurance business); the technical profits of the companies were reduced. The most important effect was felt in the life insurance branch in which the total premium generation decreased nearly by 65% and the number of the foreign companies reduced from 16 to 9 in. It was the result of the implementation of the reinsurance monopoly relating to the transfer of the mathematical reserves together with the risk associated with the life insurance business written in Turkey. Accumulated mathematical reserves of the life insurance companies were very high compared to the premium generation in that branch. On the other hand, the control over the activities of the insurance companies were also banning the foreign companies from competing through discount on premium rates The loss payments of the companies were controlled by the Milli Re according to the reinsurance monopoly. It reduced the claims in transport branch and led to the increase in technical profit.

But, in general, the supervision of the insurance business caused a decrease in unfair competition in the market. Small foreign companies did not have the chance of making easy profit in the Turkish insurance market. But, for the development of the market, diminishing premium production in life insurance market and the exit of some small foreign insurance companies were the signals of a new period. The new period was shaped with the reinsurance monopoly and the supervision of the insurance companies by the Milli Re.

Reduction in technical profits was arising from three important sources: Firstly, from the definition of the technical profits, (the remained portion of the total premium after deduction of losses, commissions and other expenses) profits were reduced by half because of the compulsory reinsurance according the Reinsurance monopoly. If that kind of risks undertaken by the insurance companies were profitable, half of the profits originated from those risks would be increasing the profit of the Milli Re.

Secondly, insurance companies were reinsuring their portfolio abroad at a certain commission. But, under the reinsurance monopoly, the amount of the commission paid by Milli Re for compulsory cession to the insurance companies were less than the foreign reinsurance companies' commission rates paid to those companies for the rest of the portfolio. So, the lower reinsurance commissions were reducing the profits of the insurance companies. On the other hand, the Milli Re was retroceding its portfolio composed of half of the compulsory cession at better conditions.

Finally, insurance companies disregarded risk selection which was very important for the profitability of the insurance portfolio due to Quota share system applied in the reinsurance monopoly. Insurance companies were able to transfer half of the risk undertaken. Because, according to Quota share system, all direct insurance business written in Turkey was poded in a basket and half of it was reinsured by the Milli Re without any risk selection. So, companies did not show much effort to undertake good business and the amount of risky business in the insurance portfolio increased. As a result of the high loss ratios for that type of business, technical profits of the companies diminished substantially.

Due to the fact that the Milli Re was a new company, it implemented the Quota share system during its early years of operation. What is more, its retention rate was very low.

The retention rate in fire and transport branches was under 15% till 1940. The accident branch where premium production was lower, this rate was above 85%. Since the life insurance branch did not require any significant amount of reinsurance due to its

[80] Eser,Kıymet, Reasürans anlaşmalarında kullanılan teknikler ve Türkiye uygulamaları, 1999

nature, the retention rate was also high. Since the retention rate was very low in fire and accident branches and due to the reinsurance techniques used, the major portion of less than the foreign reinsurance companies' commission rates paid to those companies for the rest of the portfolio. So, the lower reinsurance commissions were reducing the profits of the insurance companies. On the other hand, the Milli Re was retroceding its portfolio composed of half of the compulsory cession at better conditions.

Finally, insurance companies disregarded risk selection which was very important for the profitability of the insurance portfolio due to Quota share system applied in the reinsurance monopoly. Insurance companies were able to transfer half of the risk undertaken. Because, according to Quota share system, all direct insurance business written in Turkey was poded in a basket and half of it was reinsured by the Milli Re without any risk selection. So, companies did not show much effort to undertake good business and the amount of risky business in the insurance portfolio increased. As a result of the high loss ratios for that type of business, technical profits of the companies diminished substantially.

Due to the fact that the Milli Re was a new company, it implemented the Quota share system during its early years of operation. What is more, its retention rate was very low.

The retention rate in fire and transport branches was under 15% till 1940. The accident branch where premium production was lower, this rate was above 85%. Since the life insurance branch did not require any significant amount of reinsurance due to its nature, the retention rate was also high. Since the retention rate was very low in fire and accident branches and due to the reinsurance techniques used, the major portion of with relatively lower loss/premium rates. This practice is important from two standpoints: First, (he company transferred relatively high risk undertakings to reinsurance companies and received more commission reducing the net amount of transfers out of the country to a .

[81] Bayer, Arzu, Türk Sigorta Sektörü'nde Reaasürans Uygulamalarında Karşılaşılan Problemler ve Çözüm Yolları, 1994.

minimum which as a result created foreign exchange saving. In addition, the company's technical profits were increased by way of selecting risks and this increase was kept within the company to strengthen the financial position of Milli Re, which was the operator of the reinsurance monopoly. While these positive developments were taking place in the Milli Re's retrocession transactions, no significant growth was observed in the retention rates of the Turkish insurance companies.

Implementation of the monopoly in the Turkish reinsurance sector influenced the other developing countries and became a success story for the intervention in the reinsurance sector. The Milli Re was accepted more readily in the international reinsurance markets. The London Market in the beginning boycotted the Turkish insurance sector because of the existence of the monopoly, later; however, it lifted its boycott.
This without doubt, was a significant breakthrough, since the opportunities offered by the London Market, one of the biggest reinsurance markets of the world, were numerous. In the reinsurance business, the bargaining power of the Turkish insurance companies and especially that of Milli Re were improved significantly. Hence, better conditions could be obtained for foreign reinsurance cover.

Thanks to the security and stability provided by the reinsurance monopoly, the Turkish insurance sector grew rapidly, and managed to stand on its own feet, Starting in 1929, due to the Great Depression which hit the world economy as a whole the insurance companies faced a very serious problem in collecting of their premiums and were forced to make significant reductions in the insurance premium rate. Considering all these adverse effects of the economic depression, the growth trend displayed in the Turkish insurance sector during the 1930's can be better appreciated. The most significant developments were; the attainment of the stability in the overall premium production and the structural change the Turkish insurance companies underwent. Until then, the Turkish insurance companies were under the control and supervision of foreign insurance companies.

In 1935, 90% of the shares of Adapazari Turk Ticaret Bankasi, which was the largest shareholder of Guven Sigorta, were first bought by Sümerbank and then a certain portion of these shares were transferred to Emlak ve Eytam Bankasi. Hence, Guven

Sigorta underwent a structural change and was transformed into a public insurance company; also, it had become the first Turkish Insurance company that was able to carry out its business activities without the support of a foreign insurance company. The foreign elements in its ranks were totally eliminated. During this period, the company conducted insurance ranks were totally eliminated. During this period, the company conducted insurance business in international reinsurance markets and obtained reinsurance cover under favorable conditions, using its own bargaining power.

