

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS
BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTTEG)

ISSUES PAPER (BOPTTEG) # 24

**REINSURANCE—IMPLICATIONS FOR BALANCE OF PAYMENTS
AND NATIONAL ACCOUNTS**

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Background

1. An OECD working party was set up towards the end of 2001 to discuss the standardisation of measuring insurance output in the event of a catastrophic incident. The use of the reinsurance market is integral to the insurance of large scale risks. Reinsurance allows insurers to reduce their risks in concentrated positions and to share risks that are too large for any one single direct insurance company to take on. The role of the reinsurance market continues to increase as the number of catastrophes increase both in number and expense. Reinsurance is often arranged with nonresident insurance companies

2. Reinsurance tends to be written on one of two types of treaty reinsurance. In the first of these, proportional reinsurance, the reinsurer enters a contract to assume a share of the risk in exchange for a share of the premiums. In the second type, excess-of-loss reinsurance, the ceding company retains a risk up to a certain stated amount, and then the reinsurers pay any amount above that. This type of reinsurance is often purchased in layers. For example a reinsurer may assume the risk between 1 million and 2 million pounds sterling. This is a form of non-proportional reinsurance that indemnifies the ceding insurer for that proportion of each loss occurrence in excess of a stipulated retention.

Current international standards for the treatment of the issue

3. The main directive of the treatment of reinsurance can be found in Annex IV of the *SNA 1993*, paragraphs 27 to 30. It states that

“reinsurance is a form of insurance that involves only institutional units classified as insurance corporations and pension funds, though one party to a transaction may be nonresident.”

“The System records transactions between policyholders and claimants on the one hand and the resident life and non-life industries on the other without regard to the division within the industry between direct insurance and reinsurance.”

“When reinsurance takes place between resident direct insurers and nonresident reinsurers or between nonresident direct insurers and resident reinsurers, a complete consolidation is inappropriate. However, rather than show all flows of premiums, claims, commissions, etc., between direct insurers and reinsurers, it is simpler and more comprehensible to consider that the reinsurers deliver a service to direct insurers measured as the balance of all flows occurring between resident direct insurers and non-resident reinsurers. These flows include

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premiums ceded, investment income from technical reserves payable, commissions receivable, claims recovered and reinsurers share in the addition to technical reserves if relevant. Exports of reinsurance services are similarly estimated as the balance of all flows between resident reinsurers and nonresident direct insurers. Apart from these two flows, all insurance transactions in the rest of the world account refer to direct transactions only. ”

“ Imported reinsurance services appear as intermediate consumption of resident direct insurers.”

4. The main directive of the treatment of reinsurance in the *BPM5* can be found in chapter XIII, paragraph 257. It states that

“In principle, the measurement of transactions in international insurance services is consistent with that described in the SNA for insurance services for resident sectors.”

“For reinsurance, exports of services (credits) are, in principle, estimated as the balance of all flows occurring between resident reinsurers and nonresident insurers. Imports (debits) are, in principle, estimated as the balance of all flows occurring between resident insurers and nonresident reinsurers. ”

Concerns/Shortcomings of the current treatment

5. The *SNA 93* and *BPM5* lack the clarity needed for producing internationally consistent statistics. Transactions between resident direct insurers and reinsurers should be fully consolidated, but this is inappropriate for cross-border reinsurance transactions. Different interpretations are possible in trying to estimate the flows. There is a need for a more explicit definition of the treatment of reinsurance and the algorithm associated with calculating reinsurance. For example Para 257 of *BPM5* implies that cross-border direct insurance and reinsurance can be (or should be) treated differently - direct insurance is based on estimated service charge (with or without the premium supplement), reinsurance is based on the balance of all flows occurring.

6. Increasingly catastrophic incidents generate massive claims for non-life insurance companies and therefore reinsurers. In these situations there can be very large and volatile movements of the production and therefore the consumption of insurance which do not reflect economic reality.

Possible alternative treatments

7. The OECD taskforce into the treatment and measurement of non-life insurance discussed two solutions aimed at improving the measurement of reinsurance. The major difference between these two methods is who is the principle consumer of reinsurance - either the policy holder in the form of final consumption, or the direct insurer in the form of intermediate consumption.

