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Résumé de l'article

Presque tous les contrats assurance et de réassurance ont un aspect financier ainsi qu'un aspect de sélection des risques. Précisément, définir la réassurance financière peut être astucieux. Alors que les définitions varient, essentiellement toute transaction qui prévoit un revenu d'investissement, est une branche de la sélection des risques et son but final est de limiter la responsabilité du réassureur. Ordinairement, la plupart des réassureurs incorporent, d'une façon variée, le risque dans leurs contrats, afin de satisfaire les standards réglementaires ainsi que ceux de la comptabilité. Les contrats de la réassurance sont complexes. Il est parfois difficile d'évaluer si ils indemnisent contre le risque d'assurance. Cette évaluation exige une profonde connaissance et compréhension des dispositions des contrats, des règlementations, des standards des taxes et de la comptabilité.

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What is Financial Reinsurance?

by

Mohez Remtulla*

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Ordinairement, la plupart des réassureurs incorporent, d'une façon variée, le risque dans leurs contrats, a fin de satisfaire les standards réglementaires ainsi que ceux de la comptabilité.

Les contrats de la réassurance sont complexes. Il est parfois difficile d'évaluer si ils indemnisent contre le risque d'assurance. Cette évaluation exige une profonde connaissance et compréhension des dispositions des contrats, des réglementations, des standards des taxes et de la comptabilité.

Financial reinsurance concepts have been around for many years, but the term "financial reinsurance" only became commonplace a few years ago. Financial reinsurance can be an elusive concept to define, and the use of the terms "finite

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reinsurance," "financial instruments" or "shared risk" to describe certain financial reinsurance contracts complicates matters further.

Precisely defining financial reinsurance can be tricky. It is not for everybody, nor is it a panacea. This is in part because all reinsurance is to some degree financial, and also because the territories of financial and traditional reinsurance increasingly overlap.

It can be best described as a form of reinsurance where most of the premiums are the present value of most of the aggregate limit. Contracts are always written with an aggregate limit on the premise that the claims will at least be equal to the aggregate limit. This is one of most significant common characteristics of all such covers - the contractual limitation on the ultimate liability for the payment of claims based on the widespread use of a multiyear approach.

Therefore, the term financial reinsurance can be applied to virtually any reinsurance transaction in which anticipated investment income is an acknowledged component of underwriting, and in which the reinsurer's ultimate liability is capped. Other factors common to financial reinsurance contracts are that generally they are non-cancelable by the reinsurer, but subject to commutation by the insurer. Another distinguishing characteristic is that each contract is tailor-made to the particular situation. There are no real "off-the-shelf" products, which means deals can take considerably longer to negotiate and be more complex than conventional reinsurance contracts.

The definition of the term financial reinsurance covers a broad range of reinsurance products, from contracts that involve a single premium payment based on the net present value of known claims that a company will pay in the future, to contracts that entail a good deal of underwriting risk for the reinsurer. Every financial reinsurance contract is a little different, responding to the unique needs of the cedent, whose problems can include deteriorating claims development on old covers,

withdrawing from a line of business and unavailability of traditional reinsurance at affordable prices.

All such reinsurance products allow the cedent to reinsure liabilities for less than the amounts transferred, relying on the time value of money - the expected investment income over the life of the reinsurance contract - to make up the difference. Such products are also particularly attractive to ceding companies involved in mergers or acquisitions. A financial reinsurance product can reduce contingent liabilities, helping to fix the price for a merger or an acquisition. It can also help a ceding company smooth its earnings over a period of years. This enables cedents to predict and budget the liabilities and avoid sharp dips and turns.

Financial reinsurance, however, generally does not offer the benefits of conventional reinsurance like substantial risk capacity to insure large per-occurrence limits or assistance with claims handling and underwriting. The spectrum of underwriting risk in the contracts ranges from none to significantly large amounts. Partly because of regulatory and accounting pressures, the trend appears to be toward transfer of larger amounts of risk.

The contracts can be prospective, focusing on future claims, or retrospective, removing past liabilities from the balance sheet. These programs may or may not provide profit commissions for the ceding company, managed through an Experience Account Balance.

While there is little agreement over definitions, the most common types of financial reinsurance include:

O *Time-and-distance contracts*, which guarantee ceding companies' specific payments at specific times in the future based on the initial premium paid and the investment returns expected by the reinsurer. The uncertainty relates to the timing or schedule of the claim payments.

This product is also closely related to a structured settlement contract with no elements of underwriting risk. All risk except credit risk can be practically eliminated if asset cash

flow is made to match the timing or the schedule of claim payments.