7.2. Policies of Reinsurance in Turkey

7.2.1. "Association of the Insurance and Reinsurance Companies of Turkey" (TSRSB)

In Turkey the first insurance transactions were started mainly by foreign insurance companies decided to establish a professional organization among them. Later the insurance companies felt the need of being organized among themselves as a "professional organization" and the first respective organization was formed on the 12th July 1900 with name of "The Syndicate of Fire Insurance Companies Operating in Istanbul" by 44 foreign companies at the TEUTONIA Hall in Beyoglu. The Provisional Law regarding the foreign Insurance Companies" was approved on the 13th December 1914. This Syndicate was turned into "The Society of Insurance Companies Operating in Turkey" in 1916 which had 81 members of all of them being foreign companies.

Following the establishment of the Turkish republic in 1923, this Society was abolished and "The Club of Insurers" was set up on the 11th March 1924 which later in the year 1925 was replaced by "The Central Offices of Insurers". This expression was used for the first time in a document of the Ministry of Commerce dated 21st December 1926. "Law No.1149 regarding the Inspection and Supervision of Insurance Companies" was put into force on the 31st July 1927. Later, Law No.3392 regarding the amendments of some articles of Law No.1149 and the inclusion of new articles was approved and put into force on the 28th May 1938..

---

[82] Iktisadi Arastirmalar Vakfi yayinlari, 1996, "Türk sigorta sektörü".

In 1950 new draft-law was prepared in respect of the supervision of insurance companies at the meeting of "Insurance Council" which came together in Ankara and the subject of insurance profession organization was put on the agenda. This draft-law was then sent to the "Central Office of Insurers" in order to take their views; however regarding this draft-law there occurred disagreement among the members of this Office and the insurance companies; Genel, Güven, Halk, Ankara and Inan resigned from the membership. In July 1952, Anadolu Sigorta A..S. and Destek Reasürans T.A.S. joined this resigns and they established the "Association of Insurance Companies of Turkey" which had a status of a legal entity. On the 16th July 1952 the statue of this association was approved by the Council of Ministers, at a date between 1952 and 1954 the name of the "Central Office of Insurers" was changed to "Society of Turkish Insurers"[75]. In January 1954 the "Association of Insurance Companies of Turkey" was closed down and the regulation of "association of Insurance and Reinsurance Companies of Turkey" was published. On the 22nd January 1954 the first General Assembly of the "Association of the Insurance and Reinsurance Companies of Turkey" which was formed by the unification of the "Association of the Insurance Companies of Turkey" and the "Society of Turkish Insurers" was carried out. On the 21st December 1959 "Law No.7397 Regarding the Supervision of Insurance Companies" was accepted and came into force on the 30th December 1959[76].

The statue of association of Insurance and Reinsurance Companies of Turkey came into practice on the 10th June 1976. By the coming into force Law No.3379 regarding the Insurance Supervision on the 11th June 1987 amending certain articles of the Law No.7397, status of the association turned into a public institution. Another amendment was that the elections of the Association's organs should be made under judiciary supervision. Later on the 30th January 1989 the "Regulation Relating to the Working Principles of the Association of the Insurance and Reinsurance Companies of Turkey" came into force.

All of the insurance and reinsurance companies, local or foreign, operating in Turkey and branch offices of foreign companies in Turkey are obliged to be members of the Association within three months following their being licensed by the Under secretariat

---

[83] TSRSB . Available on site http://www.tsrsb.org.tr/tsrsb_eng/About+Us.

for the Treasury. At the end of 2002 the Association had 61 members, 58 being insurance and 3 reinsurance companies. The head office of the Association is in Istanbul and it has the power to open representative offices anywhere if it deems it necessary.

As it is stated in the Law, the main purpose of the Association is the followings:

- To ensure the development of the insurance profession,

- To secure solidarity among insurance companies

- To adopt and implement all the necessary measures needed to control unfair competition.

7.2.2. Milli Reasürans T.A.Ş. (Milli Re)

It was by the Act No. 1160 that the compulsory cession in Turkey was introduced on the 23rd June, 1927 to reduce the outflow of foreign currency as well as to provide revenue for the Treasury. It took two years of research and preparation for the government to decide in March 1929 to entrust the concession of operating the compulsory cessions to a company to be formed by the Türkiye Iş Bankası A.Ş. Thus, Millî Reasürans T.A.Ş. which was the first and only private company in the world to operate the compulsory cessions in all branches, was established on the 19th July, 1929 with a capital of one million Turkish Liras to function on the basis of compulsory quota share cessions from each and every insurance company operating in Turkey, percentages of quota share being altered from time to time.

As of the 1st January, 1982 the quota share basis of the compulsory cessions was replaced by surplus after retentions of the ceding companies, for all branches except life which was left out of the compulsory cessions and motor business where the quota share system was maintained.

With effect from 1st January, 1992 "the system increasing the local retention and the reinsurance capacity in the insurance sector" came into force for a period of ten years. As at 31st December, 2001 the first section of this system, i.e. the compulsory cession which organized the percentages of reinsurances to be ceded to the Millî Re, has come to

an end after 72 years of operation. The second section which involved a proportion of each reinsurance contract of the insurance companies to be reinsured with the Millî Re, is maintained for a further period of five years.

Thus, as of 1st January, 2002 Millî Re continues to handle the management of this second section which is called the "Decree Pool" and was formed as at the 1st January, 1970 to fulfill the local reinsurance capacity before approaching international markets. The business thus pooled, is retroceded back to the Turkish insurance companies which are willing to accept a share, remaining part being retained by the Millî Re. The premium of the Pool since inception has reached US Dollars 527 million as at the end of 2002[77].

Apart from the Decree Pool, Millî Re is continuing to accept business from the local market on voluntary basis which started as of the 1st January, 1991.

After the abolishment of the compulsory cessions, Millî Re increased its acceptances from the local treaties and the facultative reinsurance to fill the raised need of capacity in the market due to this abolishment.

After 72 years of management of the compulsory cessions in the Turkish insurance industry, it is observed that the foreseen targets have been succesfully realized by the Millî Re:

- the Turkish insurance market is nationalized;
- a moderate but steady revenue for the Treasury is provided; the outflow of foreign currency by way of reinsurance from the country is considerably reduced;
- the education of insurance is successfully carried out;
- very good international business relations have been established;
- the retentions of the companies have increased.

In the meantime, by the ten years' application of the "system increasing the local retention and the reinsurance capacity in the insurance sector" it can be observed that the target of strengthening the financial structures of Turkish insurance companies has to a

[84] TSRSB . Available on site www.tsrsb.org.tr.

great extent been materialized and the retentions of insurance companies have increased more in comparison to a decade ago.

Also, Turkish insurance industry has gained a financially strong national reinsurance company which is since years among the world's top reinsurers and has always been and still is helpful for the Turkish insurance industry in finding the appropriate reinsurance protections with the most suitable underwriting conditions and providing financial support the companies need in respect of major losses.