8. The first of these is the net method. This is based on the belief that direct insurers use reinsurers simply to transfer part of their total risk. In doing so they also transfer the service charge of the part of business they have reinsured. This approach assumes that policy holders directly consume both the untransferred element of the risk retained by the direct insurer and the element held by the reinsurer (including the service charge part). In this method there is no intermediary consumption of reinsurance by insurance companies. It is described as net because the flows between direct insurers and their policy holders are netted of reinsurance flows, and the latter are considered as if they were done directly with the policy holder.

9. One of the problems with using this method for countries with a net export of reinsurance is that whilst the direct insurer and reinsurer may be in one country, the policy holder may be in another, making it difficult to allocate full transactions. In countries which are primarily importers of reinsurance it is easier to show the flow between insurers rather than between policy holders and nonresident reinsurers.

10. The second method, generally preferred, is the gross method. Rather than netting off insurance flows, it records all flows gross of reinsurance. This follows more closely the economic reality of the reinsurance industry. In reality, the policyholder negotiates and insures through a direct insurer, and has no direct contact or control over the reinsurer. In turn the direct insurer negotiates and reinsures through a reinsurer without consulting the policy holder.

11. An important point about the gross method is that it recognises that reinsurance is a separate business from direct insurance which offers different types of contracts to direct insurance. An example of this is excess of loss reinsurance.

12. The businesses are different but the considerations used by both direct insurance and reinsurance companies for underwriting and pricing are similar. The calculations to measure the output of reinsurance, including credits for cross-border transactions, should therefore follow those used in direct insurance. The main improvement envisaged in this calculation is the adjustment of claims and premium supplements using either an expected or an accounting approach. This approach would overcome the current volatility in reinsurance data sets.

Questions/Points for discussion

13. The National Accounts Advisory Expert Group is discussing the proposal that the volatility of claims should be smoothed for direct insurance through the use of an adjusted method of claims. This method would apply to reinsurance as well. However this implicitly assumes that premiums do not need adjustment and are relatively smooth. The experience of September 11, 2001 suggests that this is not always the case. Many policies in the UK doubled to reflect the increased threat and to replenish technical reserves.

14. The UK is a net exporter of reinsurance services. For example Lloyd's of London is used to dealing with over 20 declared catastrophes each year, most of which take place abroad and which therefore have a Balance of Payments implication. The occurrence of so many catastrophes each year make it very burdensome, and unrealistic, for data suppliers to track

the impact of each catastrophe in the quarterly and annually claims data sent to the BoP compiler. Arguably these detailed data would be necessary in order to apply the current treatment for direct insurance accurately to reinsurance. In effect the fact that there are so many impacting on the UK market mean that they are largely self -smoothing in themselves, barring mega-catastrophes.

15. In addition to the direct price increase effect there are also volume effects due to the impact of policy holders bolstering their policies to include the additional risk generated by a new catastrophe, and, possibly, previously uninsured parties covering themselves against increased risk.

Supplementary information

16. In the UK inquiry forms already adopt a broadly gross approach to reinsurance. Inquiry forms are sent to direct insurers who are then asked to state how much they cede in reinsurance, and how much they receive in terms of reinsurance premiums. There is no attempt to track back the reinsured element to policyholders (by geography or economic unit).

17. Reinsurance raises a number of complications in that the direct insurer and the reinsurer are often resident in different countries meaning a large number of transactions should be included into the Balance of Payments. The base of most reinsurers is concentrated into only a small number of countries - Germany, Switzerland, UK.

18. The UK is a net exporter of reinsurance services. Lloyd's of London is used to dealing with over 20 declared catastrophes each year, most of which take place overseas and administratively it would put too much time and expense on data suppliers to track these each year with the aim of adjusting claims for each incident.

Annex of the most relevant documents

NBER Working Paper Series. Working Paper 5913 Reinsurance for Catastrophes and Cataclysms. Feb 1997 David M. Cutler & Richard J. Zeckhauser.

“Treatment of Reinsurance in the National Accounts “ A paper for the OECD. June 2003. Elena Marton & Gabe de Vries

“Recommendations on the measurement of the production of non-life insurance” SNA revision process: AEG Issue Paper. December 2003 Francois Lequiller.