Document généré le 11 mai 2024 00:33

Assurances et gestion des risques
Insurance and Risk Management

Finite risk reinsurance - increasing capacity in a difficult environment

Thomas Holzheu, Kurt Karl et Richard Sbaschnig

Volume 71, numéro 2, 2003

URI : https://id.erudit.org/iderudit/1092869ar
DOI : https://doi.org/10.7202/1092869ar

Aller au sommaire du numéro

Éditeur(s)

Faculté des sciences de l'administration, Université Laval

ISSN

1705-7299 (imprimé)
2371-4913 (numérique)

Découvrir la revue

Citer ce document

Holzheu, T., Karl, K. & Sbaschnig, R. (2003). Finite risk reinsurance - increasing capacity in a difficult environment. *Assurances et gestion des risques / Insurance and Risk Management*, *71*(2), 341–348. https://doi.org/10.7202/1092869ar

Tous droits réservés © Faculté des sciences de l'administration, Université Laval, 2003

Ce document est protégé par la loi sur le droit d'auteur. L'utilisation des services d'Érudit (y compris la reproduction) est assujettie à sa politique d'utilisation que vous pouvez consulter en ligne.

https://apropos.erudit.org/fr/usagers/politique-dutilisation/

érudit

Cet article est diffusé et préservé par Érudit.

Érudit est un consortium interuniversitaire sans but lucratif composé de l'Université de Montréal, l'Université Laval et l'Université du Québec à Montréal. Il a pour mission la promotion et la valorisation de la recherche.

https://www.erudit.org/fr/

Risk Management: FINITE RISK REINSURANCE--INCREASING CAPACITY IN A DIFFICULT ENVI
Holzheu, Thomas;Karl, Kurt;Sbaschnig, Richard
Assurances et Gestion des Risques; Jul 2003; 71, 2; ProQuest
pg. 341

Risk Management

by Thomas Holzheu, Kurt Karl, and Richard Sbaschnig

FINITE RISK REINSURANCE – INCREASING CAPACITY IN A DIFFICULT ENVIRONMENT*

In the current environment of expanding new risk classes and rising property-casualty insurance and reinsurance prices, companies are taking a new look at finite risk reinsurance. Finite risk reinsurance blends risk financing and risk transfer in multi-year contracts that involve a limited assumption of risk by the reinsurer, an explicit inclusion of sharing of investment income, and sharing of results. These types of contracts have many different advantages including lowering uncertainty regarding non-core risks of a corporation, stabilizing rates and terms of cover, improving balance sheets and financial key ratios, tax benefits, protecting from timing risk, and the ability to obtain cover for otherwise uninsurable risks. There are six main types of contracts: time and distance, loss portfolio transfer, adverse development cover, spread loss cover, financial quota share, and run-off solutions. The global potential market size is estimated to be around USD 38 billion. Over the next few years, the hard P&C insurance market, an increase in M&A activity, and privatization of risks will produce robust growth for the finite reinsurance market.

Introduction

These are difficult times for both insurers and their clients. Companies, both financial and non-financial, face an increasing array of risks – earthquakes, fire, business interruption, product

The authors :

* This column is based on Thomas Holzheu, Kurt Karl, and Mayank Raturi. "The picture of ART," sigma, No. 1/2003, which can be downloaded for free at www.swissre.com. The three authors of the sigma and Richard Sbaschnig are all economists in Swiss Re's New York office of Economic Research & Consulting.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

recalls, directors and officers liability, asbestos litigation, terrorism, financial volatility, credit risk, market risk, political risk, weather volatility, and many more. How companies manage these risks has a great impact on their market value, their risk of bankruptcy and financial distress, their ability to invest in projects with the necessary amount of funds and in a timely manner, and even their tax liability. For insurers, two years of severe capital losses on invested assets due to the stock market meltdown and record insured losses in 2001 have reduced global insurance capacity by about 21 %, compared to early 2000. New capital raised could not fill the gap of lost industry surplus. Rating agencies have downgraded all but a few insurers, reducing also the quality of the capital base. The reduction in capacity has increased non-life insurance prices substantially, hardening the market. The hard market is expected to last longer than in previous cycles, given the global shortage of quality capital, increased risk exposures, uncertain investment returns, and the ongoing concerns regarding reserve adequacy. During this time of capacity shortage, finite reinsurance can provide insurers with extra capacity and corporations with customized solutions to meet their risk transfer needs.