7.2.2.1.*POOL System in Reinsurance in Turkey*

7.2.2.1.1. FACTS ABOUT F.A.I.R. REINSURANCE POOL

7.2.2.1.1.1.Background F.A.I.R. Reinsurance Pool

The 3rd Meeting of the F.A.I.R.(Federation of Afro-Asian Insurers & Reinsurers)General Assembly was held in Istanbul on the 11th-14th September 1972 and it was unanimously decided to set up the FAIR Non-Life Reinsurance Pool with effect from 1.1.1974. The General Assembly also unanimously entrusted the management of the Pool to the Millî Reasürans T.A.Ş., Istanbul[78].

The Pool is aimed to achieve the following objectives:

- to promote cooperation among member companies;
- to provide an additional underwriting capacity in Asia and Africa and to increase the same for the member companies;
- to effect savings and even earnings of foreign exchange for the member countries and companies;
- to provide the same standard of reinsurance service as offered by international market;
- to accelerate the process of achieving increased self-reliance in the field of

[85] Milli RE Süreli Yayınları, Pools . Available on site www.millire.com.

insurance and reinsurance through cooperation;

- to improve the reinsurance terms for national insurance companies as much as possible.

The Pool had 24 members 11 from Africa and 13 from Asia in its 1st year of operation providing a premium income of Stg 857,527 whereas at the end of 2004 the premium reaching Stg 339,032,370 the profit percentage was of 4.71 % of the net premium. In 2005 it has 69 members 25 from Africa and 44 from Asia and the estimated premium income is 37,500,000 Stg[79].

Objectives of Pools

- The principal object of the Pool is to accept reinsurance and retrocession business from the African and Asian markets in the following classes of insurance business:
- Fire;
- Accident, excluding motor, credit and bonds business except when incidental or part of a bouquet;
- Engineering including C.A.R., E.A.R. and M.B.;
- Marine Hull and Cargo;

7.2.2.1.2. TURKISH CATASTROPHE INSURANCE POOL (TCIP)

As a result of the major earthquake losses of 1999 in the Marmara Region and Düzce, Millî Reasürans T.A.Ş. has undertaken an important task in respect of the system of Compulsory Earthquake Insurance in Turkey in finding a permanent solution before all else for the dwellings against the earthquake risk which constitutes a continuous threat in Turkey. Carrying out the technical activities of Turkish Catastrophe Insurance Pool (TCIP) aimed at gathering the compulsory earthquake insurances under a Pool according to the Decree No.587 in respect of the Compulsory Earthquake Insurance has been entrusted to the Millî Reasürans T.A.Ş. as the "Manager of the Pool" by an agreement signed with the

---

[86] Milli RE Süreli Yayınları, Pools . Available on site www.millire.com.

Undersecretariat for the Treasury on the 8th August, 2000[80] for a period of five years, taking into consideration its respective know-how and experience.

Millî Re's effective approach in providing reinsurance protection for the TCIP has been evaluated by the world-famous reinsurance magazine, The Review with the "Reinsurance Broking Initiative Award for 2001" together with Willis under the scope of reinsurance awards distributed every year.Also, TCIP had other rewards, such as the 2001-2002 Interpro (computer program) and 2004 Gold Quality of Consumer's Report Magazine (claim payments).

7.2.2.1.3. TURKISH REINSURANCE POOL (TRP)

This Pool was formed in 1963 taking into consideration the willingness of Turkish insurance companies to underwrite reinsurance business from abroad, the management of which was entrusted to the Millî Reasürans T.A.Ş.

The technical results of these businesses from the world reinsurance market which were satisfactory at the beginning started to deteriorate as of 1976 and reached extreme levels in the eighties. Thus, at the end of 1985 the TRP stopped writing new business, as the losses which were paid in foreign currencies exceeded the premiums already collected and the Turkish Lira started to loose value against hard currencies more and more each year.

The run off account is still handled by the Millî Reasürans T.A.Ş.

7.2.2.1.4. ECONOMICAL COOPERATION ORGANIZATION (ECO) POOL

Millî Reasürans T.A.Ş., representing Turkish delegation in the field of insurance in the "Regional Cooperation for Development (RCD)" Organization as per the agreement signed among Turkey, Iran and Pakistan in 1964, has played a very active role in forming

[87] Milli RE Süreli Yayınları, Turkish Catastrophe Insurance Pool (TCIP) Available on site www.millire.com.

the RCD Fire, Marine, Accident and Engineering reinsurance pools as well as the RCD Insurance Center.

As of the 1st January 1975 these pools were integrated under one pool and the management of the same was entrusted to the Millî Re. The name "Regional Cooperation for Development (RCD)" was changed to "Economical Cooperation Organization (ECO)"[81] in the meeting of the Organization dated 6th-7th July 1985, so the name of the Pool to ECO Reinsurance Pool.

Later, as per the decision taken by the IIIrd Summit which gathered the presidents of three countries in Islamabad on 11th-15th March 1995, the ECO Pool stopped underwriting new business as at 31st December, 1995 as "insurance" section of the Organization was shifted to Pakistan, "transportation" to Iran and "banking" to Turkey.
The Pool's premium income at the end of the first year of activities, i.e. 1975 being US Dollars 2.456.331, was of US Dollars 13.746.603 when the pool stopped underwriting new business as at 31st December, 1995 and after an eight years' run off it has reached US Dollars 20.133.056.

[88] Milli RE Süreli Yayınları, Economical Cooperation Organization. (ECO) Available on www.millire.com.

8. COMPARISON OF REINSURANCE PRACTCES BETWEEN TURKEY and EU COUNTRIES

8.1. Comparison of Reinsurance Practices Between Turkey and EU Countries

Both EU countries and Turkey have is the legal system of the reinsurance. The commision, selected by the EU Council, prepares the directives to harmonize the supervision of reinsurance business in the EU. The directives are the regulator of the reinsurance business in EU countries. On the other hand, laws for reinsurance are created by a commission which is selected by the Ministry of Treasury of Turkey. These law aim to create a better environment for reinsurance business and adjust the errors of the past.

With only a single similarity these two systems have many differences that can be listed as:

Firstly, Duration of the Laws of Reinsurance shows differences in EU countries and Turkey.

The duration of the directives that are created by the commision and approved by the EU Council is from 10 to 25 years at most. The directive must be improved for the harmonization of the reinsurance in the member countries, in which the EU Council states.

The laws for the reinsurance business in Turkey is far too different. Since the beginning of the republic to today, there are only two laws for reinsurance have been made. The first law was lasted 72 to years, the *Monopoly* system that has ended 2001. The second law of reinsurance is created for five years after the first law that is so-called *Pools* system. A new law has been started to be prepared for the EU harmonization practices.

Secondly, Market Capacity of EU Countries and Turkey has differences. Reinsurance companies in EU service not only in their home countries but also in the other European

countries with some restriction (e.g. removal of the deposites that is given to the serviced country so that is helping to open up markets to international companies). According to the Directive, that have been released in 2005 and will become operative in 2007, the reinsurance companies will get their licenses from their countries. Moreover, each licensed company will report their activities only to their countries' auditors, but they will have a regulatory passport that give them the possibility to work in the other member countries freely. This will also provide EU companies to open offices in other EU member countries which this system is used for insurance sector since 1990s.