Such transactions are not considered reinsurance because there is no obligation to pay claims anymore quickly than provided for under the contract, regardless of the cedent's underlying claims development.

The contracts are priced as the cost of high grade assets needed to meet the liability cash flow stream plus a margin for profit and expenses.

❍ *Limited Risk Reinsurance*, is a financially oriented reinsurance transaction that contains elements of underwriting risk transfer. These are transactions where underwriting concerns are important, and can be significant to the reinsurer's ultimate financial outcome, but do not dominate the financial motivations. Based on a low-risk margin, the commutation provisions permit the retirement from the agreement and the limitations imposed on the right to share profits under a profit sharing provision.

❍ *Loss Portfolio Transfers*, under which an insurer cedes unpaid claims for known claims on a discounted basis to a reinsurer. These are perceived to be the main form of traditional financial reinsurance contracts. The contracts involve a transfer of liabilities for prior accident years. There is usually an aggregate limit for claims under the contract, and this limit may be further protected by sublimits for coverages such as pollution and asbestos liability.

These contracts are priced as the present value of the full aggregate limit at an assumed rate of claim payout. The claim payments are generally estimated on a conservative basis and requires exposure based information.

❍ *Retrospective aggregate covers*, under which an insurer cedes claims for known and incurred-but-not reported claims. Sometimes also known as adverse development covers, they serve to assume prior claims, like loss portfolios, but include a somewhat broader range of protection.

❍ *Prospective aggregate covers*, under which a ceding company pays a premium and is guaranteed certain future payments to fund future claims. These contracts can provide for an Experience Account Balance calculation resulting in a payment of a profit commission if claims are less than expected, or they can simply provide for the return of premium to pay claims as needed, up to the amount of the premium paid plus investment income.

❍ *Financing quota share contracts or surplus relief*, under which the reinsurer assumes a fixed percentage of an entire book of business. The terms and conditions of such arrangements vary depending on the anticipated returns by the reinsurer on the capital employed. In some instances, the reinsurer may cap the aggregate loss under the contract. Some reinsurers place a cap on liability higher than the expected claims and expenses plus investment income to be earned, creating more risk transfer in the transaction. The larger the gap between the expected claims and expenses and anticipated investment income, the closer the product comes to a finite risk reinsurance.

❍ *Funded or Cash flow protection programs*, can be constructed for otherwise uninsurable risks such as gradual pollution with little or no risk transfer and through which the reinsurer would provide funding in the event of a claim. This would then be recovered from the insurer in subsequent years.

❍ *Funded catastrophe covers*, under which some of the premiums paid to the reinsurer are put into a separate fund. Depending on how big a catastrophe claims is relative to the fund balance, the fund could fall into the red. The shortfall then is made up by the insurer in subsequent years through increased premiums, cancellation penalties or settlement adjustments.

Requiring ceding companies to report the amounts owed to reinsurance companies as liabilities effectively means funded catastrophe covers can no longer be used to "smooth out" balance sheet volatility over several years. A contract will be considered reinsurance only if it transfers "significant insurance

risk" to the reinsurer and it is "reasonably possible" the reinsurer will suffer a "significant loss" under the contract.

Generally under most financial reinsurance contracts, reinsurers estimate when claims will be paid under a contract and invest the premium in investment securities that will mature as claims come due. Therefore, investment strategy is an integral part of the financial transaction.

Financial reinsurance is a highly technical product and as such experienced specialists should be utilized to maximize profit and to prevent costly mistakes.

If it is true that the pricing of reinsurance requires greater skill and experience than direct insurance, then the pricing of financial reinsurance must require even greater sophistication than traditional reinsurance. Legal counsel and independent auditors, an indispensable part of the team, add to the general know-how of the financial, actuarial and underwriting personnel. Without the comfort of the legal opinion regarding the acceptability of the transaction under the insurance regulations and current tax law, there can be some problems in future. Independent auditors must also review the agreements to ensure that these contain the necessary element of risk transfer to qualify for accounting as reinsurance according to current accounting rules. Involvement by management of both parties in analyzing such requirements must be limited to the underwriting and marketing of such programs to avoid undue biases. Consideration should be given to the substance of the transaction rather than its form.

Financial reinsurance is used as a management tool, to achieve the stabilization of earnings, to manage adverse claims development, to provide short term solutions to problems caused by fluctuations in the insurance business. The key issues one must address are the accounting, regulatory and tax concerns. Guidelines for gauging whether the risk transfer in a particular reinsurance transaction is sufficient for it to be accounted for as reinsurance or instead as a deposit or financing contract must not only be established internally within each individual company

but reviewed in terms of the regulatory reporting framework. The general approach of regulators has been to require a "material" transfer of risk, but a variety of approaches has been adopted to determine what "material" is and how it can be measured.