Finite risk reinsurance overview

Finite covers shift the main value proposition from traditional risk transfer towards risk financing. Finite covers are multi-year contracts reducing the client's cost of capital by means of taking provisions against non core risk through the purchase of a multi-year insurance policy. Year-to-year volatility is reduced while limiting the total amount of risk transfer over the contract period. Finite reinsurance products typically have the following features :

- risk transfer and risk financing are combined and the time value of money is emphasized in the contract;
- limited assumption of risk by the reinsurer;
- multi-year contract term;
- explicit inclusion of investment income in the contract; and
- sharing of the results with the insured/cedant.

One basic principle of reinsurance is spreading risks over time – in addition to spreading risks geographically and over lines of business. In the days of "gentleman's agreement" reinsurance, the relationships were long-term and it was understood that temporary imbalances in the results would be recouped in future years via adjustment of rates, terms and conditions. Today, these informal agreements must be for-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

malized and legally binding, given global competition and frequent entries and exits by companies from markets.

Finite deals can be structured as pre-funded (prospective) or post-funded (retrospective). In pre-funded deals, the client pays either annual or single premiums into an experience account. These funds earn a contractually agreed investment return and are used for eventual loss payments or "flow-back" to the customer. In post-funded deals, clients must pay back the claims payments of the reinsurer over a defined period of time. One basic difference between the two types of deals concerns the allocation of credit risk. The reinsurer bears the risk of the client's default in a post-funded deal, whereas the client bears the risk of the reinsurer's default in a pre-funded deal. The credit ratings of the contractual partners affect the economic benefits of the two types of deal.

Apart from its risk management functions, finite reinsurance has become an widely used instrument with a number of additional advantages. Insurers can improve key ratios, such as net premiums to capital. The use of multi-year contracts can allow for coverage and pricing that is less dependent on the insurance cycle. Corporations may be able to get a tax deduction on reserves for unpaid outstanding losses. All types of firms may use finite reinsurance to protect from timing risk on their liabilities. In addition, finite solutions can facilitate mergers, acquisitions, or restructurings by lowering the uncertainty that can be associated with a firm's long-term liabilities. In general, the ability to customize these solutions and the degree of innovation with this product allow use in many different circumstances.

With finite solutions, corporate clients can benefit from a better-than-average loss occurrence. This is true even without sufficient loss history that would allow actuarial pricing tools to calculate the beneficial treatment. Finite solutions provide corporations with a risk management tool for new risks or situations of substantially changed corporate risk landscapes – for example, after a merger, a spin-off, or any other change of business. New risks like Y2K, cyber risks, or terrorism after 11 September, can be handled in such a structure even if there is no, or very limited, capacity for traditional risk transfer. Also, risks that are closer to business risks – and therefore more prone to moral hazard – can be treated in such structures without leaving the insurer with an unbalanced risk-return profile.

Types of contracts

The standard types of finite reinsurance contract are :

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

- time and distance
- loss portfolio transfer
- adverse development cover
- spread loss cover
- financial quota share
- run-off solutions

Time and distance deals were the initial standard type of finite reinsurance. They were designed to discount loss reserves for the time value of money. Thus, they bring the accounting principle of nominal reserving closer to the economic reality. The reinsurer agrees to pay a certain agreed schedule of loss payments in the future, without assuming the risk of losses being higher than expected. The ceding company agrees to pay specified premiums in return, representing the net present value of the future loss payments. As there is only very limited risk transfer involved, these contracts are no longer recognized as insurance contracts in the United States and do not provide the intended balance sheet effects anymore.

