

### RATING TRIGGERS IN THE REINSURANCE SECTOR

The reinsurance sector contributes positively to financial stability by providing a safety net for the primary insurance industry. Reinsurance companies typically absorb the most volatile part of the risk corresponding to peak exposures (i.e. the risk of substantial losses arising from events occurring with a low probability) which primary insurers are not willing to keep in their balance sheets. By pooling insurance risk, reinsurance firms can achieve superior risk diversification, both in term of business lines and geographically and after a catastrophe event, they tend to be able to endure losses transferred by the primary sector. As a result, risks and capital in the insurance industry tend to be better managed, making the primary insurance sector more resilient when it takes out reinsurance. Furthermore, despite their central role in the worldwide insurance markets as “insurers of last resort” and their very high business concentration, reinsurance undertakings are often not perceived as being a source of systemic risk. The low potential of financial market disruption<sup>1</sup> and the limited counterparty risks for banks on the credit derivatives markets<sup>2</sup> support the view that reinsurance undertakings are not systemic core institutions.<sup>3</sup> This Box aims at questioning this view by analysing some of the ways in which the reinsurance sector may constitute a vulnerability or weak-spot for the stability of the financial system. In particular, it examines how the likely widespread inclusion of rating triggers in reinsurance contracts in the run-up to implementation of Solvency II may increase the vulnerability of reinsurers to liquidity risk in the same way as runs can take place on banks.

A rating trigger can be defined as “any clause in a contract or agreement between two parties that allows one party to take protective action against deteriorating creditworthiness of the other party once a pre-determined rating threshold is breached.”<sup>4</sup> Concretely, in the case of a downgrade of a reinsurer below a certain level, such as BBB, its customers (i.e. primary insurers that ceded risk) may require the reimbursement of part of the premiums they paid, in exactly the same way as in the case of bank runs, where depositors ask for their money back. As a result, reinsurers are vulnerable to a possible loss of confidence on the part of their customers. This means that the logic of “first-come, first-served” may also affect the reinsurance business, once a rating breaks the threshold activating the triggers. Hence, the liabilities of reinsurers may potentially become liquid, albeit perhaps less quickly than for banks.

In 2004, the activation of rating triggers destabilised the financial position of several reinsurers: as their ratings fell below security thresholds, these companies had to return large amounts of premium to customers.<sup>5</sup> This eventually led to further downgrades. The losses of business

1 See IMF (2002), “The financial market activities of insurance and reinsurance companies”, *Global Financial Stability Report*, Chapter III, May; Swiss Re (2003), “Reinsurance: A systemic risk?”, *Sigma* No 5/2003; G30 (2006), “Reinsurance and international financial markets” and G. L. Reuber (2000), “International financial stability: What risks arise from the reinsurance industry in offshore centers and how might these be reduced”, Office of the Superintendent of Financial Institutions, Canada.

2 See International Association of Insurance Supervisors (IAIS), (2005), *Global Reinsurance Market Report 2004*, December, and Fitch Ratings (2005), “Global credit derivatives survey: Risk dispersion accelerates”, November.

3 See G30 (1997), “Global institutions, national supervisors and systemic risk”.

4 See Moody’s (2005), “Rating triggers in the mortgage insurance industry – 2005 update”, Special Comment, December.

5 PMA, Atlantic Mutual, Centre Group and Converium Reinsurance all breached the rating threshold.

endured by these reinsurance firms were furthermore aggravated by implicit triggers: brokers and distributors apply minimum rating requirements as one of the criteria in the placement of reinsurance, so that if a reinsurance company fails to maintain a certain minimum financial strength rating, then they will no longer market its products. Although implicit triggers are not built into contracts, both implicit and explicit triggers may substantially hamper the capacity of reinsurers to withstand any negative shocks and to recover afterwards. In 2005, more than half of the reinsurance contracts outstanding included such an explicit clause.<sup>6</sup> Rating triggers tend to be included more often in contracts involving small reinsurance companies with rather low ratings. This is because their bargaining power tends to be limited by the closeness of their position to the trigger points.<sup>7</sup> However, some large reinsurers have also accepted such clauses in their contracts, and the implementation of Solvency II may potentially lead to widespread inclusion of rating triggers in reinsurance contracts.

