

# Sub-contract GW/S - guidance note.

## Building Employers Confederation - Standard Form of Labour

13 - Reinsurance and Other Forms of Risk Transfer	O	The relatively prescribed system of indicators of financial strain and procedures for dealing with troubled companies (including the FAWG process) has meant that interventions have been taken at an early stage.  The regulation of reinsurance is comprehensive and supervision practices appropriate with due consideration of risk. The handbook gives detailed guidance on best practices and on the evaluation of reinsurance programs.  State regulators analyse material intra-group reinsurance contracts. However, if an insurance group is holding too a complex web of reinsurance in place, there can be interactions which impact the value and potential performance of reinsurance in place.  The current valuation standard for life insurers is prescriptive and in many cases formula based. As insurance products have become more complex, the prescribed algorithms and formulae used to determine reserves have proven to be completely unworkable. New products often require tailor made approaches for valuation. Assumptions used for reserving are often static, and set at the time the insurance products were sold. The valuation standard has varying levels of conservatism, which leads to a lack of transparency. The valuation standard uses an interest cost for specific assets, under a hold to maturity argument to assets that cover liabilities. This argument breaks down for products where appropriate risk management requires a frequent re-balancing of the asset portfolio. The valuation standard does not necessarily give appropriate incentives for dynamic hedging for products where this would constitute appropriate risk management.  The shortcomings of the valuation standard are documented and mitigated by complex structures in which life insurers engage. In some states, affiliated entities can hold lower assets to back reserves. Even at the capital level, the full formulae reserve is required. However, for capital the difference between the full formulae, capital and the economic reserve is allowed to be backed by other assets, which could include letters of credit, which do not meet the definition of an asset in GAAP or statutory accounting.  FSB would reduce many of the shortcomings outlined above. It would be better placed to deal with complex products and would reduce the tendency to engage in regulatory arbitrage, i.e. via affiliated capital transactions. The supervisory review of FSB will require sufficient expertise of the state regulators.  Allowing for conservatism explicitly in a margin over current estimate would increase transparency. The explicit decomposition of reserves into a current estimate and a margin over current estimate allows assessment of the overall conservatism for different lines of products. This would allow a recalibration of the valuation standard for products where reserves are overly conservative or not sufficient.  Any capital requirement that the FSB has to develop has to be based on a valuation standard. The FSB should consider the development in use of a
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Description: -

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Notes: Cover title.

This edition was published in 1985



Filesize: 50.95 MB

Tags: #SBS #Scottish #domestic #sub

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