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Financial Reinsurance: Tool for the 21st Century

Track: Reinsurance

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Summary: Panelists provide an introduction to the role financial reinsurance can play in today's competitive environment. Panelists define financial reinsurance by comparing and contrasting it with traditional reinsurance. They also explain how financial reinsurance can play a role in meeting specific business goals. They examine the financial reinsurance marketplace and economic, regulatory, and strategic considerations in embarking on a financial reinsurance program. Panelists use numerical illustrations of how financial reinsurance might work in practice.

Mr. David Addison: I'm an actuary with RGA Financial Group, one of the largest providers of capital-oriented reinsurance in the U.S. In our presentation we're going to discuss financial reinsurance. Tim Tongson and Richard Leblanc will speak about financial reinsurance from the ceding company and an assuming company point of view respectively, and then one of my colleagues at RGA Financial Group, Larry Carson, will tell us how we match up potentially conflicting interests.

Financial reinsurance was once thought of as surplus relief and confined to the back waters of the insurance industry, but these days financial reinsurance or, more accurately, capital-oriented reinsurance, (and we're going to use those terms pretty much interchangeably), is becoming an increasingly important tool for highly-rated, growth-oriented companies. You have mutual companies facing the GAAP environment now. There's competition for the savings and investment dollar from many sources that have emerged over the past 5–10 years. Insurers need to take advantage of every opportunity to increase returns and to improve their positions in the eyes of the regulators, rating agencies, their distributors, their customers, and shareholders. Our discussion will offer an introduction to the role financial reinsurance can play in this environment.

What is financial reinsurance? I'm going to give you a broad definition and then going to compare financial reinsurance to debt or equity. Then I'll try to contrast it to what one might more normally think of as traditional reinsurance, explain why

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there's really a lot more to capital-oriented reinsurance than just surplus relief, and, finally, I'm just going to try and touch on the financial reinsurance marketplace.

You've doubtless heard of financial or capital-oriented reinsurance referred to by many other names: alternative risk transfer, surplus relief, or riskless reinsurance, although the latter name is not really true, because one of the requirements of any reinsurance transaction is that risk is transferred. Each of these names emphasizes a potentially different aspect of a transaction; none encompasses the whole thing.

Financial reinsurance is really reinsurance where the primary objective is achievement of a specific business goal. It's one more tool available to the insurance industry to achieve specific objectives, such as increasing statutory surplus, acquiring blocks of business, or achieving capital efficiencies. Like all reinsurance contracts, it involves risk transfer. The defining parameter in this case is to achieve a specific business purpose rather a specific risk transfer. More often that not, we're engaged in transactions where we expect them to be reflected immediately in the balance sheet.

Capital-oriented reinsurance is one flexible and cost-effective piece of the capital management puzzle. It can meet short- and long-term capital needs. It can provide a bridge to raising capital in the future, and you can establish a line of credit based on reinsurance very much like you might try to establish a line of debt. There are usually no up-front costs, it doesn't dilute ownership, and tends to have a lower cost than equity. Also, reinsurance is the only investment that reduces risk-based capital (RBC) and it's the only form of capital where the provider is potentially liable for additional payments based on the ultimate performance of the underlying business.

A capital-oriented reinsurance program may produce statutory earnings, depending on the structure. The proceeds may be considered taxable income and, in general, there's a higher cost than debt. Equity carries a higher price tag than capital-oriented reinsurance because of the need to earn hurdle rates of return on committed equity. Debt increases leverage ratios and can muddy the balance sheet. If relied on to great an extent, debt can make the rating agencies unhappy. The bottom line is that while there's no single best source for capital, capital-oriented reinsurance is one important piece of the capital management puzzle.

It should be noted that all reinsurance affects the balance sheet, income statement, and tax position of the ceding company. The differences between financial and more traditional reinsurance programs boil down to timing, magnitude, and motivation. Financial reinsurance seeks a more immediate effect of a measurable size, with risk transfer a necessary additional feature. With traditional reinsurance, the motivation is transfer of one or more types of risks, with the effects on the company's financial statements being secondary. We can think of reinsurance as a continuum with surplus relief and other lower-risk transactions to the left side and pure risk reinsurance to the right. Financial reinsurance can be structured to fall anywhere on the continuum.

The cost of the reinsurance is directly related to the ultimate risk of loss to the assuming reinsurer, which is the same as in any other reinsurance transaction. The reinsurer always assumes the risks inherent in the product reinsured, but the ultimate cost is determined, as I said, based on how much chance there is they will ultimately lose money, i.e., that they won't be able to recover the relief provided from the profits on the reinsured block.

Our presentation's going to focus primarily to the left side of this continuum. Financial reinsurance could be constructed to add to surplus, to subtract from it, or to have a neutral surplus effect. The subset we refer to as surplus relief tends to be more oriented to improving a company's surplus position. The ultimate risk of financial loss to the reinsurer can fall anywhere on the continuum with financial reinsurance. Within that, surplus relief transactions generally expose the reinsurer to lower ultimate risk and, thus, a more debt-like cost for coverage.

The financial reinsurance marketplace is served by a small number of innovative and highly specialized players. These companies are, not surprisingly, somewhat reticent about sharing information as to market size. As I've already suggested, it's quite difficult to differentiate at times between what is financial reinsurance and what is risk reinsurance. What is clear, however, is that the number of companies that use capital-oriented reinsurance as part of its capital planning process is increasing.

With that brief introduction I'm going to hand over to Tim Tongson, who's going to talk about financial reinsurance from the ceding company's perspective. Tim is a consulting actuary in the Minneapolis office of Milliman and Robertson (M&R) where he has responsibility for life and financial services practice. Prior to joining M&R, he was vice president and corporate actuary for the North American life insurance operations of Allianz.

Mr. Timothy J. Tongson: Prior to joining M&R, I spent much of my time in a corporate setting, most recently as a corporate actuary, but I've also managed a business unit. In that setting we used financial reinsurance quite a bit and had some situations where we had to analyze whether or not to use financial reinsurance. What I'd like to do is bring those experiences into this presentation as I talk about the ceding company perspective.

I also want to mention that I've kept this at a fairly high level. When I started to think about this, I realized this is not rocket science. Much of it is actually common sense and so I'm approaching it from trying to make good business judgments along the way. I know Larry will later have some technical examples about how financial reinsurance is used.

