Supervisory Capacity Building: Actuarial Services
Module 2.4 Case Study, 17 July 2017, Chongli, China

1. XA Insurance (XAI) is a small general insurer in Neverland. XAI was founded in 1976 and has been growing faster than its peers in the last 3 years. It currently ranks as the 25th largest insurer in the country.

2. XAI's business lines are:
   - Property (60% of gross premiums)
   - Business Interruption[1] (20% of gross premiums)
   - Motor (10% of gross premiums)
   - Others (10% of gross premiums)

3. You are part of a supervisory team performing an inspection on XA Insurance. You have noted that XAI's gross written premiums have grown rapidly in the last 3 years, driven primarily by Property and Business Interruption business.

	4. Gross Written Premiums (US$m)		
	2014	**2015**	**2016**
Property	15	21	30
Business Interruption	1	5	10
Motor	4	4	5
Others	4	5	5
Total	**24**	**35**	**50**

5. Neverland has gone through a period of accelerated and significant economic growth in the last 5 years after years of stagnation. This is largely attributed to the government taking a more open stance towards foreign investments and actively courting foreign companies to bring in manufacturing operations. This resulted in a number of new industrial parks around the country. Most of these industrial parks began operations in the last 3 years.

6. XAI participated as a co-insurer to cover Property Risks for most of these business parks, and this has driven growth in its Property business. It also started to include Business Interruption risks in its coverage to meet increasing demands from clients in these industrial parks. Due to its limited experience and expertise in Business

[1] "Business Interruption" insurance typically covers the loss of income that a business suffers after a disaster (e.g. due to the closing of an income-generating facility for repair works or rebuilding).

Interruption, it decided to reinsure 100% of its Business Interruption business for the time being.

7. XAI relies significantly on outward reinsurance, and a significant portion of its revenue and profits are derived from reinsurance commissions. In 2016 it wrote US$50m of gross premiums, of which US$35m was ceded out to reinsurers. XAI's reinsurance panel can be found in Annex 1. You have asked for copies of XAI's reinsurance contracts and your observations on those contracts are outlined in Annex 2.

Case Study Questions:

1. **What risks do you see with XAI's current business profile/strategy?**
2. **What risks do you see with XAI's current approach to reinsurance management and its current reinsurance panel?**
3. **What areas would you suggest to XAI to improve their risk management practices based on the material provided in this case study?**
4. **Are there any risks associated with the approaches currently adopted by the regulator? What could the regulator consider doing to improve the risk management practices of its industry?**

Annex 1 – Reinsurance Panel

XAI has provided the following information about its current panel of reinsurers:

The Board of Directors has approved the use of the following reinsurers:

Reinsurer	**Financial Strength Rating**
Neverland Re Private Limited	A-
New Asia Re Private Limited	A
World Reinsurance (Neverland) Private Limited	AA

The Company will seek to place outward reinsurance with reinsurers only of good credit standing. This panel of reinsurers should be reviewed from time to time, to ensure that only reinsurers of good credit standing are on the panel.

You note that all the above reinsurers are locally incorporated companies. Neverland Re and New Asia Re are both headquartered in Neverland and have a long history of business relationships with XAI while World Reinsurance (Neverland) is a local subsidiary of a regional reinsurer. These three are major reinsurers in the country and you are aware that most insurers in Neverland cede a significant amount of business to them. Furthermore, all insurers in Neverland are required to cede at least 15% of premiums for all businesses to Neverland Re, a national reinsurer.

Local rules do not prohibit the ceding of business to reinsurers outside the country, but capital requirements are more favourable if the reinsurer is a local reinsurer. Furthermore, XAI has long-established business relationships with the local reinsurers. In the interest of optimising their regulatory capital requirements, XAI has decided to cede only to local reinsurers.

Upon further inquiries, you learn the following:

- The table above was extracted from an old set of Board minutes, and was last updated in December 2015
- For Neverland Re, you noted a public report from A.M. Best, a global rating agency, dated 2 December 2016 indicating a one notch downgrade of Neverland Re's financial strength rating from A- to B++. This was due to a concentration of risk exposures in newly developed areas of Neverland that were subject to flood risk.
- For New Asia Re, you have been unable to publicly available ratings from global rating agencies. Upon further questioning, XAI staff inform you that the A rating set out in the table was from a local rating company.
- For World Reinsurance (Neverland) Private Limited, you have found a global rating agency report that rates World Reinsurance Group (its parent company) as "A", but

no such report seemed to exist for World Reinsurance (Neverland). XAI staff informed you that they had assumed World Reinsurance (Neverland) would have the same rating as the group entity, and that this should be fine as the group is ultimately responsible for the business of its subsidiaries.

Annex 2 – Observations from Reinsurance Contracts

Your review of the reinsurance contracts has revealed the following:

- The reinsurance contracts that XAI have with World Re are with the Neverland subsidiary
- XAI's largest reinsurance contract which was a 40% quota share arrangement is with Neverland Re. However the contract was dated 1 January 2016. The staff informed that the terms of the contract has not changed for 2017 and that it was typically renewed annually via email confirmations. They produce several short emails indicating agreement from a Neverland Re email address to renew the same contract at the same rates for 2017, and inform you the 2017 contract is likely to come in a few weeks.
- The company also has a 100% quota share contract with Neverland Re for its Business Interruption cover. In return, it is paid reinsurance commissions of 15%.
- None of the contracts with Neverland Re have clear terms and conditions for cash calls[2].
- The contract with New Asia Re is dated 1 Jan 2017, but you note that the contract bears no signatures. The staff have provided you with emails indicating agreement from both sides to the contract in March 2017, and they have informed you that this was sufficient given the long standing business relationship with New Asia Re.
- You have also asked for the Statements of Accounts with the three reinsurers. It appears that the accounts with Neverland Re and New Asia Re for years 2015 and 2016 had not been fully settled to date, i.e. there are net receivables from both reinsurers that have not yet been paid to XAI. XAI provided you with emails indicating they had reminded the two reinsurers once in 2016 but they do not have a formalized policy for following up on long overdue receivables, especially given their close relationship with these reinsurers.
- Specifically for property cover, the maximum loss per individual risk is capped at US$20m. The staff informed you this high limit was put in to obtain more favourable rates. Furthermore, XAI has historically insured mainly small homes and businesses worth much less than that.
- XAI staff added that they were considering purchasing CAT reinsurance cover for the Property business, as they believe that some of the industrial parks insured may be susceptible to flood. Their reinsurer of choice is Neverland Re on the basis of lowest premium rates.

[2] A "cash call" is a reinsurance contract provision which allows the insurer to collect large losses immediately/directly from the reinsurer, rather than accrue it as an outstanding receivable for payment during the regular payment schedule. It helps an insurer to manage its liquidity risk, as it may not have sufficient liquidity to pay a large loss upfront first.