Market capacity of reinsurance in Turkey is leaded and directed by only one company: Milli RE. Although, there were some companies (e.g. Destek RE, Halk RE, Istanbul RE) that existed in the past, they were all assigned to Milli RE. Also, being only one country make the market much more smaller from EU, 25 countries to 1. Turkish Reinsurance Market has foreign companies but they have so limited access in the market. As a result, they hesitate to enter the market completely because of the lack of the law.

Thirdly, policies of reinsurance has no similiraty between EU countries and Turkey. EU has a systematic and planned work schedule about reinsurance. The Directive has been improved and changed in periods of time, so that new objectives are created to make a better and harmonized environment for reinsurance. The dirictive is created by a step by step process (researches, analysis, synthesis and proposals).

There is a lack of law in Turkish Reinsurance system. So, no particular policy is in charge. However, new law proposal for the EU harmonization practices have been made, until then the laws were created just when it is needed. The two laws that became operative were not to improve or coordinate reinsurance sector but to nationalize the insurance industry, create a continous income flow to the treasury, minimize the exchange outgo from the country and create work capacity to the national companies.

Moreover, solvency margins in EU companies and Turkey has quite big differences. Solvency margins are set to reduce the risk of reinsurance failures. They help to reduce systemic risk and provide a buffer against unexpected shocks. Their aim is to create greater

stability in the market place. Solvency margins should be set having regard to them too high will impose higher costs, such as the opportunity cost of holding additional capital and lead to a lower supply of reinsurance.

The solvency requirement for life reinsurance is the same as the non-life reinsurance solvency. Non-life reinsurance has the opportunity to raise this margin 50%. Solvency margins are also used in Turkey but not accepted by EU for the lack of calculating the capital sufficiency of companies. So, a new study called Solvency II have been started. Moreover, Solvency II study is not only about capital sufficiency of companies but also a wide-range study. Solvency II study also includes accounting systems, internal audit, direct the investments, technical reserves, etc.

Projects that have been made in EU Countries and Turkey are unlike to each other. In EU, there are two kind of projects that have been made with different proposals and objectives: projects of Directive, and reinsurance supervision projects. Projects of Directive indicates and works on consultation with small businesses, competition assessment, monitoring and review and consultation. Objectives of Reinsurance Supervision Project differentiate from the directive. Proposals to improve the internal and the international market, addressing the problems and formulating solutions, harmonizing the system etc... are included in this project.

No particular project have been made in Turkey up to now, but the new law includes some new projects for the harmonization practices to join EU. Solvency margins practices, stabilizing the system in Turkey are included in this law.

Insurance and reinsurance companies create a closed sector and cannot follow the development in world about the insurance and reinsurance sector. Although, companies make risk analysis, it is known that the used risk method is not acceptable in EU systems. To solve this problem by the help of the government a risk center must be established, so the companies can standardize their risk methods.

The competition between the companies, getting worse in technical solutions and the rise of the costs, forced some companies to unite. It is argued that the creation of a pool system could solve the crisis.

One of the problems that Turkey's reinsurance sector facing is that there is no Reinsurance Jurisdiction. The globalization in insurance sector seems to be a necessity, a union in one single jurisdiction will solve the international problems faster. So, the infrastructure of Turkish reinsurance jurisdiction should be created before it becomes opposite to the World Reinsurance markets and the jurisdictions which lead these markets.

Turkish reinsurance market, has no ascendant or even equal specialties according to the EU reinsurance markets. As there is no competative market in Turkey, there is also no acceptable law that is made about reinsurance sector in Turkey.

8.2. Possible effects of EU membership of Turkey on Reinsurance

Turkish efforts for the EU membership from 1963 to the 17th of Dec. 2004 were finally successful. The date of accession negotiations was set on the 3rd of Oct. 2005. Concerning geography and culture Turkey is more Asian than European country. It is possible that it becomes full EU member in next 10 – 15 years. There will be advantages for both sides. Turkey will gain advantages from its membership – after the creation of customs union with the EU in 1996, Turkey will also acquire access to the four freedoms of common market of the EU. There is also a certain threat for Turkey concerning the free movement of labour – Turkey will have only limited access to this freedom. On the other side, the EU will acquire country with great growth dynamics and with wide market. Concerning risks, we have to mention relative political instability which is to be solved before the accession to the EU.

The negotiation duration of EU membership will affect Turkish economy positively, and insurance sector, so reinsurance sector will grow and take the real position in the economy. After starting the negotiations in the 3rd of October, 2005, a hard process has started for all sectors in Turkey. Moreover, in this period a big change awaits insurance and reinsurance

sectors because the reinsurance sector in EU and Turkey has important differences as it has been stated in the previous section. These differences are regulations, itineration of services freely, access standards to markets, capital capacity of companies and obligatory insurances etc…

When we look at the structure of EU, we can see that it is different from the other organizations. The judicial structure is a structure that is "not international" but "supra national". As the member countries create the EU, they have given some of their supremacies to the Union's foundations. EU has a "suis generis" structure with this condition.

Similar to the other countries when Turkey enters the EU it will take the suitable and benefited regulations. The Directive of Reinsurance that is the key of reinsurance sector in EU will be much more useful for Turkey. The laws, regulations and system in Turkey works only if the system starts to corrupt or a law is needed to harmonize the sector. However, the Directive is a project creating, not only applicable when it is needed but also creates projects for a period of time. A similar example in Turkey can be seen 5-year-development plans. The difference is that in EU it has been done for sectors apart from the others. So, if the Directive is applied in Turkey, the system will work much better then now. But the harmonization process of Turkish Reinsurance sector should create its infrastructure according to the system in EU.

Therefore, the changes in the market will be seen clearly. As the Directive states, the companies can work in the other countries with just getting a passport. There will be no restriction for the companies to work in the other countries. Turkey is a big market for the companies of reinsurance in EU, especially if there are no restrictions this will be a great opportunity for them. Also, there will be a great competition between the companies so the service of reinsurance will get better. Moreover, the rule of one company in reinsurance sector will end which means various companies will appear in the market.

9. CONCLUSION

EU and Turkish reinsurance systems have some similarities; although the content is quite different. Both systems have guide foundations, but the missions, goals and applications of these facilities show differences.

The laws of reinsurance and the duration of the laws of reinsurance in both EU and Turkey, market capacities of EU countries and Turkey, policies of reinsurance that are used in EU countries and Turkey, solvency margins in EU and Turkish companies, projects that have been made for reinsurance in both EU countries and Turkey, the competition between the companies in EU countries and Turkey are the main differences that have been explained in the thesis.