I'm going to talk about five different areas. First is what I call the business challenge. It sets the stage for why a company gets into a situation where they might need to have financial reinsurance. Then I'm going to talk specifically about considerations and benefits when you use financial reinsurance; the financial statement impact; rating, and regulatory perspectives; and how to select a quality reinsurer.

First, let's talk about the business challenge. Here's how I define it: it's balancing growth and profitability both within the limited resources of your organization and within defined risk tolerances. This is something every company has to struggle and deal with. There are a number of aspects to it.

The four areas of the general business challenge I'd like to talk about are: (1) influencing factors, (2) options and strategies to the ceding company, (3) options available outside your own organization, and (4) considerations in selecting an option outside your own organization. I'll conclude this section by talking about how I've seen financial reinsurance used in a number of cases.

There are obviously, a number of things that affect growth and profitability as well as risk. These are the ones that I feel are most important:

- The availability and cost of capital. Capital is a limited resource, and the cost of using it must be factored into pricing.
- Your organization's RBC and profit requirements. This will have a large impact on how much you're going to be able to sell.
- Market potential and competition. This will impact whether or not you can achieve profitable scale.
- Expertise. Do you have the people in your company that it takes to manage the business for growth and profitability making the right decisions?

The second area I want to cover regarding the general business challenge is the options and strategies an organization has. Here are the common ones, and most organizations use a combination of these:

- Just change the numbers to fit your company's needs. That is, make no substantive changes. This may be used too frequently.
- If you have a corporate area that sets the standards for your company, you can negotiate with them. Perhaps the RBC requirement for the line of business that you're managing is too burdensome. If you put together a sound business case, and I've seen this happen in a couple of situations, you may be able to negotiate with your corporate area to get the RBC requirements down. That can help your business plans through reduced capital usage and improved ROE.
- Modify the business plan. Now we're talking about making some real changes in your business through expense reductions, modifying your production, or employing strategies to increase the margins in your business.
- Look outside for help. When you look outside there are a number of options available. David alluded to some of these so I'll go through them fairly quickly. You may have a parent company that can infuse capital or surplus to your company; equity is generally available if you're a stock company; debt, particularly if you're a mutual company; surplus notes; and, of course, there's financial reinsurance.

When you use one of these options, some of the things that you want to think about include the cost for the options that are available to your company. What's the dollar cost and impact? Timing is something that's also important. How quickly do you need to implement a solution? How long do you need it to last? What is you degree of control? Do you retain full control or do you give some up in the process? How flexible is the option? Finally, there is the regulatory and rating agency perspective. It's critical, obviously, to understand those and we'll talk more about this later.

Now, let's talk about some specific examples of how I've seen financial reinsurance used in practice. The examples incorporate the business need and the reinsurance solution that we employed.

The first situation is where a rapid-growing product line is creating a cash and surplus strain. In this particular instance, back in the early 1990s, my employer got into the variable annuity marketplace and it grew substantially beyond our expectations. We were not prepared to handle, and our parent company was not willing to commit to, the investment needed to fund the growth we were experiencing. We talked to a number of reinsurers and were able to develop a surplus relief agreement that handled both the surplus and cash strain concerns. Later we will have a numerical example of how this works.

The second example is when a new product creates both surplus strain and unacceptable risk exposure. In this situation my employer wanted to get into the long-term care (LTC) market and we were concerned on two fronts: the surplus strain, and the risk exposure. Surplus strain can be significant, and the payback can be quite elongated, 5–10 years or more depending on product. The other concern is the unacceptable risk exposure. I know the information has gotten better recently, but back when we were doing this, there was a lot of concern about the credibility of LTC experience data and also with regards to the tail.

How did we handle that? We employed a combination, 100% coinsurance/YRT arrangement which, effectively, through the 100% coinsurance side we ceded the business to the reinsurer. This, basically, took care of all the strain and the risk. Then we assumed back a certain percentage of the first few years on a YRT basis to the point we were comfortable with the risk that we took. We were allowed to modify that percentage as we got more comfortable with the business. That was a nice balanced solution, a combination of traditional reinsurance with surplus relief or financial reinsurance.

The last example is to divest a business in order to both transfer risk and accelerate profits. This is a fairly common transaction, and it's typical to do this through 100% indemnity coinsurance. Because of that, I just wanted to talk more about the specifics.

There are a number of reasons to consider divesting a block of business. The block may have sub-par performance and is not meeting your hurdle rates. The business may no longer be a good strategic fit for your company. Management may want to focus on a more strategic area. Perhaps you haven't achieved profitable scale and the potential to do so is not there. If your business isn't significant enough, you may not be able to afford the investment in both technology and training to keep your customer service up to the level that you need. You may not have the expertise to manage the risk. Or, you may want to access the value that's embedded in the block of business.

Generally, the financial reinsurance solution that's typically used is 100% indemnity coinsurance. Essentially, the business is ceded so that all the reserves and risks are transferred after the effective date. But the business is still on your paper, so you've got some concerns about reinsurer performance not only from a financial perspective, but also, from a service perspective. It's important to perform adequate due diligence on the reinsurer not only from a financial perspective, which we'll talk about in a second, but also, on their capabilities to provide the service that you need.

Regarding risk transfer in a transaction like this, there are two other points to consider. First, in the cases that I'm familiar with, market conduct risk was not transferred prior to the effective date of the transaction. The ceding company retained that risk because the reinsurer isn't able to get their arms around the exposure. Second, for additional protection the ceding company typically requires the reinsurer to have assets backing reserves held in trust.

Let's talk now about specific considerations and benefits of using financial reinsurance. First, considerations:

- If you do have other options besides reinsurance, you need to evaluate whether or not the reinsurance cost is reasonable and competitive.
- Profits on reinsured business are ceded away. On the other hand, so are losses. If you take the extreme example of a block of business that you sell or divest, you get the up-front profits accelerated to you. Any future profits or losses on that block, basically, are with the reinsurer.
- Reinsurance generates credit risk exposure. Make sure you're dealing with reinsurers that are solid financially and have top ratings. It's also important to have a balanced solution with reinsurance, so that it doesn't represent a substantial exposure on your balance sheet. Rating agencies are going to look at who the credit is on your balance sheet, how strong and reputable they are.
- Understanding the risk transfer regulations is critical with regards to the transaction you're contemplating.

