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AN INTRODUCTION TO THE FINANCIAL REINSURANCE MARKETPLACE

By Jeff Burt

In the shadows of the P&C legalities going on right now in Connecticut, I suppose you could look at the timing of this discussion (OK, monologue) as either very good or very bad. Nonetheless, non-traditional reinsurance, financial reinsurance (or whatever you want to call it these days) is alive and well. Albeit not necessarily in the same form you may have come to know in the past. Surplus relief makes up only a small portion of the market, not because of stigmas, rules, risk transfer or any other technical reason. Instead, the industry as a whole has done pretty well over the last few years and finds itself with balance sheets lopsided with capital by recent standards. So, why then, you ask, are so many interested in new "financially-focused" reinsurance transactions and what form are they taking? Fair question, and although I won't pretend to understand or appreciate all the needs in the marketplace, I will attempt to shed some light on at least a few of them that are setting the stage for the next generation of financial reinsurance.

Motivations Behind Non-Traditional Reinsurance

I admit the following couple thoughts are not exactly enlightening and frankly should be obvious to all in our industry, but bear with me and hopefully I will make a point that underlies both the direction and reason for the positive trend in financial reinsurance over the past few years. Our industry is OLD. Sure, I guess I could be kind and say "mature" or "developed," but I think "old" is accurate for two reasons. First, insurance, and reinsurance for that matter, have been around for a long time and some of the best and the brightest have spent many years developing the market(s). As such, new "advancements" are often few and far between. That being said, whether it is considered "buiding a better mousetrap" or not, the reinsurance industry can point to multiple examples over the years of providing solutions to direct issuer concerns. Second, in addition to being mature and developed, suggesting that the direct market has not seen many new product ideas in the last few years may be the understatement of this young 2008. So, in light of a challenging marketplace for growth and innovation combined with balance sheets ready to take on new growth and production, it is not surprising to me the direct market is looking for some assistance.

Let's be frank. There is no textbook one can read on this subject, much like there is no textbook one can follow as to how to make money in the equity markets—and I would speculate for much the same reasons. For example, if you have an investment strategy which you think works, are you going to tell the world about your secret? You may tell a few friends, but will to look ride that horse as long as possible. Sure there are the tried and true approaches which have stood the test of time, as well as the rules of thumb and guidelines to follow which are known to many. I would suggest that those familiar with this line would propose that non-traditional reinsurance, or whatever we decide to call it, is much more art than science. I think that some might take offense to this statement or read more into than is intended. Certainly, actuarial science is exactly that, science, right? If so, where is the exam covering non-traditional reinsurance? Where is the exam covering optimal risk/return trade-offs for life and health insurers? Last I checked, there wasn't one and really this is all I mean by the comment. Setting risk/return tradeoffs in our industry is very much art over science.

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If we agree there is a demand, and we agree the product is more art than science, where is the supply and what does this product look like? For the most part, the products sold in the marketplace have not changed: YRT, coinsurance, ModCo, partCo, funds withheld coinsurance and any combination thereof. The only reason for the different names, as much as I can surmise, is to confuse the accountants and add job security. At the end of the day, all the structures are meant to transfer the risks (or at least can) of the insurer to the reinsurer, or any other entity taking secondary market insurance risk, including: capital markets, banks, special purpose vehicles, captive reinsurers, side cars or securitizations. As best I can tell, if we simply used the term reinsurance and did not specify what type (e.g., YRT, Co) it would be much simpler for all to follow.

… WHAT IS THE DIFFERENCE BETWEEN FINANCIAL REINSURANCE AND SECURITIZATIONS? OUTSIDE OF WHO HOLDS THE RISK AND PROVIDES THE CAPITAL, I WOULD SUGGEST THERE ISN'T A DIFFERENCE.

If the type of reinsurance is not the key to identifying non-traditional reinsurance, what is? How do we get a sense of the marketplace? The key to this market is to understand a round peg is not meant to fit into a square hole. Perhaps not the most profound sentence you'll read all year, but I think it summarizes the market well. In other words, the financial needs of a direct writer are rarely so simple and straightforward that the best answer for them is a traditional excess or quota-share YRT or a straight sale of the business through indemnity coinsurance with a ceding commission, your "round pegs." Many times, the best answer or at least a better answer lies somewhere in the middle, the "square hole." This assertion leads us to a fairly clean definition of non-traditional reinsurance, "… any reinsurance that is not straight YRT or coinsurance, e.g., traditional reinsurance." My high school English teacher would likely deduct points for using the word in the definition, but you get my point.

