



INSTRUCTION No. 10/2021

ON REINSURANCE ARRANGEMENT FOR INSURANCE COMPANIES

Reinsurance is a core risk management tool available to the insurance companies, reducing their insurance risks and the volatility of financial outcomes, stabilizing their solvency, making more efficient use of their capital, increasing their underwriting capacity and providing them specialised technical expertise.

In fact, as every insurance company carries, in its financial statements, a significant amount of liabilities to policyholders and claimants, the reinsurance management plays an important role in ensuring these entities' ability to meet their obligations.

On the other hand, reinsurance exposes insurance companies to other risks, as operational, legal, counterparty and liquidity risks. Inadequate reinsurance risk management practices and procedures can materially affect an insurance company's financial soundness and reputation, affecting its ability to meet its obligations to policyholders and claimants, and can ultimately contribute to its failure.

In accordance to article 34. (b) of the Law no. 6/2005, of 7 July, on Regime for the Licensing, Supervision and Regulation of Insurance Companies and Insurance Intermediaries, states that the BCTL shall define by instruction, on the directives for and restriction on reinsurance programmed.

The Governing Board of Banco Central de Timor-Leste, pursuant to the authority granted in Article 31 paragraph 1 of Law no. 5/2011 of 15 June, and in Articles 3 and 4 of Law no. 6/2005 of 7 July, hereby resolves to approve the following Instruction:

Article 1 Applicability

1. This Instruction applies to all insurance companies licensed by the Banco Central de Timor-Leste (hereinafter designated by BCTL).
2. The BCTL requires the insurance companies to adopt strategies and techniques in the reinsurance that are best suited to their activity, for which they should comply with the directives established by this Instruction.

Article 2 Prohibitions and restrictions

1. An insurance company shall not outsource the reinsurance programme to the group/associate of business and/or external counterparty.
2. An insurance company shall not enter into a contract on reinsurance arrangement without the prior written approval of the BCTL.
3. An insurance company shall not enter into a fronting arrangement with another insurance company or reinsurance company without the prior written approval of the BCTL.
4. An insurance company shall not participate in a co-insurance pool or in a reinsurance pool, as cedant, without the prior written approval of the BCTL.
5. An insurance company shall keep records of its reinsurance programme in hard copy and/or electronic copy in its head office.
6. The BCTL may review the above provisions from time to time.

Article 3

Article 3
Definitions

In this Instruction the terms below shall have the following meaning:

1. "Alternative Risk Transfer" (ART) means any form of risk transfer by an insurance company, other than through a traditional reinsurance arrangement, that has an element of insurance risk, rather than purely financial risk, including the securitization of insurance risks, catastrophe bonds, reinsurance sidecars, industry loss warranties and finite reinsurance;
2. "Captive Insurance Company" (CIC) is a wholly-owned subsidiary company that provides risk mitigation to its parent company or a group of related companies;
3. "Ceding insurance company" is an insurance company that transfers the risks to a reinsurance company under a reinsurance arrangement, or a reinsurance company that transfers the risks to another reinsurance company under a retrocession arrangement;
4. "Facultative Reinsurance" means the reinsurance of a single individual risk, or a specified group of individual risks, on the basis of an offer by the cedant and acceptance by the reinsurance company where this entity is not under an obligation to accept each offer by the cedant;
5. "Foreign Reinsurance Company" means a foreign reinsurance company whose primary business is entering into reinsurance arrangements;
6. "Fronting Arrangement" is an arrangement through which an insurance company cedes more than ninety-five percent of the risks under an insurance contract that it has entered into, to another insurance company, while remaining liable under the insurance contract to the policyholder;
7. "Net Retention" is the amount of risk that a cedant retains, after taking into account of all their reinsurance contracts in relation to the risk concerned;
8. "Pooling Arrangement" is an arrangement made between two or more licensed insurance companies or reinsurance companies, through which the participating insurance companies or reinsurance companies provide insurance cover to particular types of agreed risk on the basis that those entities will share the premiums, expenses, losses and profits in pre-agreed proportions;
9. "Qualifying Foreign Reinsurance Company" refers to a foreign reinsurance company that has:
 - a) financial strength rating of any of the following rating or higher:
 - (i) A+, A, B+, B or C+ assigned to it by the A. M. Best Company;
 - (ii) AAA, AA, A, BBB or BB assigned to it by Fitch Group or Standard & Poors;
 - (iii) Aaa, Aa, A or Baa assigned to it by Moody's Corporation, or
 - b) such other financial strength rating given by other companies accepted by the BCTL.
10. "Reinsurance Contract" refers to an insurance contract under which an insurance company, acting as a reinsurance company, indemnifies, or otherwise compensates another insurance company (the ceding insurance company), against losses on one or more contracts of insurance entered by the ceding insurance company
11. "Retrocession Contract" means a reinsurance contract where the cedant is a reinsurance company;
12. "Risk Appetite" refers to the aggregate level and types of risk exposure that an insurance company or a reinsurance company is willing to undertake within its risk capacity to achieve its strategic objectives and business plan;
13. "Risk Concentration Limits" should be based on premiums, expected claims, amount of risk, and possible future exposures (at time of inception or renewal of policy), on a consolidated basis, to individual counterparties, groups of individual counterparties or related entities and counterparties in a specific geography;
14. "Risk Tolerance" refers to specific parameters and/or limits on the level and amount of risk that an insurance company or a reinsurance company is willing to accept/retain, such as maximum net retention;