Let's talk now about the benefits:

- No initial, up-front costs.
- Rapid implementation.
- Competitive pricing with other outside options.
- Flexibility.
- Access to expertise. A good reinsurer is going to have been in the business for a number of years and done a lot deals, possibly some very innovative ones. They can provide some advice and maybe help you do some things that you didn't think you could.
- Ability to resolve a temporary situation. I talked about the variable annuity situation that we had. It took us sometime to get the support we needed internally. Financial reinsurance provided a quick solution that allowed us to continue on with our business plan without having to shutdown a production source, which we may never get back again.

A discussion of the financial statement impact of reinsurance is worthy of its own seminar. Because of the nature of the transactions, there is a lot of variation in financial statement impact. I showed you the combination agreement, a surplus relief reinsurance situation, and a divestiture. Each of these is unique in its own way, especially when you consider the products that are incorporated into the deal. The point I want to get across is that you need to know the impact on your company for the transaction you're contemplating on cash flow, statutory, tax, and GAAP financial statements.

Let's talk about the rating and regulatory perspectives. What are the regulators and the rating agencies going to want to know? .

First, they want to have a sound understanding of your business plan and your strategies. That's where it starts. Once they know that, then they're going to want to know why you are using financial reinsurance. What other options have you considered? Is it part of a balanced solution? Are you heavily leveraged on financial reinsurance or do you have some other options? They'll want to definitely know the structure and the financial impact. Try to avoid esoteric or complicated structures (if you can). The easier it is to explain, the easier they'll understand. A test for that is simply if you have difficulty explaining it to your own corporate management team, you may have trouble with the rating agencies. Clearly, they're going to want to understand that you're complying with regulations, and you need to be able to explain that to them when they ask. Finally, as mentioned previously, they're looking at the credit risk that you've got on your balance sheet. They want to know that you've got solid reinsurers behind those obligations.

How do you select a quality reinsurer? One of the keys to think about is, ideally, you're going to enter into a long-term business partnership with your reinsurer. With that in mind, there are a number of things that I think you ought to look at. I want to be dealing with a reinsurer that is not only experienced and knowledgeable, but has financial strength and top ratings. A solid reputation is important, and you can usually find information on this from associates in the industry. Asking the reinsurer for referrals is also an option.

Strategic and cultural fit is also very important, especially in a long-term relationship. How do you determine it? Pay attention in your discussions and negotiations with the reinsurer, and think about how it feels. Does this feel like somebody you want to have as a business partner? Price, of course, has to be competitive. However, if I'm getting value-added from the other areas, I don't mind paying a little bit more on price.

Mr. Addison: Richard Leblanc is a Canadian Chartered Accountant, a U.S. C.P.A., and a Fellow of the Institute of Risk Management. He started his career with KPMG. In 1991 he joined the corporate finance team of Sedgwick Global, initially, with responsibility for tax planning, leasing, and accounting policies. Subsequently, he led Sedgwick's risk financing practice. There he and his team were responsible for assisting major corporations in profiling their risks, determining risk tolerances, and implementing tax efficient, and GAAP friendly programs to finance and transfer uninsurable and difficult to insure exposures.

Richard joined Manulife Reinsurance in 1997 to develop and market new products to meet clients' evolving financial objectives. Richard is charged with expanding the distribution of Manulife's structured solutions. Manulife has been active in the financial reinsurance business more than 20 years and uses a variety of onshore and offshore facilities to provide North American and European clients with surplus relief, RBC relief, cash financing, GAAP earnings management, credit wraps, and conduit facilities.

Mr. Richard Leblanc: I want to discuss the reinsurers' perspective. What do we look at when we contemplate writing one of these types of transactions?

First, we'll start by yet again defining what financial reinsurance is. We'll talk also about what our motivation is from the perspective of the reinsurer, how we go about evaluating the deal, and a little bit about how we price it. Briefly it's what is it, why do we do it, how do we do it, and how much do we charge for it.

What is it, substance or illusion? I often hear financial reinsurance associated with reinsuring business offshore. In other words, the reserves just happen to fall into the ocean. Now, what does that mean? I guess there are two interpretations of that. One is you've entered into a contract with a counterparty that isn't financially strong, or you've structured it such that you have absolutely no chance of recovering any losses that you might have. I think those really are sham transactions and definitely not what my fellow panelists and I are discussing.

What we're talking about are substantive transactions, which you may have entered into with an offshore reinsurer. However, I would propose that that offshore reinsurer is actually holding something that is probably more economically realistic, given the constraints and the environment that they're in to deal with that risk versus, perhaps, the environment in which the ceding company exists.

What's the definition? As David pointed out earlier, it's really a transaction that's entered into where the primary purpose is something other than necessarily seeking indemnification. It may be because you want to manage the growth that you're experiencing. There definitely should be something at the heart that is not easily solved by traditional reinsurance, which is simply I'll pay you $1 now in the hopes of getting some indemnification in the future.

We do classify it as a low-risk transaction. These products are structured such that the likelihood of loss is relatively small. However, the magnitude of the loss if you do lose can be very large. If you poorly structure the performance of the block as such, you can most definitely lose money. In terms of trying to define anything such as financial reinsurance, the definition truly evolves and it's just limited by the creativity of the people in the business in terms of what really can happen.

Is it a legitimate tool? When I think about legitimacy, I think of the ethics of entering into such a transaction. One of the things that we look at very carefully is the knowledge level of our buyer. It's in everyone's best interest that each party knows absolutely what they're entering into, why they're entering into it, what the possible ramifications are, and how to ensure that you achieve the objective that you set about.

I also found that by educating your buyer you also leverage their creativity. You may think that as the reinsurer having done this for a number of years that you have all the solutions, but more times than not we find that our clients definitely have some creativity to add to the process.

These transactions are entered into with an awful lot of due diligence. I would equate it fairly similarly to what you would do when you enter into a traditional indemnification transaction. However, the levels of due diligence within both the client organization or in the reinsurer's organization are such that you'll get the involvement of your corporate tax people, your legal department, your financial reporting people. Because of the uniqueness of each transaction, there is no set model on how these transactions would be reported, so everyone who has an interest will have looked at it. In many cases, you'll find that financial reinsurance transactions actually undergo a more thorough due diligence than more of a routine, traditional reinsurance transaction.

When I think of ethics, at least our perspective is that we don't enter in these transactions to save an insurer that's about to fail. Avoiding an S.O.S. situation isn't the function of financial reinsurance. I think that's something that in the past may have been associated with financial reinsurance, but I don't think that that's very true today. Obviously, these transactions have to be regulatorily compliant and they're definitely structured such that they truthfully reflect what's being entered into.