If you follow the trail of logic so far (I give you credit, it is admittedly suspect) then the question at hand, "understanding the landscape of the financial reinsurance marketplace," is simple, but still difficult to answer. The question then is: "how many non-vanilla YRT or non-coinsurance agreements are being written out there? The answer is, plenty. Pretty much every capital markets transaction, every embedded value securitization, every surplus-relief agreement, and every new-business financing agreement has some non-vanilla component attached. Why you ask? Because all of these agreements have at least one thing in common, they were designed to be somewhere in the middle of the risk/return spectrum and not at one end or the other. What about risk transfer you ask? The practical implication of this is that rather than risk transfer being the goal, appropriate risk sharing becomes the goal. Let me be very clear, ALL of the agreements I am referring to satisfy statutory risk transfer according to the NAIC. Otherwise, they are generally useless to both parties in that a simple loan would suffice as that is how they would be treated in such a situation. Developing an alignment of interest is paramount to the success of most transactions and certainly to the transactions to which I have been referring. There are many techniques used to both share risk and create an alignment of interest, not the least of which is the use of experience refunds. The appropriateness of experience refunds, or ERs, have been questioned by some recently. I will avoid getting distracted too much here with a discussion of ERs, but at the risk of exaggeration suggest that this principle and concept underlies all insurance structures and is paramount to the long-term success of the industry. They can be found everywhere from participating whole life contracts, to reinsurance to TPA agreements. They do not impair statutory risk transfer and are an excellent tool in aligning the interests of all parties.

The Round Peg in the Square Hole

Hopefully by now, if you are still reading this, you are starting to appreciate the goals of this marketplace and the needs it serves. But the question likely still remains, how do these transactions work? What makes them different? What are the challenges? Why are they often associated with risk transfer discussions? How do you fit the round peg in the square hole?

All fair questions and very difficult ones to summarize in one article. Perhaps a popular question which can be answered and gets to the heart of the matter is this: what is the difference between financial reinsurance and securitizations? Outside of who holds the risk and provides the capital, I would suggest there isn't a difference. When it comes to the nature of the underlying transactions and not who is executing them (reinsurer vs. investment bank), the moving parts of the agreements are very much the same. At the end of the day, at the heart of the agreement is a reinsurance transaction and for that matter, most often a coinsurance transaction. The names differ because the counterparties differ, reinsurance goes to reinsurers and "securitizations" go to investment banks.

That being said, I would guess most of you reading this have seen a schematic of a standard XXX transaction. If not, go to the SOA Web site and pull up any recent securitization presentation from a recent annual or spring life meeting. The schematics do a decent job painting a picture of the cash flows of a coinsurance transaction. The only addition in these diagrams is often a third party which provides the funding as opposed to the reinsurer itself.

The difficult question many ask when first being introduced to reinsurance agreements which try and fit the "square hole" is, how do they work? And, what does it look like on my balance sheet. Unfortunately, I can't provide a very straightforward answer to that. As you might expect, with many things actuarial, the answer is: "it depends." I don't say this to be facetious. The fact of the matter is, by definition, every square hole is different. It is a function of the client's underlying goals of a transaction. For instance, perhaps a client feels their in-force block is forced to carry excess reserves and excess capital. This is a fairly common and fairly easy problem to deal with, reinsure the business to another party willing and/or able to hold lower reserves and/or capital. However, the cost and structure of such a solution will depend in large part as to how much the ceding company wants to pay and how much risk they are willing to keep. An easy answer is to sell the whole block and look for a maximum one-time up front ceding commission. This is common and generally very straightforward. However, suppose the block is not material, or is unstable, volatile or otherwise difficult to predict. Furthermore, suppose the seller is not able to find a buyer willing to pay what he/she thinks it is worth. An easy answer would be to not pay as much up front and instead provide dividends or experience refunds over the life of the agreement if the business exceeds agreed upon expectations.

The more challenging questions arise when it is not so clear that reserves and capital are in fact excessive by some measure. Or, equally difficult is when all the risks in a contract cannot be easily passed to the counterparty as with the setting of non-guaranteed elements in a ULSG or AXXX contract. Much more thought and design must go into structuring an agreement which can be mutually agreeable to both parties, yet still serve the ceding company's needs. The same can hold true for reinsuring the risk(s) of a product where there is not a large secondary market, as with longevity-based products.

Client's needs are generally complex and rarely vanilla. As such, writing agreements that understand and support those needs while aligning the interests of both parties and creating a win-win in the end is rarely easy.

Appreciating a company's risk tolerance and return requirements, as well as understanding the client's products and challenges, are requirements in any reinsurance agreement, but take on even greater importance with financial reinsurance. Challenges to the stability of the marketplace will continue in the future, including: principles-based reserves, reserve credit for alien reinsurers, capitial markets and securitizations, among others. While a more detailed discussion of these "threats" to the marketplace might certainly be informative, it requires much more detail than I am prepared to indulge here. I would note only that the marketplace focusing on client needs and support may change in its look and feel but will survive so long as insurers have the desire to modify and manage their risk return profile. ✹

Jeffrey R. Burt is vice president, Marketing, for Hannover Life Reassurance Co. of America. He can be reached at *jburt@hlramerica.com*