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Reinsurance Section News

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Year-End Capital Management Using Financial Reinsurance

by Richard Leblanc

Another December 31 has passed and I'm pleased to report that financial reinsurance continues to thrive. In fact, by most accounts 2002 will be remembered as both one of the most successful and challenging years for this specialized field of reinsurance. A multitude of economic factors converged to increase the demand for financial reinsurance to levels not seen for many years. Those insurers who were proactive and sought out solutions early in the year generally found their needs met while many who followed the usual solicitation of offers late in the fourth quarter were disappointed.

While financial reinsurance can be structured to address an almost endless array of objectives, the more common year-end applications include: i) accelerating the recognition of statutory earnings from current-year issues; ii) reducing the risk-based capital requirements associated with a significant in-force block; and iii) improving the tax efficiency of reserves by reinsuring non-deductible deficiency reserves. While sound financial management principles suggest that these are worthwhile objectives throughout the year, experience has shown that many firms, large and small, turn to financial reinsurance as year-end approaches when they can better estimate the gap that will result between their desired and actual financial position at year end from their core business strategies.

Factors Leading to Increased Demand

One could easily write several books on the financial challenges faced by North American life insurers during 2002. A preponderance of rating and equity analysts further downgraded their negative outlook on the industry as a whole. While competition remained as intense as ever, many firms struggled to keep pace as their financial flexibility was diminished as a result of:

1. **Low interest rates:** interest-sensitive and spread-based products have largely seen their profitability erode due to a combination of significantly lower new money rates and contractually or statutorily mandated minimum crediting rates.

2. **High credit default rates:** many of history's largest bankruptcies have occurred in the past 12 months. While few were immune to the impact of "fallen angels" such as WorldCom and Enron, many insurers suffered losses from a succession of their holdings. Predictions are that the bottom of the credit cycle has not quite been reached.

3. **Guideline XXX:** most insurers continue to struggle to reduce the strain associated with no-lapse guarantees on their UL products, and reinsurers in particular experienced a greater burden to collateralize reserves that they have reinsured out of the United States as the cost of LOCs rise and the volumes quickly grow as reserves climb the "hump back".

4. **GMDB strain:** the reinsurance market for such risks has largely disappeared. Many of these benefits are currently "in the money" resulting in increased benefit costs.

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5. **Horrible equity market performance:** this reduced the fees earned on wealth accumulation products such as variable annuities. Some insurers with a higher than average asset allocation to equities have seen their surplus depleted by unrealized losses, and many with European parents have found it more difficult to secure additional capital because the parent's surplus has either been eroded or because the capital markets were flooded with, and not overly receptive to, new debt or equity issues.

6. **Growth in fixed-rate products:** bear equity markets have caused a much greater than anticipated shift of consumers' investments into guaranteed investment products resulting in very substantial increases in required capital for many fixed annuity writers.

Combined, the above factors resulted in deterioration in many of the financial measures prevalent in the industry to measure financial strength and success. Most notably, the risk-based-capital ratio for certain insurers was projected to be unacceptably low unless some of the business was sold or reinsured.

Supply of Financial Reinsurance Somewhat Constrained

Almost unanimously, peers within organizations that either structure or provide financial reinsurance, concede that many of these same factors that caused demand to surge also created significant stress for certain in-force transactions. While most wanted to write as much new business as was available, the deterioration in the level of collateralization of existing deals caused them, as well as their executive management, to question whether or not the level of risk inherent in these structures was significantly greater than anticipated and by extension rethink their continued participation in the market.

For some, transactions that were substantially overcollateralized at the start of 2002 had either deteriorated to a reasonable possibility of significant loss or revised projections suggested a much extended payback period. As a result, many of the limited resources in this niche market were re-allocated to in-force management in an effort to restore the intended risk profile to such deals and to identify what further deterioration might occur under continued adverse scenarios.

Counterparty credit risk has become a more important consideration for cedants as the "flight to quality" continued. However, during 2002, financial reinsurance providers also were much more conscious in selecting insurers, which they would finance. While insolvency risk has always been a concern, as a result of recent press reports in the UK and Australia there is a greater awareness of the risk of tarnishing one's reputation by being associated with a client who might experience serious financial difficulties. Furthermore, from a practical perspective, it is prudent to minimize the time and effort in developing a solution with a prospective counterparty that has significant risk of being downgraded below your organization's minimum counterparty rating.

While the overwhelming majority of in-force transactions remain structurally sound, speculation exists within the industry as to whether some of the more occasional, less disciplined providers of financial solutions will join the growing list of reinsurers that have permanently exited this niche. Users of financial reinsurance understand that it is in their and the industry's best interest that they continue to work with their financial reinsurer to minimize the risk of ultimate loss under the arrangement. Rough parallels can be drawn with a borrower who defaults on a loan or a successful retailer who turns away from a manufacturer that has significantly helped them grow. In both cases, not only is trust destroyed between the two parties, but it will be much more difficult to secure future financial partners. While we may have observed 99th percentile events during 2002, indications are that financial reinsurance will continue, in adequate supply, to provide the most flexible financial management tool available to address insurers ever changing needs.

However, coupled with the heightened sensitivity to risk management in a post September 11 world, the general response was a more cautious approach to new business. Generally this has translated into higher prices, greater collateralization requirements and more restrictive treaty wording.

Helpful Hints for 2003

Here are some final suggestions for those organizations that may wish to explore financial reinsurance during 2003:

1. **Be prepared:** know your needs, understand your constraints, involve all key stakeholders within your organization and compile comprehensive information to facilitate the reinsurer's understanding of your business.

2. **Be realistic:** many organizations value their in-force business using best estimates and slightly optimistic assumptions; financial reinsurers will be much more conservative and interested in how the business will perform under various protracted adverse scenarios to be assured that the block can support the financing to be provided.

3. **Be committed:** be open if your intentions are to "kick the tires." Most providers view educating the clientele as one of the most important aspects of their business. However, during the fourth quarter, financial reinsurers need to focus on deals that parties intend to close by year end.

4. **Be selective:** unlike other reinsurance products, financial reinsurance is not a commodity; a "mass mailing" approach to the market will likely not entice the leading providers to dedicate the time needed to implement the best solution.

5. **Allow time to implement the optimal solution:** inadequate due diligence by either party (i.e. last-minute modeling requirements, incomplete answers) will likely result in either an overly restrictive transaction or no solution.

Financial reinsurance is a very powerful, low cost financial management technique that all should investigate. Many of the largest and most sophisticated insurers in the United States and Europe are significant and increasing users of these solutions. While on the surface the structures may appear complicated, this is not rocket science and is easily entered into for most financially sound organizations—especially those who adopt the preceding helpful hints. ✍

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Reinsurance Section Photos

Council members gathered in Boston to plan the 2002–2003 activities of the Reinsurance Section

Left to right—Leigh Harrington, Mel Young, Tim Tongson, Bob Reale, Mike Gabon, Ronnie Klein, Jay Biehl, Dean Abbott (newsletter editor), Tim Alford, Jeff Katz, Jim Dallas.

Thanks, Jeff!

Jim Dallas (left) incoming section chairperson, presenting retiring chairperson, Jeff Katz, a gift of appreciation for a job well done.