In EU, the Directive makes new projects to develop reinsurance. Moreover, it is not the only project developer in EU. There are also other projects that will be developed such as "Reinsurance Supervision Projects". These projects have different objectives, goals to develop reinsurance in EU and also they have different work systems. However, in Turkey there is only Ministry of Teasury for developing new projets about reinsurance. There are new projects that provide alliance possibilities between Turkish and other country companies. Number of insurance companies will decrease and unions will be established and as a result only the best companies will stand. Quality of insurance and reinsurance will increase.

In EU, insurance and reinsurance is much more developed than Turkey. There are banks that belong to reinsurance companies. However, if we look in Turkey, there are sub-foundations of the banks that are for insurance and reinsunrace.

Finally, Turkish Reinsurance system has a long way to get to the level of the EU Reinsurance system. However, we have to work a lot since we must have the same level of reinsurance system of the EU countries once we become an EU member.

Appendix 1: Increase in the Premium Income of Milli Reasürans T.A.Ş.

	2003 (in U.S. Dollars)	2004 (in U.S. Dollars)
Gross Written Premium	340,385,656	427,082,726
Net Retained Premium	293,753,088	364,985,800
Net Earned Premium	249,087,574	339,287,377
Net Losses Incurred	(181,561,107)	(250,965,603)
Net Commissions	(77,151,911)	(86,196,324)
General Underwriting Expenses	(9,787,110)	(12,353,611)
Other Technical Income (Outgo)	2,320,447	2,414,011
Underwriting Result	(17,092,108)	(7,814,150)
Financial Income	44,523,989	60,469,611
Net Profit/ (Loss) before tax.	27,431,880	52,655,511
Contingency Earthquake Loss Reserve	(14,918,609)	(14,139,579)
Taxes, Tax Reserves + Others	(10,441,910)	(29,933,120)
Balance Sheet Profit	2,071,361	8,582,812

Total Assets	323,996,319	515,779,453
[- Liquidity	237,660,276	376,601,608]
- Bonds	177,576,955	272,672,018
- Real Estates	39,971,899	88,501,226
- Affiliates	30,088	331,728
- Insurance Debts	54,964,541	54,696,640
- Cash	47,479,837	89,255,838
- Other Assets	3,972,999	10,322,003

Total Liabilities	190,160,584	257,136,814
- Technical Reserves	163,424,287	221,662,733
- Premium Reserve	97,291,766	126,883,519
- Loss Reserve	66,132,521	94,779,214
- Other Liabilities	26,736,297	35,474,081

Shareholders' Fund	133,835,735	258,642,639
- Capital	15,881,594	46,715,112
- Legal Reserve Fund	2,947,779	3,937,022
- Contingency Reserve Funds	115,006,362	113,238,384
- Capital Reserves due to Inflation Adjustment	-	94,752,121

Number of Employees	187	184
Year-end Rate of Exchange / 1USDollar = TL	1,402,567	1,348,600

Appendix 2: Profit and Loss Account of Milli RE for 2004

	FIRE	MARINE	ACCIDENT	ENGINEERING	AGRICULTURE	HEALTH	0NON-LIFE TOTAL	LIFE	TOTAL
I- INCOME (TECHNICAL)	**287,038,944,216,426**	**55,204,886,249,625**	**388,050,576,485,363**	**69,885,930,111,375**	**1,959,937,339,372**	**92,208,493,098,716**	**894,348,767,500,877**	**9,404,244,122,448**	**903,753,011,623,325**
A)Premium	181,316,152,763,017	27,913,101,190,522	253,165,499,405,741	39,151,461,769,578	1,165,963,969,864	66,078,053,215,738	568,790,232,314,460	7,173,531,533,599	575,963,763,848,059
B)Commissions	6,204,003,872,523	1,285,435,751,315	2,461,106,937,329	2,437,709,297,168	159,985,112,450	11,076,588,255	12,559,317,559,040	230,850,333,926	12,790,167,892,966
C)Retrocessionaires' Shares in Paid Losses	23,645,698,729,637	3,066,635,091,336	4,662,911,849,821	3,596,702,061,007	238,618,575,234	2,089,750,201,833	37,300,316,508,868	121,436,440,000	37,421,752,948,868
D) Technical Reserves Brought Forward (Nett)	52,373,341,526,185	13,748,800,562,342	119,503,279,564,882	19,239,608,926,080	229,009,192,050	22,386,393,337,525	227,480,433,109,064	1,733,078,423,880	229,213,511,532,944
a) Current Liabilities Reserve	23,272,733,964,725	4,568,237,988,421	79,533,850,126,016	9,223,194,631,380	54,516,233,582	19,042,309,593,786	135,694,842,537,910	763,378,493,277	136,458,221,031,187
b) Outstanding Losses Reserve	29,100,607,561,460	9,180,562,573,921	39,969,429,438,866	10,016,414,294,700	174,492,958,468	3,344,083,743,739	91,785,590,571,154		91,785,590,571,154
c) Mathematical Reserves (Life)							0	798,906,904,211	798,906,904,211
d) Outstanding Indemnity Reserve (Life)							0	170,793,026,392	170,793,026,392
e) Reserve for Profit Share (Life)							0		0
f) Other Technical Reserves							0		0
E) Retrocessionaires' Shares in Technical Reserves	21,684,981,098,525	9,189,279,595,460	5,999,769,689,558	5,439,975,499,511	169,223,538,642	1,478,601,947,429	43,961,831,369,125	141,258,574,703	44,103,089,943,828

a) Current Liabilities Reserve	7,598,283,896,762	1,203,770,799,430	3,333,478,600,620	2,372,434,884,972	29,498,560,420	1,312,074,496,042	15,849,541,238,246	141,258,574,703	15,990,799,812,949
b) Outstanding Losses Reserve	14,086,697,201,763	7,985,508,796,030	2,666,291,088,938	3,067,540,614,539	139,724,978,222	166,527,451,387	28,112,290,130,879		28,112,290,130,879
c) Mathematical Reserves (Life)ı							0		0
d) Outstanding Indemnity Reserve (Life)							0		0
e) Reserve for Profit Share (Life)							0		0
f) Other Technical Reserves							0		0
F) Other Income	1,814,766,226,539	1,634,058,650	2,258,009,038,032	20,472,558,031	(2,863,048,868)	164,617,807,936	4,256,636,640,320	4,088,816,340	4,260,725,456,660
II-OUTGO (TECHNICAL)	**283,075,105,704,793**	**52,536,914,439,609**	**393,660,693,326,505**	**80,498,448,543,969**	**2,009,631,948,245**	**97,272,335,799,175**	**909,053,129,762,296**	**8,544,259,003,779**	**917,597,388,766,075**
A) Premiums due to Retrocessionaires	53,811,243,113,598	5,895,639,195,897	8,298,690,544,817	12,129,874,397,651	522,864,124,779	2,310,509,596,360	82,968,820,973,102	775,092,624,334	83,743,913,597,436
B) Commissions Paid	42,328,457,740,845	8,845,597,959,538	50,483,064,283,541	14,166,162,580,219	361,537,314,656	9,818,941,260,932	126,003,761,139,731	3,030,769,576,214	129,034,530,715,945
C) Losses Paid	79,429,673,534,466	12,463,484,434,866	173,306,249,107,802	24,407,441,574,968	735,550,840,137	48,143,158,347,089	338,485,557,839,328	2,324,450,999,599	340,810,008,838,927
D) Technical Reserves	106,172,904,310,818	25,319,010,912,441	161,137,003,323,055	29,752,013,323,258	373,492,720,196	36,941,263,217,865	359,695,687,807,633	2,410,400,762,948	362,106,088,570,581
a) Current Liabilities Reserve	33,932,562,640,186	7,103,249,360,037	102,759,828,628,404	12,118,650,510,687	66,784,226,418	29,638,622,004,580	185,619,697,370,312	1,486,216,586,092	187,105,913,956,404
b) Outstanding Losses Reserve	53,541,077,845,516	18,215,761,552,404	58,377,174,694,651	17,263,990,325,507	306,708,493,778	7,302,641,213,285	155,007,354,125,141		155,007,354,125,141
c) Contingency Earthquake Reserve	18,699,263,825,116			369,372,487,064			19,068,636,312,180		19,068,636,312,180
d) Mathematical Reserves							0	701,784,858,755	701,784,858,755