Under the new regulatory regime, more capital relief may be expected from primary insurers' use of reinsurance, so that EU primary insurers may face a stronger incentive than in the past to transfer risk to the reinsurance sector. This will raise the credit risk exposures of primary insurers vis-à-vis reinsurers. In Solvency II, credit risk will be explicitly included in regulatory capital requirements. Hence, any financial problem faced by a reinsurer will result in rising credit risk and also higher capital requirements for the primary insurers. The propagation channel between the two sectors may therefore be enhanced. To avoid this, primary insurers may face a stronger incentive than in the past to seek rating triggers in reinsurance contracts in order to protect themselves against any significant deterioration in the creditworthiness of their reinsurers. To a certain extent, the primary sector could achieve greater stability, as rating triggers should shelter them against solvency pressures arising from their credit risk exposures to reinsurance companies. However, this may have adverse consequences in the reinsurance sector, especially for those companies involved in the retrocession market.

Indeed, in a slightly similar way that banks participating in a payment system are interconnected within the interbank market, the retrocession market links the majority of reinsurance companies worldwide. For reinsurers, retrocession is part of any risk management strategy, as reinsurance companies rarely keep all the risks they underwrite: they typically transfer most of the risk they do not want to bear to those reinsurance undertakings that participate in the retrocession market. Only a small fraction of the risk is by contrast transmitted to the financial markets through securitisation. Such retrocession of risks between reinsurance companies splits up large and unique risks and distributes them in the international reinsurance market. This allows cover to be obtained even for risks which are too large for the largest individual reinsurers. Such spirals of risk retrocession within reinsurers links them in a tight network via a multitude of reinsurance contracts. Retrocession leads to a significant level of credit risk for all companies, as these contracts may not be fully collectible in the case of insolvency risk. On average, about 15% of the total reinsurance premiums written in 2004 were subsequently retroceded. As not all reinsurance companies participate in the retrocession market, the average exposures of retrocessionnaires are therefore much higher.

6 About 51% of the reinsurers surveyed by Moody's in 2005 responded that they had rating triggers within their reinsurance contracts, compared with 41% in 2004, 35% in 2003 and 26% in 2002; see Moody's (2005), "Rating triggers in the property & casualty insurance industry – 2005 update: widespread, but unlikely to result in industry-wide downgrades", Special Comment, December.

7 See Fitch Ratings (2004), "Mid-year 2004 global reinsurance outlook", Special Report, Insurance, September.

If a systemic event were to occur, which in the reinsurance sector could be the confluence of several major natural catastrophes<sup>8</sup> to which a critical mass of reinsurers are exposed and whose impact on claims are much larger than expected, then the mechanism of shock propagation between reinsurers would involve credit risk.<sup>9</sup> Each reinsurance company participating in the retrocession market would have to absorb the repercussions of the initial systemic shock as well as the potential withdrawal of its customers, and would additionally face significant credit risk from their reinsurers' counterparties. Indeed the counterparties could also be affected by the initial shock and by liquidity shrinkage from runs of their own primary insurers. With Solvency II, the increase in credit risk should lead to higher capital, and all reinsurers may therefore potentially face the need to raise regulatory capital at the same time. As reinsurance companies are very often part of large conglomerates, such pressures on capital requirements may well spread to other parts of the financial system such as the banking sector.

Finally, it is unlikely that the increased supervision and harmonisation of regulation that may be expected from the implementation of the Reinsurance Directive<sup>10</sup> and of Solvency II will reduce the incentive to include rating triggers in reinsurance contracts. This is because the information of regulatory authorities is not public, which ensures that the information conveyed by rating agencies in the choice of reinsurance companies by primary insurers will continue to be valuable. Furthermore, even if regulators were publicly to disclose some of their information, it would not enjoy some of the characteristics of the information revealed by ratings (e.g. being directly understandable, readily available and regularly updated). The new regulatory environment is therefore unlikely to push the role of rating agencies together with rating triggers into the background.

8 Owing to climatic changes, whose influence on natural catastrophes is currently very difficult to predict, the probability of systemic events for the reinsurance industry has been increasing.

9 Liquidity risk as a propagation mechanism between reinsurers is much less relevant when compared to the banking sector, as pressures on liquidity cannot materialise quickly from one reinsurer to another; however, liquidity may be exacerbated by banks refusing to extend some credit lines to reinsurers facing financial stress.

10 The Reinsurance Directive was approved by the European Parliament on 7 June 2005 and adopted by the EU Council on 7 November 2005. Following its adoption, Member States have two years to implement it.