15. "Management" refers to the individuals or body responsible for managing the business on a day-to-day basis in accordance with the strategies, policies and procedures set out by the Board ; and
16. "Treaty Reinsurance" means the reinsurance under which the cedant agrees to offer, and the reinsurance company agrees to accept, all risks or a pre-determined proportion of risks within a defined class or type of insurance business that meet any pre-agreed criteria.

Article 4
Reinsurance Risk Management Policy

1. All licensed insurance companies should develop a Reinsurance Risk Management Policy (RRMP) as an integral component of the overall risk management plan of these entities.
2. The RRMP should take into account the scale, nature and complexity of the insurance company's business, as well as its risk appetite and risk tolerance.
3. The RRMP should reflect the insurance company's approach to managing risks through reinsurance, including the purpose and objectives of seeking reinsurance, risk diversification objectives, risk concentration limits, ceding limits and the practices and procedures for managing and controlling its reinsurance.
4. The RRMP should detail:
 - a) the methodology for determining the reinsurance arrangements, including the types of reinsurance to be purchased, the setting of net retention limits and the process of selecting reinsurance companies;
 - b) how the financial soundness of the reinsurance companies is assessed, including the conditions to require any collateral from them;
 - c) the insurance company's policy on the use of registered and unregistered reinsurance companies;
 - d) how liquidity risk arising from a timing mismatch between the payment of claims and the receipt of reinsurance recoveries is to be managed;
 - e) the determination of whether reinsurance brokers and other intermediaries should be employed and, if so, their role and how they are to be selected, monitored and managed;
 - f) the roles and responsibilities for those in charge in the implementation of the RRMP; and
 - g) the process for ensuring that the RRMP is updated to reflect changing market conditions.
5. Additionally, the insurance company must assess the adequacy and effectiveness of the reinsurance arrangements to ensure that exposures to large and catastrophic losses are adequately addressed. This may require stress testing of exceptional but plausible scenarios to determine if the reinsurance arrangements entered into are adequate at mitigating losses to acceptable levels in accordance with the insurance company's risk appetite and risk tolerance.

Article 5
Management Oversight

1. The management of the insurance company should oversee the development and implementation of the RRMP and, at a minimum, should review the RRMP annually.
2. Management has the responsibility of ensuring that the RRMP is operationalized through the dedication of adequate resources and is implemented by those in charge of the day-to-day responsibility for the RRMP.
3. It is the responsibility of management to ensure that appropriate policies, procedures and internal controls exist to monitor the effectiveness of, and operational compliance with, the RRMP on an on-going basis.

Article 6
Due diligence on Reinsurance Arrangements

1. An insurance company should perform a sufficient level of due diligence on its reinsurance counterparties on an on-going basis to ensure that the insurance company is aware of its counterparty risk and is able to assess and manage such risk.
2. An insurance company should evaluate the ability of all current and prospective reinsurance counterparties to meet their liabilities under exceptional but plausible adverse events on an on-going basis, for which the

level of an insurance company's due diligence should be commensurate with its level of exposure to that counterparty.

3. In that evaluation an insurance company should generally not rely solely on third parties, including rating agency assessments or insurance broker analysis and recommendations. Prudent practice dictates that the insurance company should, to an extent proportional to the importance of such counterparty, conduct its own due diligence on the financial strength and capabilities of all reinsurance counterparties.
4. When performing its due diligence, an insurance company should give consideration to, among other matters, the reinsurance counterparty's:
 - a) claims payment record;
 - b) expected future claims obligations;
 - c) balance sheet strength; funding sources, including its level of and access to capital, and type, amount and sources of liquidity;
 - d) management, including the quality of its governance practices and procedures; and
 - e) retrocession arrangements and the direct and indirect impact they may have on the insurance company's own arrangements with the reinsurance companies.
5. Similarly, an insurance company acting as a reinsurance company should, commensurate with its level of exposure to the ceding insurance company, conduct its own due diligence on the risk management and risk assessment of the ceding insurance company.
6. The evaluation of each of an insurance company's reinsurance counterparties should be updated throughout the life of the reinsurance contract and, in cases where there may be material exposures to incurred but not reported losses, the management should ensure that the evaluation continues beyond the expiration date of the contract to ensure that the insurance company assesses potential amounts recoverable from the reinsurance arrangements in the future.

