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What Is A Dollar Worth? (An Overview of Financial Reinsurance)

by Mark Troutman

Editor's Note: This is the first part of a multi-part series presenting an overview of Financial Reinsurance.

What is Financial Reinsurance? For purposes of this discussion and any follow-up articles, let's describe it as any reinsurance where the primary purpose is financial management rather than risk management. At my former employer, the financial reinsurance unit was called FX, which was appropriate since that can stand for "special effects." The name of the unit was ultimately changed to Financial Strategies Group, given the perception that financial reinsurance had in the market. As Shakespeare wrote, "A rose by any other name will still smell as sweet." A case in point about labels! All reinsurance is financial reinsurance, just some more so than others!

This article will cover: financial reinsurance as a form of capital; a few differences between property and casualty vs. life and health financial reinsurance deals; financial reinsurance objectives; and a discussion of key dynamics upon which a financial reinsurer must focus.

Financial reinsurance is really a form of capital (or capital relief) and needs to be compared to other forms of capital. These include equity, debt (including surplus notes), and reinsurance. Each has its advantages and disadvantages to various interested parties such as shareholders, regulatory authorities, rating agencies, and policyholders. For example:

1) Equity is the most permanent form of capital. Debt may be the cheapest. Reinsurance typically falls between these two alternatives in both permanence and cost. This seems only fair, since equity owners deserve the most upside potential since they have the most downside risk.

2) It is often easier to tailor the terms of a reinsurance treaty to meet insurance company needs while providing other valuable services such as pricing, underwriting support, and claim services in addition to actually assuming insurance risk. Executing a reinsurance treaty is clearly quicker and easier than raising equity in the capital markets.

3) Reinsurance is less visible than debt as a leverage vehicle, and unlike debt or equity, it may impact the income statement of the operation. This depends on the business and the treatment in the NAIC model act for life and health reinsurance agreements.

4) Surplus relief reinsurance is more flexible than debt repayment terms because the surplus relief is repaid as the profits emerge (if they emerge!), rather than via some bank schedule regardless of financial results of the block of business or the company.

5) The regulatory environment is mixed regarding these sources of capital and is heavily dependent on the transaction. It may be possible to obtain regulatory approval in advance for a financial reinsurance transaction, and this may occur quicker than a protracted Form A/Form B filing.

Motivations of various financial reinsurers can vary dramatically, e.g., why go onshore or offshore? Is the company using surplus relief to shelter taxable income elsewhere? Are they looking for fee income? It is easy to dispel the myth of offshore smoke and mirrors by giving examples of using a letter of credit versus a dollar of real equity. There are good offshore companies and bad ones, just as there are good onshore companies and bad ones. Watch the size of the brush with which you paint!

Let's play Jeopardy. The answer is: "Earth, wind, and fire." The question is: "What is an old rock group that is also three perils associated with reinsuring P&C business?" Property and casualty financial reinsurance is a different kind of animal. The differences of P&C financial reinsurance from life and health financial reinsurance are:

a) More cash is involved.

b) P&C vs. life and health risk underlying the business.

c) More international business is involved.

d) More brokers/intermediaries are involved.

e) More banks and external players to make deal structures work given cash flow considerations.

f) Further along the spectrum of blurring of capital market and insurance risk.

g) More GAAP-driven versus statutory accounting, and it is still a gray area versus the NAIC model act for life and health, which is straightforward.

h) Clients are typically reinsurers rather than direct writers

i) Often quota share participations for several players given size of deal /nature of risk.

j) More forward looking to future earnings and balance sheet stability versus surplus enhancement now.

Financial reinsurance for both P&C and life and health business can effectively be used to accomplish any or all of the following results:

1) Support company growth by providing a form of capital.

2) Demonstrate integrity of surplus position to increase dividend capacity.

3) Manage risk-based capital by increasing actual surplus or reducing required surplus. Deficiency reserve/xxx strain — Financial reinsurers are tripping over themselves for this new form of surplus relief demand by clients.

4) Support acquisition financing or divestiture strategy.

5) Manage the asset or liability side of the balance sheet.

6) Facilitate tax planning.

7) Maintain/upgrade ratings with rating agencies.

8) Smooth out earnings over time such as spreading losses or gains.

9) Facilitate other activities ("conduit").

10) Securitization of mortality risk into an investment in a bond. ("Q-bond" where q is mortality!)

11) Perception assets (junk bonds/ mortgages) where perception is not reality. Use the profits on the business as collateral for an asset with a high R.B.C. value.

Almost all of the above will, by definition, improve return on equity and create value-added. How do they do that? Contrary to popular belief, it is not done with smoke and mirrors. It is balance sheet arbitrage in a legitimate reinsurance treaty wrapper. But it focuses on clients where the financial statements do not truly reflect economic reality, clients whose opportunities to increase value is in excess of their internal capacity, clients who face some structural constraints to optimizing such performance, and clients with unusual and complex needs for an economically viable block of business.

One trademark of a financial reinsurer is its flexibility in adapting to a changing landscape. This involves successfully navigating various dynamic environments and disciplines including tax, accounting, regulatory, and risk. To use a sports analogy, "Take what the defense gives you." Or "A proliferation of new laws creates a proliferation of new loopholes." The key is to structure deals that manage risk while providing a viable capital and balance sheet impact to the client. The number and types of tools in your toolbox determine your success in deal structuring.

Various dynamics a financial reinsurer must focus on include:

Risk appetite - No pain, no gain. No risk, no reward. It all starts with understanding and assessing risk — the mortality or morbidity, lapse, investment return, asset default, disintermediation, etc. You have to understand the perceived economics, as well as the true economics, and structure a deal appropriately for those risks. Arbitrage risk preferences between various players/markets.

Accounting framework - Let us not forget that accounting doesn't change the results, only the timing of their recognition. Therefore, accounting is not always representative of the economic reality. So it is your job as a financial reinsurer (should you decide to accept it) to allow the reinsurance treaty structure to better reflect true economic reality. The flagship surplus relief is essentially a reinsurance agreement, which improves the capital surplus position of the company by advancing the present value of future profits (a proportion), which reduces surplus strain. In essence, a reinsurer acts like a pawn shop, where the person drops off the asset and the pawnbroker pays a fraction of the cost and a financing fee and allows the person to buy it back.

Tax law - I.R.C. Section 845 is a powerful weapon. You're not looking for tax loopholes. You're looking for a tax-efficient treaty in the overall context of the deal. Tax should not be a primary motivating factor. However, still structure a deal to pay as little as possible as late as possible, all within the law. One could cite the origin of financial reinsurance as the 820 modco deals and even some small life company qualifications. These are much less prevalent given IRC 845 allowing them to reallocate or even unwind transactions, which have a disproportionate tax effect.

Regulatory bodies - Make sure you walk a mile in their shoes and figure out why they regulate companies the way they do. Make sure your treaty complies with the spirit and intent of the laws.

Structural facilitation - What if you know what you need to do or where you need to get to, but you need help getting there? Do you need certain tools to help facilitate the transaction? A helping hand? Packaging is key. Facilitation and structure is valuable. You need a variety of companies with a variety of economic motivations to make things work. Not every tool is used on every job. But he who has the biggest toolbox, and knows how and when to use the tools, wins!

Editor's Note: In the next newsletter, Mark will continue this series by discussing some examples of financial reinsurance and presenting a checklist of how to get into the mainstream of financial reinsurance activity.

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