These transactions tend to be low likelihood, high impact. That sounds an awful lot like a nonproportional insurance cover like a stop-loss. Just because the chance of a loss is remote, it doesn't mean that there's no transfer of risk. More than one reinsurer has lost money in entering into these transactions. In fact, because of the way that these transactions are priced, if you underwrite one deal that goes sour, it can definitely offset the 20 other good transactions that you've written during that year.

What do we do try to do to bring value to the transaction? We have to have an arbitrage opportunity. We have to, in some way, have an ability to do something a little bit better than what the client is able to do. Whether that's a tax advantage that we may have, whether it's a different GAAP reporting environment, - or whether it's a more flexible regulatory environment that is how we add value.

You've probably heard about the common uses of financial reinsurance before. Something that's a little different that we've done is as follows. Some assets on your balance sheets will essentially be intangibles, something like a deferred acquisition cost (DAC). On occasion you'll enter into a financial reinsurance transaction to harden that asset or make that asset an admissible asset or to make it more value from the perspective of the financial statement reader. Perhaps, we can transform a DAC asset into an accounts receivable from a reinsurer and, therefore, really strengthen the value of that asset.

There are, on occasion, transactions that are entered into for marketing reasons. The insurer may want to increase their level of RBC because their competitors are running at 240% RBC, and even though they're at a healthy 220%, they feel that they're at a competitive disadvantage. There are ways that you can enter into a transaction to improve those ratios.

Why does any reinsurer provide financial reinsurance? I think it comes down to two quick points. One is, obviously, it can be an attractive business line. It's an area of growth in an increasingly consolidating and increasingly competitive industry. Also, from the perspective of a defensive play, if your competitors are offering these types of services to your client, then it's prudent for you to evaluate the feasibility of you providing those services.

What does a reinsurer get out of providing financial reinsurance? from a quantitative perspective, there's fee income. This business truly is a fee-for-service business. There definitely is risk and the fee is a function of what risk is involved in the given transaction. There also can be a fairly attractive return on capital, given that most of these transactions are not capital intensive. What they are dependent upon is the intellectual capital of the people that you have providing these services. Some reinsurers enter into these transactions for their own tax deferral. They can write a surplus relief treaty and gain a $35 million tax deduction in one year. Even though that transaction will reverse over a period of five years, they've had the use of $35 million for a period of five years on a declining basis. Some players have seen that as the major motivation for entering into financial transactions. The list goes on depending on the specifics of the reinsurer.

There are also more qualitative reasons to do it. How do we strengthen our ties to our clients? How do we make our clients value us a little bit more? Our client has a unique problem that, perhaps, is nonrecurring. If we can provide assistance in this given situation, then, hopefully, that will lead to a stronger relationship and more opportunities in the future. Also, in certain financial transactions it's an opportunity for the reinsurer to demonstrate their innovativeness. If you're a reinsurer and you come up with the XXX solution, that will get you access to those clients that, perhaps, you haven't been able to access in the past. It really allows you to differentiate your capabilities relative to some of your competitors.

Another factor is, as risk tools evolve and as the investment bankers enter our business, there really is an increasing use of hybrid structures for either transferring the risk or financing the risk. If you're going to be a reinsurer in the 21st century, definitely, the ability to try these types of solutions is very valuable.

When you enter into a financial transaction you really do get to know your client, the environment that they operate in, and the particularities of their problem. In certain cases it led to the opportunity to identify an insurer that was in the need of a strategic partner that may initially need some financing, but it may, also, lead to more of a business combination in the future. It can also provide you some early warnings in a given product line or a given segment of the industry. It gives you that outlook without exposing your capital to the same extent as if you had reinsured the product on a traditional basis. Similarly, it allows you to identify the value of new products that may be entering the market. It allows you to observe from a very close proximity, meanwhile, minimizing the downside for yourself.

What do we need to be able to provide this from the reinsurer's perspective? Obviously, we need knowledge. We need knowledge of what the insurance products are, what the constraints within the given environment of our particular client, and what mechanisms can be used to solve the problem.

I would argue that financial strength is also very important as Tim mentioned. The ability to provide securities, particularly if you're going to do this in an offshore jurisdiction, you'll need to be able to provide assets, trust, or letters of credit for an extended period of time. You'll also need to be able to demonstrate the ability to fulfill your commitments if in the event that there is a loss under the transaction.

You also should have the ability to arbitrage whatever is the constraint that your client is facing. Maybe there's more flexibility in your jurisdiction. Maybe due to your size, you have greater liquidity or a lower cost of capital than your client has. Therefore, you're bringing value to this transaction and this can result in a win-win situation for both you and your client. Perhaps, your client is fully exposed to a certain type of risk and would like to transfer that on a temporary basis. Perhaps, as a reinsurer you don't have exposure to that specific area and, therefore, you have ability to, in some sense, arbitrage.

What do we look at in terms of underwriting the deal? I would argue that this is likely the most important element of financial reinsurance. First, we have to look at how unique is the problem. How much time is this going to take to successfully implement a solution? In the industry you may find that one in five transactions may successfully close. If you're not careful, that one in five can drop to one in ten. You have to realize that there is a very finite amount of individuals with expertise in this area. We are in

this business to make money, so we have to dedicate our resources to the transactions that can truly come to successful fruition.

You also have to look at leveraging off your strengths. It may be an interesting problem that you'd like to solve and you potentially have the ability to solve. But there may be some element of the risk that you're not experienced with and it may be very difficult to gain that experience within the time required to solve the problem for your client.

Risk analysis is truly an important area. What type of risk do we look at? Obviously, we look at the insurance risk, variability of the cash flows, and credit risk. In many cases, credit risk can be much greater than the insurance risk. Credit risk can be in the sense of what is the likelihood that your cedent will draw on the letter of credit (LOC) that you've provided. What happens if you've provided financing on a block of business because the cedent has been downgraded, but then there's a run on the bank and, therefore, the profits that you expected to emerge over the next few years failed to materialize? Indirectly it was a credit risk, but at the end of the day you failed to recover the financing that you've provided.

Obviously, there are a few other risks, e.g. regulatory risks from the perspective of the reinsurer's domicile. You know, they can change as easily as they can change domestically. You also have to look at the perspective of what is the regulatory risk from the cedent's perspective. If you're currently providing a LOC, will the LOC be acceptable five years forward? These are unknowns.

