Introduction to Financial Reinsurance

And Related Accounting Considerations

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Today's Agenda

- Overview of financial reinsurance structures
  - Transaction Objectives
  - Sample Financial Reinsurance Structures
    - Reserve Relief
    - RBC Relief
  - Common Features
- Statutory Risk Transfer Considerations
- Establishing Statutory Reserves
- IFRS Risk Transfer Considerations
- Establishing IFRS Reserves

Financial Reinsurance Structures can be Highly Specialized

And Depend on the Intent of the Parties Entering Into the Transaction

- Motivation for entering into a financial reinsurance transaction may include:
  - Efficient funding of statutory reserves
  - Efficient funding of statutory capital requirements
  - Unlocking embedded value
  - Financing of new business strain
  - Economic capital optimization
  - Cash flow relief in the event of temporary experience fluctuations
  - Exit a line of business

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Financial Reinsurance Treaties Require the Transfer of Risk

However They Typically Include Protections for the Reinsurer

- Concurrent reinsurance of multiple risks
  - Coinsurance of annuity block with concurrent reinsurance of waived surrender charge benefits (on this same block) using YRT
  - Reinsuring the coinsured risk provides reserve and RBC relief for the ceding company
  - The YRT block serves as collateral and YRT profits are used to retire the coinsured risk in an orderly manner
  - Experience refunds return excess profits (in excess of the periodic fee) to ceding company
  - The YRT rates may be increased subject to certain restrictions and caps

While there is real risk transferred under the coinsurance portion of this agreement, the YRT cession subordinates the reinsurers position to the YRT profits

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Financial Reinsurance Treaties Require the Transfer of Risk
However They Typically Include Protections for the Reinsurer

- Reinsurance of highly subordinated block to obtain RBC relief
  - Coinsurance funds withheld (or mod-co) reinsurance of seasoned block of participating business or highly leveraged UL block
  - This will provide RBC relief and may also support cash relief
  - The nature of the reinsured block provides subordination sufficient to satisfy reinsurer
  - The risks and profits on the reinsured block are ceded to the reinsurer and then returned (net the periodic fee) to the ceding company
  - An experience account tracks the performance of the block

While there is real risk transferred using co-funds withheld or modified coinsurance, the nature of the reinsured block insulates the reinsurer from a "first layer" loss

Common Financial Reinsurance Treaty Features
Certain Treaty Provisions Will Be Of Particular Interest to Auditors

- Experience Refunds
  - Return excess profits to ceding entity after periodic fee has been paid
  - Refunds are suspended if reinsurer is in a net loss position
- Experience Account Balance
  - Used to track treaty performance
  - Typically grows with interest
- Recapture Provision
  - More liberal than for non-financial reinsurance treaties
  - Linked to repayment of experience account balance (if any)
- Efficient cash transfer
  - Settlement is on a net basis with only fee income exchanging hands
  - Ceding company typically retains assets

Statistory Risk Transfer Requirements for Financial Reinsurance

Permanent Transfer of all Material Risks

- Premised on the requirements of the *Life and Health Reinsurance Model Regulation* and Appendix A-791 of the SSAP
- The aim of the statutory risk assessment is to demonstrate that:
  - Transfer of risk is permanent and complete
  - Risk transfer is neither temporary nor illusionary
  - Ceding company may legitimately reduce liabilities / obtain reserve credit
- Scope of the model regulation excludes agreements which do not provide significant reserve credit:
  - YRT
  - Non-proportional reinsurance

Section 4 of Model Regulation Outlines Risk Transfer Criteria

- Reinsurance allowances need to be sufficient to cover renewal expenses (4.A.1)
  - Prevents temporary surplus relief in the form of early allowances
  - Requires that a liability be established for the shortfall
- Ceding entity cannot be compelled to terminate coverage or recapture risk (4.A.4)
  - Recapture provision may provide incentives to ceding company
  - Election to recapture is at the sole discretion of ceding company

Section 4 of Model Regulation Outlines Risk Transfer Criteria

- Ceding company cannot make payment to reinsurer using amounts other than income from reinsured business (4.A.5)
  - Recall that YRT reinsurance is excluded from Model Regulation
- All significant risk must be transferred (4.A.6)
  - All significant risk may not be a material amount of risk
  - Reinsurer would seek assurances regarding investment guidelines
  - Reinsurer would seek alignment of interest
- Quarterly settlement is required (4.A.8)
  - Prevents accumulation of losses without timely settlement by reinsurer

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Statutory Reporting Requires Reinsurer to Post Prudent Reserves

- Statutory reserves are well defined for traditional YRT, coinsurance, modified coinsurance and stop loss transactions
- Statutory reserves are less well defined for highly structured transactions where reinsurer assumes risk using atypical YRT or stop loss arrangements
  - For example, reinsurer assumes risk of claims exceeding attachment point
  - The attachment point is defined as any excess claims over the economic reserve
  - Consider ceding company objectives when entering into the agreement
  - Reinsurer may consider “safe harbor” standard
  - When the safe harbor requirement is not satisfied, consider economic principles
- Statutory reserves in instances where reinsurance premium is level but risk is not
- Unearned premium reserves when premium paid in advance

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IFRS Risk Transfer Requirements for Financial Reinsurance

SFAS 113 Requires the Possibility of Significant Reinsurer Loss

- Premised on the requirements of the FAS113
- Paragraph 11 of the FASB pronouncement allows reinsurance accounting if:

> *"Indemnification of the ceding enterprise against loss or liability relating to insurance risk […] requires reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk"*

- Paragraph 11 specifies the manner in which risk transfer demonstration be performed however, this same paragraph indicates that:

> *"If […] the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the resinsurer".*

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IFRS Reporting Requires Reserves Reflecting Best Estimates

Financial Reinsurance Typically Results in a Zero IFRS Liability

- Best estimate liability reflects management's best expectation for future experience
- Typically results in a zero liability for the reinsurer
- Both ceding company and reinsurer reflect fee income over lifetime of the deal

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IASB Guidance Focuses on Commercial Substance of Transaction

May Allow Risk Transfer to be more Easily Evidenced

- Under IASB, an insurance contract is one where

"*one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder*"

- Risk is transferred if there is a scenario that has commercial substance in which the payments made by the reinsurer exceed the premium paid by the ceding company.
- IASB guidance allows risk transfer to be more easily evidenced when all of the insurance risk relating to the *reinsured portion* of the underlying insurance contracts (as defined and limited by the agreement) is assumed by the reinsurer.
- FASB ED has similar wording.

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somewhat different

Thank You

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