With loss portfolio transfers (LPTs), the policyholder transfers outstanding claims to the insurer. This makes LPTs a retrospective form of reinsurance. The policyholder pays a premium corresponding to the net present value of the outstanding claims plus a loading for administrative expenses, risk capital and profits. Long-tail lines lend themselves particularly well to LPTs as timing risk is their key element. The insurer assumes the risk of unexpectedly rapid claims settlements. A faster than expected claims settlement implies a lower earnings potential via investment income on the cash-flow. The ultimate total nominal amount of claims indemnification is usually contractually limited. The main benefits of LPTs are :

- settlement of self-insured claims and possibly the acceleration of the closing down of a captive;
- facilitation of mergers or takeovers, since claims settlement risk does not need to be assumed by the acquirer who might feel uncomfortable with evaluating and/or assuming this type of risk;
- the ability to exit from a discontinued line of business;
- a mechanism for transferring risks, freeing up risk capital to support the writing of new business. This type of redeployment of capital is particularly important in the current, low capacity market. In a low capacity market, capital is reserved

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

to support old unprofitable business, while the writing of new, more profitable business is starved of capital.

Adverse development covers offer a broader spectrum of cover than LPTs, since they usually also include incurred but not reported (IBNR) losses. Hence, the insured does not retain the risk of incurred but unreported claims for which he is liable, but passes it along to the reinsurer. Unlike LPTs, there is no transfer of claims reserves. Instead the policyholder pays a premium for the transfer of losses exceeding the level that already has been reserved. This can be arranged by either a stop loss treaty or as a working or catastrophe excess of loss treaty. The main benefit of adverse development covers is that they facilitate mergers and takeovers since the insured can offload both the timing and the reserves development risk. The acquiring company can assess the target company without an actuarial due diligence process and the adverse development cover improves the view of analysts and rating agencies of the acquisition by reducing volatility.

For spread loss covers, the insurer pays annual premiums or a single premium to the reinsurer for coverage of specified losses. These premiums – less a margin for expenses, capital costs and profits – are credited towards a so-called "experience account," which serves to fund potential loss payments. The funds earn a contractually agreed investment return. The balance of the experience account is settled with the client at the end of the multi-year contract period. The reinsurer limits the payments for each year and/or over the entire duration of the contract. The reinsurer holds the credit risk of the insurer, if the balance on the experience account turns negative. Usually these types of contracts involve very limited underwriting risk but provide the insured with the liquidity and security of the reinsurer. The reinsurer assumes the (contingent) credit risk of prefinancing losses. The amount of risk transfer is frequently low but must meet the requirement necessary to qualify the arrangement as a reinsurance contract.

The financial quota share, which is a quota share agreement with implicit financing via commissions, is one of the oldest types of finite risk reinsurance. Policies are usually prospective and cover underwriting risks in current and/or future underwriting years. Depending on the nature of the commission arrangements, these types of treaties provide financing and/or risk management. Financing can be achieved by overcompensating in the initial period(s) and undercompensating over a prearranged period of time.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Run-off, although often differentiated from finite risk reinsurance, is a special segment of products that manage retrospective liabilities. Unlike retrospective finite solutions, which usually substantially limit the amount of underwriting risk transfer, run-off solutions focus on the full-scale risk transfer of reserve development risks. Run-off solutions are tools to address a firm's risk of inadequate loss reserves for past underwriting activities. There are a number of factors that can caüse a company to choose a run-off solution :

– corporate restructuring;

– mergers & acquisitions;

– closing lines of business;

– economic changes in the value of a liability;

– regulatory, accounting or tax changes;

– legal developments, for example, court decisions.

The biggest run-off transactions to date, in the United States, have involved either Asbestos & Environmental (A&E) or workers' compensation liabilities. Most transactions have involved insurers, but the economics also work for corporations and captives.

In a usual transaction, a discontinued book of business is sold to a reinsurer. All the (remaining) premiums and all the risk are assumed by the reinsurer. The claims reserves are transferred from the client to the reinsurer. In terms of the benefits of these types of transactions, capital relief via discounting of reserves is not a driving force since US GAAP no longer allows capital relief for retroactive transactions. Mutual companies can still gain capital relief based on statutory accounting, however. The key objectives of run-off deals have shifted from capital relief to risk transfer and removing uncertainty from a company's balance sheet by minimizing the insured's exposure to :

– the default of co-insurers and reinsurers;

– an adverse development of judicial / loss inflation;

– peaks in losses due to exogenous factors (e.g. exchange rate changes).