You also have to look at the expense risk. If I'm providing a LOC to provide security for regulatory reasons, what is that cost of my LOC going to be three, five, or seven years in the future? Bear in mind that some of these transactions can last 10–15 years.

One risk that is probably not considered enough in this industry is the reputation risk or as one of my investment banking colleagues like to call it, the C1 risk. C1 being a certain page in *The Wall Street Journal* and not wanting your name showing up there.

In terms of due diligence, how do we go about evaluating a block of business? Obviously, we request a complete description of what the product is, what the client's assumptions were, and what the experience has been. This is nothing different than what you would look at from a traditional reinsurer's perspective. We'll also look at the customer's profile. What are their financial statements? What are their constraints? What are their growth prospects? Assess the credit risk. You also have to look at what the reason is for the request. If your client wants to raise $100 million to take a bet on the Nikkei, that's not the best reason to enter into a transaction. But if your client is looking for, or has experienced, tremendous growth, and is looking at financial reinsurance as part of an overall recapitalization plan, then that's a very convincing argument that the person entering into the transaction has a realistic business plan for what they're going to do with the capital that you're going to provide.

In terms of underwriting, we look at sensitivity testing. What is the embedded value? What is the raw quantum, but as well what is the emergence of that embedded value?

You also have to look at what call leverage and that I would equate to ensuring that your client has a significant financial interest in the performance of that block of business. They've transferred the risk to the reinsurer, but at the same time they have the greatest ability to control the performance of that block of business. As a reinsurer you have to ensure that your client is incented to ensure that the block performs as expected.

What are some of the common parameters that we look at? We'll look at a typical financial transaction with a 5–7 year life span. We'll look at an amount of embedded value to surplus provided of roughly a 150% on a present value basis. We'll also look at counterparties and what is their credit rating. Most transactions are done with investment grade counterparties. However, some of the clients that are in the greatest need of financial reinsurance may be a BB-rated company, so these transactions can most definitely be done for counterparties of all credit ratings. That just means that you have to do a little more underwriting or a little more structuring to ensure you have the proper risk profile and you can offer the price that the client needs.

What's the impact on assuming the business? Obviously, we have to look at what is it immediately, but what is it in the event that performance isn't as expected? What would that do to your own financial statements as the reinsurer? What do we need to manage this business? How do we have to monitor this? What are the liquidity demands? Some of these financial transactions can be simply financing risk over time. You have to look at what will be the demands and what is the cost of providing that liquidity? We have to look at what kind of remedial action you can take in the event that the performance isn't as expected. All these things you have to factor in before you, ultimately, propose terms to your client.

You also have to look at increased scrutiny from the reinsurance perspective. You'll often find that, perhaps, those people in corporate thought doing a little bit of financial reinsurance was good, but now you've grown the block of business quite significantly and what's the impact on us? What's the impact from the rating agencies? What's the impact from our investors? It is both looking at the block of business, but also looking at yourself in terms of your ability to do this, and how it impairs your ability or can impair your ability to do your core risk transfer business.

How do we price this? I'll start off by saying there's no common standard, which isn't reassuring from anyone's perspective, but I'll give you some general trends. I think financial reinsurance has been around since the late 1970s, but the number of providers increased in the 1990s, which led to downward pricing pressure. Recently, there have been a few providers that have exited the market, leaving a small core of long-term suppliers.

You also have people who will come in opportunistically, so, perhaps, they need a certain tax deferral in a given year and that can cause some strange variances in the pricing that are demanded. You also have a seasonal variance. Historically, about 80% of transactions are placed within the last three weeks of December. If you're a good planner and you come to your reinsurer in Q1 or Q2, you're likely to get, perhaps, a better price than you will if you come December 24 needing a $100 million solution.

Obviously, this is no different than any other product. The laws of supply and demand truly do rule. As I said, the supply's been relatively static and has been decreasing somewhat. There's been consolidation in the industry and some participants are exiting. Some of the new entrants into the reinsurance world, the offshore entities, aren't necessarily targeting financial reinsurance. They like to use their advantages for truly assuming the risk and being able to truly maximize the upside potential of the business that they reinsure.

Demand before Guideline XXX was relatively flat. Starting in 2000, we've seen a tremendous increase in demand and inquiries from clients. Perhaps, it was Guideline XXX related. Perhaps, it's been driven by a series of demutualizations. But, also, I think it's just driven by the ongoing need to be more competitive and more efficient. You have to find as many tools as you can to be more capital efficient.

The insurance fundamentals, obviously, play an important role. As in anything, risk reward is always the tradeoff that you evaluate. You have to bear in mind that in most financial transactions the reinsurer has a very limited upside. What they've agreed to do is enter into a transaction for usually what is a fixed fee. Any performance above expectations is, typically, refunded back to the client. When you take that into consideration, the structuring that goes on to minimize the downside really seems appropriate.

You also have to look at the capital requirements from a statutory perspective, from a rating agency's perspective, and also from the reinsurer's internal perspective. GAAP may be the measure that they use, and so this will have an impact on how prices may vary from different suppliers of financial reinsurance.

We also look at the administrative burden of entering into this transaction, both up front and also in terms of administering the business on an ongoing basis. Do you have to keep going in and auditing the business? Is it that volatile that it will demand a lot of management attention or is it something that's a fairly predictable block of business that once you write the transaction, perhaps, you'll review it once a year or quarterly?

We also look at, as I mentioned, the cost of security and what are the competing demands on your capital. It really comes down to what is the value that you can add to a certain client and you try for a reasonable sharing of benefits.

Certain types of transactions are not administratively complex. They don't consume a lot of capital. There are not a lot of expenses tied to it. To price it, you may look at the value that the client derives from entering into this transaction and what would be reasonable to share with the reinsurer. Again, different types of transactions will have different drivers in terms of what the price would ultimately be.

Of course you have competitive pressures in certain situations. You can go through these several different factors of what the price should be in any given situation, and then someone will do something completely unexpected. Competitive dynamics are definitely in play. People do things to start a new relationship with a new client, or a certain reinsurer may have a pressure to grow and pass on those savings to his client.

To conclude, I'd just like to say that these transactions focus on an alignment of interests that you have to go for a win-win situation. They're very unique. They're customized to the individual problem, both from the reinsurer's perspective and the cedent's perspective, and the returns are driven by value added.

Mr. Addison: Larry Carson is an actuary with RGA Financial Group where he specializes in constructing, pricing, and analyzing financial reinsurance transactions. Prior to working at RGA, he held positions at Equitable Life and M&R in New York, where he worked on demutualizations, market conduct settlements, and reinsurance projects.

