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The Financial Impact of Reinsurance under the Prudential Sourcebook

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Introduction

- Consultation Papers that have an impact on reinsurance
  - 97, 143, 144, 167, 195
- Impact on reserving for reinsurer credit risk
  - Term Assurance, Annuities, Stop Loss (Cashless Fin Re)
- Operational issues
- Impact of reinsurance on Individual Capital Assessment
- Miscellaneous questions

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Prudential Sourcebook

June 2001	CP97	Proposals to replace current regulation
July 2002	CP143	Feedback on CP97
July 2002	CP144	Use of financial engineering
Jan 2003	CP167	Explicit responsibility of directors for setting reserves
Aug 2003	CP195	Capital requirements for life offices
Late 2004		New Integrated Prudential Sourcebook regime

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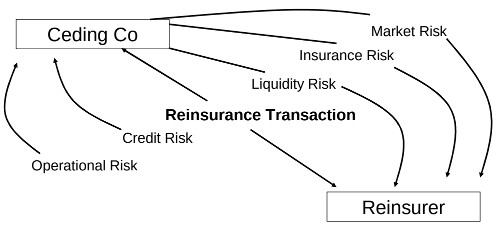
Risk Transfer



Broadly neutral: Group Risk

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CP97: June 2001

- Allowance for reinsurer default
- Adequate diversification of exposure to reinsurance counterparties
- Introduction of reinsurance limits
- Introduces the concept of Loss Mitigation Techniques

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CP143:

- FSA re-consulting:
  - Credit risk for insurers: Revised rules cleaner and tackle reinsurance concentration both prospectively at purchase and retrospectively when an exposure occurs
- Detailed feedback:
  - Restriction of the use of with-profits fund
- Reinsurance Limits replaced by requirement to notify FSA if thresholds are breached

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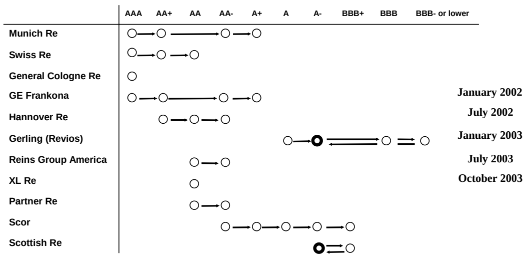
Reinsurers Credit Ratings



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Impact on Reserves:

- Term Assurance
- Annuities (no assets)
- Annuities (assets)
- Stop Loss (cashless Fin Re)

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Case study 1 – Impact on Regulatory Reserves

A life insurer's term assurance business, 90% reinsured

Model of business:	Average age 40 years
	Average term 20 years
	£100,000 of cover
	Paying £14.21 per month
Gross initial mathematical reserves:	£625
Reinsurance "asset":	£678 (before any allowance for credit risk)
Net mathematical reserves:	£0

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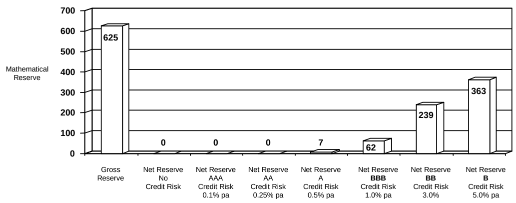
Case study 1 – Impact on Regulatory Reserves (cont'd)

Including the credit rating of the reinsurer could lead to a fall in the value of the reinsurance "asset"



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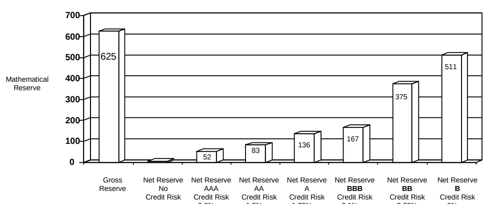

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Case study 2 – A portfolio of annuity business

- Annuity portfolio with £500m mathematical reserves
- Statutory basis:
  - Interest Rate = 5%, mortality 80% PMA92 with Medium cohort improvements
- Reinsurance basis (i):
  - "Risk Premium"
  - 90% PMA92 with Medium cohort improvements
- Reinsurance basis (ii):
  - Asset Transfer
  - 5% interest, 90% PMA92 with Medium cohort improvements

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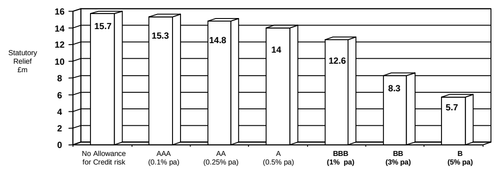
Case study 2(i) – Swapping actual for fixed

Ignoring credit risk reinsurance allows statutory relief of around £15.7m. Allowing for credit risk has the potential for substantially reducing this relief



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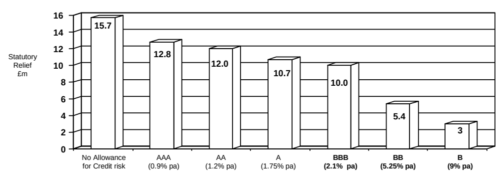

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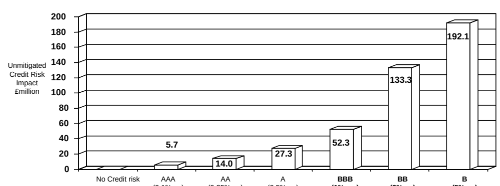
Case study 2(ii) – Asset Deal

If the premium is paid up-front to the reinsurer then insurers need to be very confident in their credit risk mitigation approach as they are relying on them for potentially very large amounts



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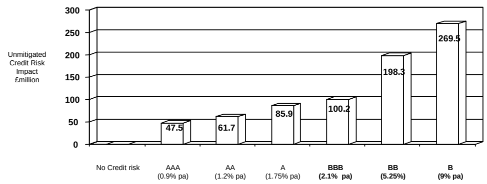

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Term and Annuity Statutory Relief

£m	Aggregate reinsurance Credit	Free Assets
	31/12/2002	31/12/2002
Legal & General	2,057	4,245
Alba Life	612	161
Norwich Union L&P	439	3,325
Standard Life	359	4,213
Scottish Provident	472	326
Scottish Equitable	200	1,093
Century Life	403	60

Source: FSA Returns, 2002. Forms 9 & 51-55.