Finite Re Market Features

Among Alternative Risk Transfer (ART) products, finite reinsurance has been available for a relatively long period of time, and as such, it tends to be one of the more well-understood and accepted

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

products. The market for finite reinsurance is generally mature, although healthy growth is expected. This product has a large number of established players competing for business, but new competition continues to enter the market.

The global potential market size for finite reinsurance is estimated to be around USD 38 billion for both corporate and insurance clients. There is only a small number of deals each year and hence the market size fluctuates annually. The market grew exponentially in the late 1990s and leveled off in 2000 and 2001. The majority of prospective finite deals are now credit-risk driven. There are higher market-size figures cited in the trade literature, but these usually include retrospective finite deals. Many retroactive transactions are M&A driven. With the current low level of M&As, there are few retroactive deals. However, the current critical capital position of many players is expected to result in another wave of consolidation. This will improve the market for finite re and run-off solutions.

With a limited underwriting risk, the profitability of finite reinsurance is primarily driven by investment results and credit defaults. A sample of Bermuda finite (re)insurers revealed a sharp decline in profitability after 1999. This period of low profitability will continue until investment yields recover from their current poor performance.

For retroactive re, the clients tend to be insurance companies, or captives, with loss portfolio transfers. The largest global companies with a liability, such as payments for asbestos and environmental claims, may also seek an adverse development cover. For prospective re, clients tend to be insurers, but also include large corporations. Finite re covers that qualify as insurance reduce taxes and smooth earnings.

Market outlook

The finite reinsurance market is currently struggling with two very important issues. First, the accounting scandals in the United States have altered the appetite of corporations for some finite solutions. These products often include a special purpose vehicle or create off-balance sheet assets/liabilities. The accounting scandals have tarnished the image of SPVs, off-balance sheet financing and stabilizing earnings, making it more problematic for corporations to seek these solutions, even if they make good economic sense. Over time, the market will adjust, transparency will increase and corporations will again use solutions that have unambiguous economic advantages.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Second, recent events in the global financial markets have altered the general attitude towards finite reinsurance Finite covers played a role in the collapse of Fortress Re; were the core business of the two Bermuda reinsurers, Overseas Partners and Scandinavian Re, which shut down operations early in 2002. Clients, reinsurers and regulators are likely to change their attitude towards finite deals. There will be more focus on risk transfer and more disclosure. In the UK especially, the Financial Services Authority (FSA) has expressed concern about the use of financial reinsurance for purposes of regulatory arbitrage. Transactions that are more geared towards regulatory and/or tax arbitrage will face more scrutiny, and also lose some attraction, due to the higher price of credit risks involved in some of the multi-year arrangements.

Demand is increasing rapidly for transactions with unambiguous economic advantages due to the current hardening of the commercial market. The hardening commercial rates – partially caused by weak equity markets, low interest rates, uncertain corporate credit conditions and losses stemming from 11 September – is fueling the trend toward the substitution of finite solutions for traditional commercial business. Clients need to increase their deductibles in order to keep their total insurance premiums within their budgets during times of rising premium rates. At the same time, clients are also forced to increase their deductibles substantially because of capacity constraints in some lines of business (property, aviation). Finite solutions are in demand to provide some cover for these increased deductibles.

M&A activity is expected to increase again soon, fueling retroactive finite re. There is also a large potential for loss portfolio transfers (LPT) in the privatization of state-owned pools or insurance companies. There is political momentum among many state governors and legislators to transfer government liabilities to the private sector. In 1997, Swiss Re became the first reinsurer to privatize a state-sponsored workers' compensation pool. With the hard market, an increase in M&A activity, and a shift of liabilities to the private sector, medium-term growth in the market is expected to be around 10 %.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.