Mr. Lawrence S. Carson: I'm going to talk about some examples of financial reinsurance, walk through the impact on the financial statements, and briefly discuss in a bit more detail some of the considerations that are important.

The examples I'm going to go over will be examples that will improve GAAP rate of return (ROE) and statutory internal rate of return (IRR). I will also explain an example showing how financial reinsurance can be used to fund the acquisition cost strain, and, finally, how financial reinsurance can be used to reduce RBC requirements. Then I'll discuss some of the considerations in financial reinsurance, the historical environment, the current environment, and a couple of predictions for the future.

What kind of problems can financial reinsurance solve? It can improve statutory IRR or GAAP ROE. It can help to fund acquisition cost strain. It can help to cover RBC strain. It's a tool to be used in capital allocation and corporate strategy. It's very useful as a way of assisting and funding corporate mergers and to enable companies to both acquire blocks of business and hold companies. It can also be used very effectively in tax planning.

The example (see Table 1) involves an in-force block of paid-up nonparticipating life insurance. We're going to assume a target RBC ratio of 250% and acquisition expenses equal to 5% of the premium. Everything is on a pretax basis. The table shows only the first five years, but all these examples go on to attained age 100.

TABLE 1
Statutory Financial Statements Before Reinsurance (First 5 Years)

Year	Face Amount	Stat. Reserve	Target Surplus	Premium	Inv. Inc.	Benefit + Expense	Change in Reserve	Stat. Earned	Inv. Inc. on TS	Dist Earned
0	478.1	100.0	5.0	100	--	5.0	100.0	(5.0)	--	(10.0)
1	453.8	100.0	5.0	--	7.0	6.3	(0.0)	0.7	0.3	1.1
2	430.7	99.7	5.0	--	7.0	6.4	(0.3)	0.9	0.3	1.3
3	408.6	99.2	5.0	--	7.0	6.5	(0.5)	1.0	0.3	1.4
4	387.5	98.6	4.9	--	6.9	6.5	(0.6)	1.1	0.3	1.4
5	367.5	97.9	4.9	--	6.9	6.5	(0.7)	1.1	0.3	1.5
IRR 14.6%										

In Table 1 the single premium is $100 million, and that's equal to the initial statutory reserve on this block of business. We have 5% of reserves as acquisition expenses and another 5% equal to our target surplus. On a statutory basis this leads to a first-year distributable earnings loss of $10 million. If we were to continue Table 1 past the five years shown, it would show a pretax IRR of 14.6% on that initial investment.

On a GAAP basis the invested assets now change, but, of course, we have a DAC asset for the acquisition expenses. The initial GAAP equity would be equal to the target surplus, plus the DAC. Though the GAAP ROEs in the early years are declining, they're going to build up in the years that are shown in Table 2 and over time it's going to come out to approximately the same 14.5%.

TABLE 2
GAAP Financial Statements Before Reinsurance (First 5 years)

Year	Assets	Liab.	Equity	Prem.	Inv. Inc.	Benefit + Expenses	Change in Net GAAP Res.	GAAP Income	ROE
0	110.0	100.0	10.0	100.0	--	5.0	95.0	--	--
1	109.7	99.4	10.4	--	7.3	6.3	(0.4)	1.4	14.2%
2	109.2	98.6	10.6	--	7.3	6.4	(0.5)	1.5	14.0%
3	108.4	97.7	10.7	--	7.3	6.5	(0.6)	1.5	13.9%
4	107.5	96.8	10.7	--	7.3	6.5	(0.7)	1.5	13.8%
5	106.5	95.9	10.7	--	7.2	6.5	(0.7)	1.5	13.7%

Just to summarize our base line model, and bearing in mind that I'm making enough assumptions and cutting enough corners, we're talking about a pretax IRR of 14.6% and an average GAAP ROE over the first five years of 13.9%.

Now, let's see what financial reinsurance can do for us. As the other panelists have discussed, financial reinsurance is essentially a form of leverage. Quite simply what we're doing is we're decreasing the initial investment, and that more than offsets the decrease in the future earnings. What we're going to do is find a reinsurer with a lower cost of capital that can price for a lower hurdle rate, lower expenses, or use its own internal leverage.

Improving GAAP ROE is really the same concept. The idea is simply to decrease GAAP equity (E) proportionately more than we decrease return (R) from the fees from the financial reinsurance. The chain of logic is simply that reinsuring the business leads to lower target surplus requirements and that translates into lower GAAP equity.

Now, Table 3 shows straight traditional reinsurance for this example = modified coinsurance on a 50% quota share of the business, so the reserves stay on the ceding company's books. Fifty percent of the premiums, claims, and renewal expenses get netted. Our target surplus is reduced, because the RBC factor for reserves ceded, either coinsurance or modified coinsurance (modco), is 1%, while our assumed RBC factor for the retained reserves is 2%. The IRR goes up to 15.7% due to the lower target surplus requirements and the $3.6 million investment of the reinsurer in this business. The reduction in cash strain consists of a $1.2 million reduction in target surplus, plus the ceding commission of $3.6 million.

TABLE 3
Statutory Financial Statements After Full Risk Reinsurance

Year	Stat Res	Target Surplus	Prem	Ceding Comm	Inv Inc	Ben + Exp	Chg in Res	Modco Adj	Stat Earn	Inv Inc on TS	Dist Earn
0	100.0	3.8	50.0	3.6	--	5.0	100.0	50.0	(1.4)	--	(5.2)
1	100.0	3.7	--	--	7.0	3.1	(0.0)	(3.5)	0.4	0.3	0.6
2	99.7	3.7	--	--	7.0	3.2	(0.3)	(3.6)	0.4	0.3	0.7
3	99.2	3.7	--	--	7.0	3.2	(0.5)	(3.7)	0.5	0.3	0.8
4	98.6	3.7	--	--	6.9	3.3	(0.6)	(3.8)	0.5	0.3	0.8
5	97.9	3.7	--	--	6.9	3.3	(0.7)	(3.8)	0.5	0.3	0.8
50% Quota Share						IRR 15.7%					

On a GAAP basis (Table 4), equity has gone down due to the lower target surplus and the investment of the reinsurer in the business. This raises the average pretax GAAP ROE over the first five years to a whopping 17.5%. While we've used just a traditional modified coinsurance transaction and raised our ROEs by 3.6%.