Accounting for such reinsurance transactions is a complex issue. Although the accounting rules towards these arrangements are much clearer today, the interpretations of the rules are still subjective, and inconsistent. Significant judgment is required in the interpretation of the provisions of the contract and in the evaluation of the transfer of risk. The accounting treatment accorded to a particular transaction does not necessarily determine its status for income tax purposes, but may be a significant influence. To be treated as a reinsurance transaction for income tax purposes, the contract must be a contract of insurance. The general anti-avoidance rules must be taken into account in determining the tax treatment of any financial reinsurance contract.

The risk or significant possibility of loss criteria now required to permit the agreements to be accounted for as reinsurance, are being scrutinized more closely. Obtaining regulatory approval in accordance with the reinsurance regulations is now a much more challenging task. A straight forward test in assessing the transfer of risk criteria may require an evaluation along the following lines :

❍ what obligation would the insurer have to the reinsurer if the insurer were to cease business on the date on which the catastrophe event occurred? - if a commitment remains to repay the reinsurer, whether or not it may lie ahead of commitments to pay policyholder claims, then the transaction is not reinsurance.

Three additional circumstances require special mention:

- automatic reinstatement premiums whilst they do not affect the issue of transfer of risk, may impact on the insurers' solvency.

- arrangements where a premium may be altered as a result of changes in the scope or extent of the risk would normally not change the nature of a true reinsurance arrangement.
- contracts supporting the transfer of portfolios between insurers and thus the funding of existing claims or events may be treated as reinsurance for prudential purposes.

Reinsurance contracts that would be considered as "financing arrangements" involve only the transfer of:

❍ *Investment risk*, or the risk that the reinsurer will earn less investment income than expected on its reinsurance premium before claims become due.

❍ *Credit risk*, or the risk that amounts due from other reinsurers may prove partially or wholly uncollectable.

❍ *Expense risk*, or the risk that the reinsurer's operating expenses may be higher than expected when the reinsurance premium is established.

❍ *Timing risk*, or the risk that the reinsurer will have to pay claims more quickly than expected, eliminating investment gains on its up-front reinsurance premium.

It is important to understand the concepts of underwriting and timing risk in order to discuss the pricing of such risks. Underwriting risk relates to the uncertainty of the quantum of ultimate claims. This amount is independent of when the claims are notified or settled. In contrast timing risk is due to the uncertainty of when claims will be paid.

Obligations owed to reinsurers under multi-year contracts must now be reported as liabilities by ceding companies and assets by reinsurers. Conversely, if a ceding company stands to make a profit under a multi-year contract because of good claims experience, that amount must be booked as an asset while the reinsurer reports it as a liability.

New, non-traditional or financial reinsurance products will continue to be developed to provide the insurance industry with pools of capital to mitigate catastrophic risk. Characteristics of catastrophe exposures make the linkage with capital markets very desirable. Alternatives for protecting the surplus of insurance companies and therefore protecting the viability of the company will challenge the traditional reinsurance concepts. The whole process of securitizing risks - that is, transferring underwriting and timing risk in the form of a security will draw considerable attention from other financial institutions. This could produce products that blend banking and reinsurance, securitize insurance risks and help finance new reinsurers.

The reason for the development is because reinsurance, which has always provided a level of surplus protection to insurers, is transforming as the stakes get higher, resulting in traditional reinsurance capacity being unable to handle the potential claims which may arise from catastrophe exposures. Catastrophic covers are basic to the need for self-preservation and are used to protect against risks that pose a threat to the existence and well-being of the insurer itself.

Financial reinsurance agreements are no more than tools to be used by insurance companies to achieve specific financial goals. *While it is apparent that the move toward such reinsurance arrangements may gain momentum in the future, it is also clear that there are still only a handful of people who are able to design and set up these products and that for many who see this as a quick way to make an easy fortune, it is a solution desperately seeking a problem.* Assessing the degree of risk transferred in such reinsurance agreements is dependent on traditional underwriting skills, however there are many more considerations that need to be evaluated to quantify the financial exposures or the risks.

Aristotle and his peers believed that the heavens beyond the moon were forever unchanging. This view went unchallenged for almost 2,000 years. Then, after discovering a changing star - a nova - Tycho Brahe, a Danish astronomer, learned that we

must never close our minds to the unusual. There was much to be learned. Or is it simply a question of attitude towards risk? At the heart of every reinsurance contract is the assumption of risk in consideration of premium. There is no better way to determine the cost of adequate reinsurance protection than to measure it against the option of not buying anything.