e) Outstanding Indemnity Reserve							0	222,399,318,1 01	222,399,318,101
f) Reserve for Profit Share							0		0
g) Other Technical Reserves							0		0
E) Other Outgo	1,332,827 ,005,066	13,181,936,867	435,686,067,290	42,956,667,873	16,186,94 8,477	58,463,376 ,929	1,899,302,0 02,502	3,545,040,684	1,902,847,043,186
III- TECHNICAL PROFIT/LOSS (I-II)	**3,963,838 ,511,633**	**2,667,971,810,016**	**(5,610,116,841,142)**	**(10,612,518,432,594)**	**(49,694,6 08,873)**	**(5,063,842 ,700,459)**	**(14,704,362 ,261,419)**	**859,985,118,6 69**	**(13,844,377,142,750)**
IV- GENERAL EXPENSES	**0**	**0**		**0**	**0**	**0**	**45,535,825, 626,703**	**310,533,414,7 47**	**45,846,359,041,450**
A) Personnel							13,336,791, 938,285	291,904,336,6 63	13,628,696,274,948
B) Administration							3,030,864,5 06,088	518,908,884	3,031,383,414,972
C) Taxes and Duties							28,629,724, 100,945	2,975,437,500	28,632,699,538,445
D) Depreciation							400,212,40 7,551		400,212,407,551
E) End of Service Remuneration Provision							138,232,67 3,834	15,134,731,70 0	153,367,405,534
F) Other Expenses							0	0	0
V- FINANCIAL INCOME	**0**	**0**		**0**	**0**	**0**	**94,651,888, 163,847**	**897,657,255,6 60**	**95,549,545,419,507**
A) Interests							68,365,549, 091,674	897,657,255,6 60	69,263,206,347,334
B) Profit Share Income							557,410,23 0,929		557,410,230,929
C) Sales Profits							413,727,18		413,727,182,496

							2,496		
D) Rents							6,604,255,966,367		6,604,255,966,367
E) Foreign Exchange Profits							14,378,583,237,447		14,378,583,237,447
F) Comp.Earthquake Ins.Commissions							4,301,864,766,215		4,301,864,766,215
G) Other Income							30,497,688,719		30,497,688,719
VI- FINANCIAL OUTGO	**0**	**0**		**0**	**0**	**0**	**23,796,843,687,281**	**487,185,181,323**	**24,284,028,868,604**
A) Interests							0	0	0
B) Sales Losses							645,960,407,325		645,960,407,325
C) Foreign Exchange Losses							11,631,912,693,603		11,631,912,693,603
D) End of Service Remuneration Provision							0		0
E) Comp.Earthquake Ins.Commissions							31,498,103,348		31,498,103,348
F) Tax Provisions							11,247,920,404,637	487,185,181,323	11,735,105,585,960
G) Other Outgo							239,552,078,368		239,552,078,368
VII- PROFIT/LOSS (III-IV+V-VI)							**10,614,856,588,444**	**959,923,778,259**	**11,574,780,366,703**

Appendix 3: F.A.I.R. Pool's Premium and Membership – Wise Experiences

YEAR	PREMIUM IN STG	MEMBERSHIP		
		Africa	Asia	Total
1974	857,527 (accounted)	11	13	24
1975	1,939,998 (accounted)	12	18	30
1976	2,608,860 (accounted)	17	25	42
1977	3,386,703 (accounted)	17	26	43
1978	4,274,209 (accounted)	19	31	50
1979	5,517,263 (accounted)	23	34	57
1980	6,640,032 (accounted)	24	40	64
1981	9,298,266 (accounted)	25	40	65
1982	8,871,891 (accounted)	27	39	66
1983	9,865,970 (accounted)	28	40	68
1984	10,327,917 (accounted)	28	41	69
1985	9,940,333 (accounted)	27	39	66
1986	11,876,728 (accounted)	30	38	68
1987	10,714,068 (accounted)	29	38	67
1988	11,700,657 (accounted)	28	39	67
1989	12,639,454 (accounted)	31	43	74
1990	13,247,108 (accounted)	36	43	79
1991	13,017,830 (accounted)	34	42	76
1992	15,871,099 (accounted)	34	41	75
1993	16,987,373 (accounted)	31	43	74
1994	16,441,623 (accounted)	27	41	68
1995	14,969,182 (accounted)	23	41	64
1996	14,707,831 (accounted)	21	39	60
1997	13,264,310 (accounted)	21	38	59
1998	12,005,795 (accounted)	23	37	60
1999	11,816,399 (accounted)	26	36	62
2000	16,900,000 (estimated)	26	41	67
2001	20,000,000 (estimated)	23	44	67
2002	25,000,000 (estimated)	23	42	65
2003	30,500,000 (estimated)	24	45	69
2004	32,500,000 (estimated)	23	46	69
2005	37,500,000 (estimated)	25	44	69

11. GLOSSARY

ACCIDENT INSURANCE	Insurance coverage against loss by accidental bodily injury.
AGENCY	A legally established relationship (often a business firm) whereby one party (the PRINCIPAL) delegates to another party (the AGENT) the right to act on behalf of the principal in business transactions and to exercise some degree of discretion while acting. For example in the insurance industry, an agency represents an insurance company (the PRINCIPAL).
AUTOMATIC REINSURANCE	An agreement that the insurer must cede and the reinsurer must accept all risks within certain explicitly defined limits. The reinsurer undertakes in advance to grant reinsurance to the extent specified in the agreement in every case where the ceding company accepts the application and retains its own limit. See also, Treaty Reinsurance.
BROKER	One who acts as an intermediary between parties in a transaction. A broker, for a fee or other consideration, arranges a transaction (a sale) by a seller to the buyer. A license is often required for businesses engaged in brokerage transactions.
CATASTROPHE BOND	Risk-based securities that allow (re)insurance companies to transfer natural catastrophe insurance risk to institutional investors in the form of bonds. Cat bonds help to spread peak exposures
CATASTROPHE REINSURANCE	A form of excess of loss reinsurance that, subject to a specified limit, indemnifies the ceding company for the amount of loss in excess of a specified retention with respect to an accumulation of losses resulting from a covered catastrophe, such as a hurricane or hailstorm.