Article 7

Contents of the reinsurance contract

1. The terms and conditions of the reinsurance contract should provide clarity and certainty on reinsurance coverage.
2. An insurance company should have processes and procedures in place to ensure that a comprehensive written and binding reinsurance contract is executed prior to the effective date of the reinsurance coverage.
3. To achieve clarity and certainty on reinsurance coverage, a reinsurance contract should be unambiguous, and should be complete and final agreement of all material terms and conditions of the contract, documented in writing, by all parties prior to the contract's effective date.
4. BCTL recognizes that there may be situations where a comprehensive reinsurance contract is only duly executed by all parties after the effective date. In such circumstances, historical practice has been that the reinsurance coverage during this interim period is usually set out in a less formal document (e.g., slip, cover note, letter of proposal, binding letter of intent, all of these terms hereinafter referred as the "summary document"). If an event were to occur within this interim period, lack of certainty relating to the terms and conditions of the reinsurance coverage in the summary document could result in operational and reputational risks for both the cedant and the reinsurance company.
5. In an effort to mitigate these risks, the insurance company should:
 - a) obtain contractually binding summary documents prior to the effective date of the reinsurance coverage, including, but not limited to, electronic copies, or original hard copies, of signed documents that set out:
 - (i) the premium paid by the cedant;
 - (ii) the percentage of risk assumed by each reinsurance company;
 - (iii) the risk(s) reinsured;
 - (iv) the duration of the coverage;

- (v) where applicable, any exclusions to the terms of coverage; and
 - (vi) any standard clause that are to be relied upon or incorporated by reference into the reinsurance contract.
- b) address, within the summary document, any material issues most likely to arise, including all variable or unique agreement terms; and
 - c) ensure that all final comprehensive reinsurance contracts, including any amendments thereto, bear the duly authorized signatures of both the cedant and the reinsurance company(ies) within a relatively short timeframe having regard for the nature, complexity and materiality of the agreement.
6. BCTL also recognizes that there may be situations where it is necessary and appropriate for an insurance company to enter into a supplemental or subordinated reinsurance contract, a side letter, or other types of arrangements that are ancillary to, and form part of, the main reinsurance contract. In addition to ensuring that these arrangements meet the requirements set out in this Instruction, the insurance company should be transparent with the stakeholders about these arrangements, ensuring that such amendments are appropriately reflected in its financial statements and they do not adversely change the terms or conditions of the original contract to the detriment of policyholders.

**Article 8
Special clauses**

1. The terms and conditions of a binding reinsurance contract should provide that funds will be available to cover policyholder claims in the event of either the cedant's or reinsurance company's insolvency.
2. To this end, reinsurance contracts should include an "insolvency clause", and particular attention should be paid to the appropriate of "off-set" or "cut-through" clauses, the structure of "funds withheld" arrangements, and other such types of terms or conditions that may frustrate the scheme of priorities under the Law no. 6/2005, of 7 July or in any Instructions issued by the BCTL.
3. Cedent insurance companies should ensure that all their reinsurance contracts contain an insolvency clause establishing that the reinsurance company must continue to make full payments to an insurance cedant without any reduction resulting solely from the cedant's insolvency.
4. Such a clause should provide greater certainty that reinsurance receivables remain within the overall general estate of the insolvent insurance company, rather than being allocated toward the payment of specific claims of creditors or policyholders.
5. Reinsurance contracts should not contain other types of terms or conditions that may limit a troubled or insolvent cedant's ability to enforce the contractual obligations of a reinsurance company, or that may adversely affect the treatment of any claims in respect of the cedant's policyholders.
6. If a reinsurance contract provides for a funds withheld arrangements, the contract must clearly provide that, in the event of the cedant's or reinsurance company's insolvency, the funds withheld, less any balance due back to the reinsurance company, must form part of the property of the cedant's general estate.
7. BCTL determines that all contracts related to reinsurance coverage to stipulate a choice of forum, a choice of law, and the appointment of agents for service of legal processes that are necessary to ensure that the reinsurance contracts and any disputes arising from such contracts are subject to the laws and courts Timor-Leste or another legal jurisdiction of, in the reasonable opinion of the BCTL, equivalent or greater reliability and certainty which has a natural connection with the transaction.

**Article 9
Alternative Risk Transfer Arrangements**

1. An insurance company shall not enter into a contract that constitutes an alternative risk transfer, or any arrangement that constitutes a direct transfer of the risk under any insurance contract entered into by the insurance company to the capital markets without the prior written approval of the BCTL.
2. The BCTL will regulate the alternative risk transfer arrangements through a specific Instruction.

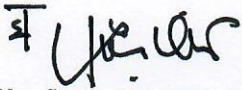
**Article 10
Information to provide for supervision purposes**

1. An insurance company is required to maintain and provide to BCTL, upon request and within the fixed time schedule by this entity, its RRMP and a complete description of all its reinsurance arrangements, including levels of reinsurance, the due diligence performed on reinsurance counterparties, and the proportion of risk cessions by reinsurance companies.
2. An insurance company should promptly inform the BCTL if it becomes aware of any reinsurance issues that could materially impact its financial condition.
3. The insurance companies should annually provide to BCTL all the information contained in the forms about reinsurance, according to the requirements set up by the Instruction related to reporting of annual accounts.

Article 11
Entry into force

This Instruction shall come into force on the following day after its publication on Jornal da República.

Adopted on 30 September 2021



Abraão de Vasconcelos
Governor