TABLE 4
GAAP Financial Statements After Full Risk Reinsurance

Year	Assets	Liab	Equity	Prem	Ceding Comm	Inv Inc	Ben + Exp	Chg in Net GAAP Res	Modco Adj	GAAP Income	ROE
0	108.8	103.6	5.2	50.0	3.6	--	5.0	98.6	50.0	--	--
1	108.5	102.7	5.7	--	--	7.3	3.1	(0.6)	(3.5)	1.2	21.6%
2	107.9	101.8	6.1	--	--	7.3	3.2	(0.7)	(3.6)	1.1	18.7
3	107.2	100.8	6.4	--	--	7.2	3.2	(0.8)	(3.7)	1.1	16.9
4	106.3	99.7	6.6	--	--	7.2	3.3	(0.9)	(3.8)	1.0	15.7
5	105.3	98.5	6.8	--	--	7.2	3.3	(0.9)	(3.8)	1.0	14.8

For variable business, while there might not be a lot in the way of surplus strain at issue, there certainly is a cash strain at issue. Financial reinsurance can be used a cost effective way to fund that cash strain. It will cover some or all of the acquisition costs. The financing provided will relate to the risk level of transaction and that also ends up influencing what the net financing cost is.

In Table 5, what we're doing is we're providing about $1.75 million of relief in the first year only. The $1.75 million was picked simply because that's an amount that's likely to amortize within five years. The risk fees are simply paid on the outstanding cash relief balance and to reimburse the reinsurer for its RBC requirements. That raises the statutory IRR to 15.9% due to the lower surplus requirements and because we're providing the cash at a rate lower than the company's internal hurdle rate.

TABLE 5
Statistory Financial Statements After Initial Surplus Relief Reinsurance

Year	Target Surplus	Prem	Ceding Comm	Inv Inc	Ben + Exp	Risk Fee	Exp Ref	Chg in Res	Modco Adj	Stat Earn	Inv Inc on TS	Dist Earn	Relief
0	3.8	50.0	1.8	--	5.0	--	--	100.0	50.0	(3.3)	--	(7.0)	1.8
1	3.7	--	--	7.0	3.1	0.2	0.2	(0.0)	(3.5)	0.4	0.3	0.6	1.7
2	3.7	--	--	7.0	3.2	0.2	--	0.3)	(3.6)	0.3	0.3	0.5	1.5
3	3.7	--	--	7.0	3.2	0.2	--	0.5)	(3.7)	0.3	0.3	0.6	1.1
4	3.7	--	--	6.9	3.3	0.1	--	0.6)	(3.8)	0.4	0.3	0.7	0.7
5	3.7	--	--	6.9	3.3	0.1	0.1	(0.7)	(3.8)	0.6	0.3	0.8	0.4
50.0% Quota Share								IRR 15.9%					

But we can do better by refreshing the relief. On an annual basis the reinsurer provides additional relief compared to the natural five-year amortization of that relief. This is by no means guaranteed and depends on the capital available to the reinsurer at the time that the relief is to be refreshed and how the business is performing among other things. By refreshing the relief we can take advantage of low cost capital for a longer period of time and, thus, the IRR may go up.

Table 6 shows that by refreshing the relief, the statutory IRR goes up from 15.9% to 16.7%.

TABLE 6
Statutory Financial Statements After Refreshed Surplus Relief Reinsurance

Year	Target Surplus	Prem	Ceding Comm	Inv Inc	Ben + Exp	Risk Fee	Exp Ref	Chg in Res	Modco Adj	Stat Earn	Inv Inc on TS	Dist Earn	Relief
0	3.8	50.0	1.8	--	5.0	--	--	100.0	50.0	(3.3)	--	(7.0)	1.8
1	3.7	--	--	7.0	3.1	0.2	0.2	(0.0)	(3.5)	0.4	0.3	0.6	1.7
2	3.7	--	--	7.0	3.2	0.2	0.3	(0.3)	(3.6)	0.5	0.3	0.8	1.7
3	3.7	--	--	7.0	3.2	0.2	0.3	(0.5)	(3.7)	0.6	0.3	0.9	1.7
4	3.7	--	--	6.9	3.3	0.2	0.3	(0.6)	(3.8)	0.7	0.3	1.0	1.7
5	3.7	--	--	6.9	3.3	0.2	0.4	(0.7)	(3.8)	0.7	0.3	1.0	1.7
50.0% Quota Share								IRR 16.7%					

Table 7 shows this last example on a GAAP basis. Even though this meets statutory risk transfer requirements, it does not meet the GAAP requirements for risk transfer that is covered under Financial Accounting Standard (FAS) 113. What GAAP forces you to do then is really collapse the entire transaction. The only thing that flows into the GAAP income statement is the risk fee being paid. There won't be the ceding commission or the modco adjustments. However, the transaction does affect the assets, liabilities, and equity. Since there's a small change in the target surplus, our investment income is also changing. Our 5-year average pretax GAAP ROE goes up to 15.9% due to the lower surplus requirements and the cash financing more than offsetting the risk fees being paid. It also stays higher after the relief is gone due to the continuing RBC relief provided.

TABLE 7
GAAP Financial Statements After Refreshed Surplus Relief Reinsurance

Year	Assets	Liab	Equity	Prem	Inv Inc	Ben + Exp	Risk Fee	Chg in Net GAAP Res	GAAP Income	ROE
0	108.0	101.8	7.0	100.0	--	5.0	--	95.0	--	
1	108.5	101.1	7.4	--	7.3	6.3	0.2	(0.4)	1.2	16.4%
2	107.9	100.4	7.6	--	7.3	6.4	0.2	(0.5)	1.2	16.0%
3	107.2	99.5	7.7	--	7.2	6.5	0.2	(0.6)	1.2	15.9%
4	106.3	98.5	7.7	--	7.2	6.5	0.2	(0.7)	1.2	15.7%
5	105.3	97.6	7.8	--	7.2	6.5	0.2	(0.7)	1.2	15.6%

To summarize, by doing a financial reinsurance transaction where the reinsurer is not taking the full upside potential of the business, we can still get a very nice bump up in GAAP ROE.

RBC strain, as I mentioned, works simply because the factors for reserves retained are typically greater than the factor on reinsured reserves, whether it's coinsurance or modco. Thus, reinsurance is a tool to reduce RBC strain. It's important to note as of the end of 1999 this applies to modified coinsurance as well. This was not previously the case.

