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THE IMPACT ON REINSURERS OF CURRENT XXX AND AXXX FINANCING SOLUTIONS

by Graham Mackay

Haven't we all been watching for the next big financing transaction and wondering whether it will be done by a reinsurer or an insurer? Also will it support XXX reserve redundancies or will the market have finally "cracked the code" for the financing of AXXX reserves?

These transactions are targeted at accomplishing two essential goals: (1) raising funds to support statutory reserves that are considered to be economically redundant and (2) receiving favorable rating agency treatment since the monies raised are considered to be either debt neutral or considered as operational leverage.

For the most part, these structures have been around for years and are used by both reinsurers and direct writers. Risks are reinsured to affiliates outside of the NAIC regime with the monies raised posted as collateral for the statutory reserve credit associated with the redundant reserves. The analysis needed to assure redundancy, however, has lately become much more rigorous so that outside observers can have greater confidence that the capital supporting these lines is adequate to support the retained risk.

The interesting advancement has been the securing of more stable sources of alternate funding via methods other than traditional letters of credit (LOCs). The rating agencies have clearly expressed their concern with companies' continued dependence on LOCs and pushed for the need to provide financing solutions that have long-term viability and pricing stability. To the relief of all concerned, the solutions presented to date have met some, or all, of the rating agencies' criteria for favorable treatment. We should continue to see an evolution over time.

Shift in Focus Away From Reinsurers

Before these alternative financing structures were introduced, the financing of XXX redundancies was largely the purview of the reinsurers. Risks were coinsured to the reinsurers who then in turn executed the financing through an internal retrocessional agreement. The costs passed on to the insurers were low and significant volumes were reinsured on this basis.

Today, the reinsurance sector holds a significant portion (60%+) of the inforce term business subjected to the XXX reserving requirements. As a result, reinsurers are excellent candidates for these alternative arrangements due to the potential size of these transactions and their growing need to reduce their dependence on LOCs. However, data quality often hampers their ability to fully execute.

Then again, insurance companies who have access to better data quality are hamstrung by not generating the volume of reserves necessary to execute a cost effective solution. However, insurers can accumulate these reserves by reducing the proportion of risks reinsured on a coinsurance basis or by shifting to a YRT basis thereby more fully assuming the responsibility for the funding of the statutory reserves. This approach will require the insurer to warehouse reserves until critical mass is attained. This creates new challenges for the insurers.

Today, the providers of alternative solutions view both insurers and reinsurers as attractive candidates for these financing programs. Both groups have the potential to execute these transactions, although not without challenges that must be overcome.

Impact on Reinsurers

The biggest threat to future growth for reinsurers will come from the potential reductions in amounts ceded as insurers pursue their own internal financing solutions. With the recent increases in the cost of reinsurance, more insurers appear to be motivated to seek an unbundling of their coinsurance programs. Self reliance and internal financing for XXX and AXXX reserves appears to be the order of the day. These decisions will largely be driven by the cost/benefit of these alternate solutions relative to the cost of reinsurance. Reinsurers should expect downward pressure on their margins in order to remain competitive.

Insurers are now competing more actively in the market for capital and first call on financial guarantors' capacity. So far this capacity has continued to expand, making it difficult to claim an immediate impact on reinsurers.

Cycle Shift

It is abundantly clear that the reinsurance cycle has shifted away from the leveraging of low-cost coinsurance solutions. We are not certain where this next phase in the cycle will take us, but it will certainly include, in the short-term, the counter-balancing of alternative financing and reinsurance solutions. ✺

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