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CP144

- Acceptable financial engineering ...
  - a legitimate commercial purpose
    - strengthening solvency e.g. through risk transfer
    - accessing overly prudent economic reserves
  - credit commensurate with risk transferred
    - e.g. taking into account related agreements
  - considered within context of firms overall risk management strategy
  - rules and requirements fully complied with
  - improved transparency
  - appropriate supervisory scrutiny

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CP144

- High-level standards - Guidance Note
  - broad description of financial engineering
  - good and bad financial engineering
    - bad if used to obscure a firms underlying financial condition or designed to mislead
    - bad if no genuine risk transfer but full credit is taken
    - bad if used to remove all margins
    - guidance on implicit items a benchmark
  - management and control
    - appropriate understanding and risk controls
  - accounting & reporting
    - include allowance for contingencies and credit / legal risk

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CP144

- General tone
  - there is a legitimate role for financial engineering, including financial reinsurance at the present time
  - fair value and solvency II will address some of the current anomalies that financial engineering seeks to overcome
  - increased management responsibility and greater disclosure with respect to financial engineering

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Reinsurance Activity: Financial Reinsurance in place

Financial Reinsurance in place

31st December 2000	£2.9bn
31st December 2001	£2.4bn
31st December 2002	£2.9bn
31st December 2003	£? bn

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Stop Loss (Cashless Fin Re)

Pre –PSB

[CF * (l + i)^t] / (l + i)^t

CF = amount of cashless financing “advanced”

i = valuation rate of interest

t = expected time at which claims will be made

Post – PSB

[CF * (l + j)^t] / (l + i + d)^t

d = default risk addition to yield

j = i + d?

j = i?

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Impact of PSB on Fin Re

- Fin Re will be restricted to Non-Profit business
- Existing With Profits Fin Re will have no value on a fully realistic basis
- Existing With Profits Fin Re will be inadmissible or will need to be restructured
  - No transitional arrangements

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CP167: With-profits governance, the role of actuaries in life insurers, and Certification of insurance returns

- Directors and senior management become more explicitly responsible for decisions taken on actuarial advice.
- Reinsurance will generally represent:
  - Largest figure on the balance sheet relating to a single transaction
  - Largest transactional risk
  - Largest counterparty risk

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Review of UK insurers' risk management practices: October 2003

- No life company responded that they were concerned about the impact of reinsurer default
- No life company responded that they were concerned about the operational risk associated with reinsurance

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Question for the Board:

- How many treaties are unsigned?
- Does the board understand the reinsurance treaties?
- Is the organisation complying with all the terms of the agreement?
- Does the board understand the implications of non-compliance?
- Does the organisation have a reinsurance strategy/philosophy document?
- Does the board know what the current credit ratings of its reinsurers are?

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Arbitrations per Reinsurer

	1998 – 2001	1994 – 1997	1990 - 1993
Zero	10	20*	21
One	1	2	3
Two		1	2
Three	1	-	-
Four	2	1	-
Nine	1	-	-

* One company resolved through mediation

Source: Reinsurance Arbitration Survey 1998 – 2001, Aon Worldwide

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CP195: Enhanced capital requirements and individual capital assessments for life insurers

- Companies must justify exposures to reinsurance within a group are managed to a suitable level
- Reinsurance exposures to subsidiary undertakings where the subsidiary is managed in a “designated territory” are excluded from the proposed limits
- The FSA may go ahead with different exposure levels for different credit-quality reinsurers at one stage in the future
- The onus remains on companies to justify to the FSA’s satisfaction that their credit risk management is appropriate
- Value of non-profit business in the with-profits fund can be taken as a deduction from capital requirements, subject to prescribed stress tests for credit risk

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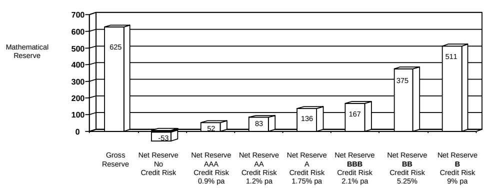
Value of non-profit business in the with-profits fund

Including the credit rating of the reinsurer could lead to a fall in the value of the reinsurance asset



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Conclusions

- Much time and effort has gone into with-profit business. Non-profit business needs more thought
- Reinsurer credit worthiness now has tangible and measurable value
- Operational issues are currently underestimated
- 90% quota share one size fits all might not be appropriate going forward

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Miscellaneous Questions

- Level playing field between non-profit and with-profit fund?
- Ability to reinsure property linked business?
- Credit risk on intra-group reinsurance between UK-regulated entities?
- Regulation of small entities with large reinsurance credit?
- Power of unregulated rating agencies?
- A lower deduction for credit risk from unrated reinsurers than for some investment grades?

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