CATASTROPHE RISK
In insurance language, the risk of a major devastation of person or property, generally due to natural calamities. In securitization language, it also means the risk of an unprecedented near-complete collapse of the originator's cash flows, leading to a catastrophe for the investors.

CEDANT
A ceding insurer or reinsurer. Ceding means to contractually transfer a portion of a risk or risks to a reinsurer.

CERTIFICATE OF INSURANCE
A document issued by an insurance company verifying coverage of property, specifying the amount of coverage.

CESSION
Amount of the insurance ceded to a reinsurer by the original insuring company in a reinsurance operation.

CO-INSURANCE
Sharing of an insurance risk; a provision in an insurance policy or contract requiring the insured party maintain some amount and type of insurance to protect another party from certain provisions of the policy or contract if a loss occurs. Co-insurance is prudent when one company cannot underwrite the entire risk or when more that one company is working on the same project. Also, co-insurance can apply to a situation wherein you insure for 100 percent and your business assumes co-insurance for 20 percent (20 percent FLOOR or 20 percent DEDUCTIBLE); thus, your insurance premium is much less because you have assumed only 20 percent of the loss.

DAMAGES
Unsalable merchandise for which reimbursement is sought from the supplier or the transporter. In insurance, the physical and financial cost of a loss.

EXCESS OF LOSS REINSURANCE
A contract between an insurer and a reinsurer, whereby the insurer agrees to pay a specified portion of a claim and the reinsurer to pay all or a part of the claim above that amount.

FACULTATIVE REINSURANCE	A reinsurance policy that provides an insurer with coverage for specific individual risks that are unusual or so large that they aren't covered in the insurance company's reinsurance treaties. Reinsurers have no obligation to take on facultative reinsurance, but can assess each risk individually. By contrast, under treaty reinsurance, the reinsurer agrees to assume a certain percentage of entire classes of business.
FINANCIAL REINSURANCE	Reinsurance that combines risk transfer with elements of risk finance.
FIRE INSURANCE	Coverage for loss of or damage to a building and/or contents due to fire.
HIDDEN RISK	A risk associated with a business venture that is not apparent without considerable investigation and knowledge. In business, there are always unknown factors that can affect the profitability of the business. Therefore, the business entrepreneur should constantly evaluate all phases of business activity to minimize the amount of hidden (unknown or unforeseen) risk.
INDEMNITY	Indemnity is generally a payment or compensation for damages done. For example, after wars, the losers have sometimes been required to pay indemnities. An insurance payout is often called an indemnity, or it can be insurance to avoid paying expenses in case of a lawsuit.
INSURANCE	Indemnification against (reimbursement for) financial loss resulting from a specific risk, hazard or peril. In a broad sense, insurance transfers risk from individuals to a larger group that is better able to pay individual losses from a pool of money collected from all members of the group.
INSURANCE AGENCY	A group of insurance agents representing one or more specified insurance companies. The agency sells insurance policies offered only by those companies.

INSURANCE AGENT	A person who is authorized to represent an insurance company and acts on behalf of the insurance company, such as a salesperson for an insurance company.
INSURANCE BROKER	A person or firm that represents and sells for more than one insurance company. An insurance broker often, has knowledge of several insurance companies' policies and reputations, allowing selection of the optimum policy for an individual business situation.
INSURANCE COMPANY	A business engaged solely in the protection against financial loss; a business as an INSURER. An insurance company may be a source of money for a small business to borrow using real property as collateral since the insurance company desires to earn interest income.
INSURANCE COVERAGE	The amount of INSURANCE purchased to protect a financial risk, hazard or peril.
INSURANCE POLICY	A document describing risks, hazards or perils of an individual or business (the INSURED) covered by the INSURER (INSURANCE COMPANY) including the conditions of coverage, amount of coverage and PREMIUM to be paid for such coverage.
INSURANCE POOL	A group of INSURERS who share the premiums and losses in order to spread the risk of unique situations. Thus a group of insurance companies can take on larger risks than any individual company could bear alone, thus permitting small insurance companies to collectively compete with larger companies.
INSURED	The person or business covered by insurance; the POLICY HOLDER; the one who purchased the insurance policy.
INSURER	The one who insures against financial loss-e.g., an INSURANCE COMPANY.

LIABILITY INSURANCE	Financial protection from a loss resulting from the legal responsibility for an act; the obligation to make good any loss or damage that occurs in a given situation; financial compensation for such a loss.
LIFE INSURANCE	An agreement that guarantees the payment of a stated amount of monetary benefits upon the death of the insured.
LOSS	In an accounting situation, a negative value resulting when expenses are deducted from income of a business as shown on an INCOME STATEMENT. In an investment transaction, the amount by which the ending CAPITAL is smaller than the beginning CAPITAL (invested amount), a loss of CAPITAL. The opposite of a PROFIT. In insurance, the amount reimbursed (before any deductible) by an insurer resulting from a financial risk covered (indemnified) under an INSURANCE POLICY, such as damage, injury or death.
MARINE INSURANCE	Insurance that compensates the owners of goods transported overseas in the event of loss that cannot be legally recovered from the carrier. Also covers air shipments. Compare Credit risk insurance.
POLICY	Short for an INSURANCE POLICY. Wise, prudent or visionary guidance from the very top level of an organization, setting the general direction, as opposed to a law or rule that has distinct limits; a plan or course of action to be pursued by the business.
POLICYHOLDER	The INSURED.
POOL	In business finance, a concept of gathering monies from several sources for a single use; to pool the money. See more specific uses of the term pool used in various aspects of business, such as: INDUSTRY POOL; INSURANCE POOL; INVESTMENT POOL.