There are many different things we can do. We can do a cash modco transaction, like we were just looking at. We can do a combination of coinsurance and modco with the coinsurance being on the tax-neutral reserves. Another thing we can do is in a coinsurance transaction include high-risk assets. That gets rid of lots of C-1. The C-2 and C-3 are going to get transferred to the reinsurer and the C-4 will always stay with the ceding company.

What's the impact? We get rid of some tax inefficient reserves and, thus, we increase the admitted surplus of the ceding company. The formula RBC is reduced, because we're increasing the numerator and the RBC ratio and reducing the denominator.

I am going to conclude with some remarks on the environment. Historically, before the mid-1980s it was really a virtual free-for-all in the reinsurance industry. Regulators, the IRS, among others, really did not like the situation very much. The current situation is far different because a lot of the major loopholes were closed. Some of those were a couple of loopholes in the

Internal Revenue Code which were exploited mercilessly by a good number of companies. I don't have time to get into these now, but suffice it to say that financial reinsurance was abused to the detriment of the Internal Revenue Service and, naturally, they didn't like that. However, what this did do is it showed a lot of companies the financial value of a well-structured reinsurance deal. GAAP wasn't a concern back then for a good number of the companies in the business. Now, of course, it is. So let me discuss some statutory considerations, some GAAP considerations, and some tax considerations.

From a regulatory perspective, one of the key regulations is the Life and Health Reinsurance Agreements Model Regulation. Really what this is concerned with is risk transfer. Again, I hasten to point out all the examples we've talked about in this session all satisfy statutory risk transfer regulations. The model law and credit for reinsurance deals with issues like LOC are very important in properly structuring a transaction.

FAS 113 deals with risk transfer on a GAAP basis and it's a stricter test than statutory risk transfer. That's why a number of low-risk financial reinsurance transactions do not meet the GAAP standard for risk transfer and those are the transactions that get collapsed on your GAAP statements. All that comes through are the fees.

On a statutory basis, on new business the gains will go through earnings. On existing business it all ends up being accomplished through changes in the surplus account. That's an important point to keep in mind.

There are some tax considerations. Some of the early abuses were repealed. Section 845 is a very important section to keep in mind if you're trying to use financial reinsurance for tax planning. It gives the IRS some pretty broad powers to reclassify items in reinsurance transactions. However, there are certain red flags as well as documented safe harbors. A well-crafted financial reinsurance transaction can go a long way in the tax planning process. Section 848 deals with DAC taxes, and that also plays a very important role in the proper financial reinsurance treaty.

I have some predictions for the future. You know, now that some of the most egregious of uses of the 1970s and 1980s have been eliminated, what really exists is a road map for what qualifies as reinsurance and what does not. This is good for the industry, because all reinsurance, including financial reinsurance reimburses the ceding company for losses. I think what we can really expect in the future is a greater understanding on the part of both regulators and rating agencies of where this line is.

The one constant when dealing with government is that they're going to change the way our industry is taxed and companies will continue to look for ways to mitigate their taxes. As we've discussed, a carefully structured transaction can be a very powerful tool in this regard.

The possibility of a unified valuation system could lessen the need for traditional surplus relief, but financial reinsurance, I believe, would still be alive and well. Cash financing on variable products would still be an important use of financial reinsurance. Depending on whether or not the IRS goes along with that, there still could be uses for financial reinsurance in tax planning.

In conclusion, I think we've all tried to stress that financial reinsurance is a lot more than surplus relief. It's really a multidimensional set of financial tools. It's really an important part of any CFO's arsenal, but just one part. It is one tool out of many. This is not your father's reinsurance or your mother's reinsurance. This is a lot more than YRT and it's a very useful tool that needs to be considered.

Mr. Alex Cowley: To what extent do you think that securitization will become a major force in the financial reinsurance arsenal of both investment banks and reinsurers in the future?

Mr. Leblanc: I think it's something that we've looked at reasonably well. I've spoken with a few other investment bankers and the issue comes down to, are the capital markets going to be more efficient at assuming this risk than the majority of reinsurers that are currently doing so? Do they have better information? It's doubtful. Do they have lower cost of capital? Likely. As investment bankers will point out, the capital markets total $14 trillion and the combined capital of the reinsurance marketplace is somewhere under $100 billion in the U.S. I would say that there is some potential in certain cases. It's probably a few years away. I think most investment bankers had hoped that it would be here. They haven't given up and they're very creative people, so I would definitely say that they'll be a role for them to play and most reinsurers will also evolve to continue to be competitive.

Mr. Louis M. Weisz: I'd like to make a comment about whether business meant to be financial reinsurance is treated as reinsurance or as financing out of FAS 113. We ran into a situation with a reinsurance deal several years ago; we got our accounting firm to agree that if there was a decreased return to the company and to the reinsurer, then there was risk involved and the business could be treated as reinsurance. I think that FAS 113, unfortunately, has only been written third hand as far as the effects on life reinsurance. It's principally written and is a doctrine for property & casualty (P&C) reinsurers.

Mr. Carson: In general, I would agree with that comment. I would say that it really depends on the nature of the particular transaction. A lot of the types of financial reinsurance transactions that all of us see on a day-to-day basis would not properly qualify under FAS 113 risk-transfer guidelines. I've heard various tests mentioned over the years. They're going to have 10% risk of loss of 10% or more and, typically, our transactions would not meet that test.

Mr. Weisz: That 10% test applies to P&C business. It does not apply to life reinsurance and that's where I think there's a problem with FAS 113. It's not a problem with the way the life industry has structured the deals. If the deals are going to be structured so that there's a chance the reinsurers could lose up to 10%, I'm not so sure that if there were a 10% chance of loss that the life reinsurers would want to be doing financial reinsurance.

Mr. Carson: Certainly, if there were a decent chance of that magnitude of a loss we probably wouldn't be doing this type of business.

Mr. Gerard Kopel: I take a different view of that. I believe that the accounting firms believe that FAS 113 applies to both P&C and life. It doesn't exclude life. It should. They meant to, but it doesn't. But I believe that as long as all the risk in the business is passed, then it is a risk transfer. That's what most of the accounting firms now feel. I don't think there's a problem with FAS 113 as long as all the risk in the business is passed, even if it's a very minimal risk.

Mr. Carson: In fact, FAS 113 actually puts that in writing. In essence, if the reinsurer stepped into the shoes of the ceding company, then that does pass risk transfer rules from an FAS 113 perspective.