PROPORTIONAL REINSURANCE	A type of reinsurance where the ceding insurer cedes to its reinsurer a predetermined proportion of the liability and premium of those policies subject to the reinsurance agreement.
QUOTA SHARE REINSURANCE	A proportional or pro rata reinsurance treaty where the same proportion is ceded on all cessions. The reinsurer assumes a set percentage of risk for the same percentage of the premium.
REINSURANCE	Sharing the RISK among two or more insurance companies. Part of the primary insurance company's risk is assumed by back-up companies. Thereby, reinsurance allows an individual company to take on clients whose coverage needs are greater than the individual insurance company's capacity alone.
REINSURER	An insurance company that assumes part of the risk in exchange for part of the premium, as back-up, to a primary insurer.
RETROCESSION	Amount of the risk accepted by the reinsurer which is then passed on to other reinsurance companies.
SOLVENCY	The ability to meet financial obligations on time.
SOLVENCY MARGIN	The minimum excess of an insurance company’s capital over its liabilities. Insurance companies are required to maintain a minimum solvency margin.
TREATY REINSURANCE	A standing agreement between insurers and reinsurers. Under a treaty each party automatically accepts specific percentages of the insurer's business.
INSURABLE INTEREST	A condition in which the person applying for an insurance policy and the person who is to receive the policy benefit will suffer an emotional or financial loss if the event insured against occurs. Without the presence of insurable interest, an insurance contract is not formed for a lawful purpose and, thus, is void from the start.

UTMOST GOOD FAITH	Mutual trust in negotiating an insurance contract. A breach of good faith by one party entitles the other to avoid the contract.

12. REFERENCES

Direct References

Swiss Re., “Reinsurance – a systemic risk”; Sigma 5/2003.
Alistair Johnston. 'Accounting for Financial Reinsurance', a paper presented to the 1994.
Ali Bayram, Birsen Çankaya, Ticari Terimler Sözlüğü, 2002.
Andrew J. Barile & Peter R. Barker, Reinsurance and Reinsurance Management, 1968.
Baydar, Özgen, Reasürans işlemleri ve Türkiye'de reasürans tekeli uygulaması, 1988.
Bayer, Arzu, Türk Sigorta Sektörü'nde Reaasürans Uygulamalarında Karşılaşılan Problemler ve Çözüm Yolları, 1994.
Cahit Nomer, Hüseyin Yunak, Reasürans, 1998.
C.E.Golding, Reinsurance Obligations.
C.E.Golding, Reinsurance Survey.
C.E.Golding, The Development of Fire Reinsurance in the United Kingdom, 1952.
C.E Golding, A history of reinsurance, 1931.
“Reactions Publishing Group”, England.
Commission, “Directive of the European Parliament and of the Council”, 2003.
Council of the European Union, “Commission Staff Working Paper: Extended Impact Assessment”, 2002.
Council of the European Union, “Commission Staff Working Paper: Extended Impact Assessment”, 2004.
Christoph Pfeiffer, Reinsurance, 1992.
Douglas Holtz-Eakin, April 14 2005, "Federal Terrorism Reinsurance",CBO Testimony.
Ekener, Türkiye'de Mükerrer Sigorta Sorunu ve Bütün Vesaiki ile Reasürans İnhisar Davası, 1974.
Euromoney Yearbooks, International Reinsurance Review, 2005 / 06.
Eser,Kıymet, Reasürans anlaşmalarında kullanılan teknikler ve Türkiye uygulamaları, 1999.
Graham C. Pewter. 'Step by step'. The Review. March 1991.
Guy Carpenter, The World Catastrophe Reinsuırance Market 2004.
Heidi E Huller, 'Financial Reinsurance: Answering the Critics', Best's Review, March 1991
http://www.fsforum.org/home/home.html .

Iktisadi Arastirmalar Vakfi yayinlari, 1996, "Türk sigorta sektörü".
J.A.S. Neave, Reinsurance Today: A General Survey.
J.O. Irukwu, Company, the Shareholder, the Director, and the Law, 1995 .
John E. Tiller, FSA, Denise Fagerberg Tiller, Life Health & Annuity Reinsurance, Chapter 4, 2005.
John Jennings, Reinsurance industry underreserved, S&P warns. (Standard & Poor's Insurance Rating Services Group), 1993.
Lothar Sudekum, The Intermediary in International Reinsurance.
Kenneth C. Froewiss, A Practical Guide to Finite Risk Insurance and Reinsurance, 1998.
M.H. Atkins, Simulation Models in Risk Managament, 1992.
Council Directives "On reinsurance and amending" 73/239/EEC, 92/49/EEC and Directives.
Paul Walther, Buyers perspectives on the Reinsurance Market, 2003.
R.L. Carter and P. Falush, The Londan Insurance Market: Issues and Responses.
RL. Carter, Reinsurance, 1995.
R.L Carter, Reinsurance Essentials, 2003 .
R.L.Carter, Reinsurance, 4th Edition, 2005.
RCD Insurance Manual, 1967.
Reinsurance Directive, "Regulatory Impact Assestment", 2005.
Robert C Reinarz, A reference book of property and liability reinsurance management , 1968.
Robert Hammesfahr, Reinsurance Claims, August 2004.
Robert W. Strain, Reinsurance, 1997.
Savaşçı, Sevim, "Türkiye'de sigorta ve Reasürans şirketlerinin yatırımları için ekonometrik model çalışması", 1997.
Schmitter, H., , Setting Optimal Reinsurance Retentions, 2001 Swiss RE Publishing, Zurich.
Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003.
Standard & Poor's, Global Reinsurance Highlights 2003 Edition, London/New York 2003.
Şakarcan, R.Can, Non-Proportional Reinsurance, 1991.
TSRSB. Available on site www.tsrsb.org.tr.
UNCTAD Secretariat, "Reinsurance Security", 2004.
Victor Dover, a handbook to marine insurance, 1975.

Indirect References

Available on site www.globalreinsurance.com.

Available on site www.lrg.com.

Available on site www.millire.com.

Available on site www.reinsurancecontracts.com.

Available on site www.rrccanada.org.

Available on site www.captive.com/services/signestart/GlosRein.Html.

Availabe on site www.rsi-solutions.com.

Available on site http://www.fsforum.org/home/home.html.

Conference of The Association of Insurance and Risk Managers..

Council of the European Union, Commission Staff Working Paper: Extended Impact Assessment.

Dacey, Mark S., Principles and Practice of Insurance, 2nd Ed., 1989.

Dickson, G.C.A., and J.T. Seele, Introduction to Insurance, 2nd Ed., 1996.

Doherty, N.A., Innovations In Managing Catastrophe Risk, The Journal of Risk and Insurance, 1997.

Global Reinsurance Online Magazine Articles, 2005.

Güven, O, Açıklamalı Sigorta ve Reasürans Terimleri Sözlüğü, Munich, 1995.

Hansell, D.S., Introduction to Insurance, 1996.

London Reinsurance Group.

Milli Reasürans T.A.Ş., 2005, Sigorta Genel Şartlarının Yargısal Denetimi, Sayı:56, Süreli Yayınlar.

Munich RE, 1997, "Guidelines for the Rendering of Accounts Between Direct Isurersand"

Munich RE Publications "Reinsurers in the Non-Life Classes of Business", Munich.

Nomer, C., Yunak, H., Reasürans, İstanbul, 1998.

Phifer, R., Reinsurance Fundamentals Treaty and Facultative, John Wiley and Sons, Canada 1996.

Anderson, Jack R. Defense counsel and reinsurance, 1996