

**FINANCIAL REINSURANCE**

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### **SUMMARY**

Natural catastrophes and prior year claims development have had a profound effect recently on market results within the UK. Alternative solutions have been sought to conventional reinsurance, with "time and distance" policies being the first instance of financial reinsurance. Such policies in effect discount claims reserves for past years and discount at a gross rate by being sited offshore.

As reinsurance costs escalated and capacity became limited, financial reinsurance developed into prospective covers, with an insured paying for its own losses over time. Concern was expressed by various interested parties as to whether such contracts contained sufficient elements of risk to be classified as reinsurance.

The debate continues as accounting, taxation and regulatory bodies discuss the validity and presentation of such contracts within the UK. Financial reinsurance is still evolving.

### Financial Reinsurance

The reinsurance market, especially in the UK, has gone into turmoil because of the significant loss ratios being incurred as a result of the catastrophes which have hit the market since 1987. Problems have been made much worse because of the sheer size of claims arising from Piper Alpha, Hugo and the January 1990 storms. The losses from these claims in the London Reinsurance market, where reinsurers reinsure other reinsurance business (the LMX market), have been significant as claims spiral through the market. These developments have made the reinsurance market reassess its position and, to a large extent, the capacity in the LMX market has dried up. When a reinsurer opens its doors for what is known as the renewal season, before it can decide on the level of risk it can take on, it has to ensure that it has sufficient protection to cover its book if it is hit by one or more catastrophes. The level of protection which can now be found is more limited and the price has risen significantly, in many cases by a factor of 10. To alleviate this problem many reinsurers have taken out financial reinsurance. The direct market has also been concerned at the level of rates being charged for reinsurance cover, which for the lower layers could be as high as, or even higher than, the level of risk premium being received for the business. Again here, there has been a significant move to financial reinsurance.

The nature and types of financial reinsurance are many and varied. Contracts range from the old "time and distance" contracts as used in Lloyd's where a premium of  $X$  is paid and the recovery at the end of the period,  $N$  years later, is this amount rolled up at a rate of interest,  $i$ , which is typically gross of tax, ie  $X(1+i)^N$  is paid back after  $N$  years. The repayment would be dependent on contingencies where the probability of occurrence would almost be 100% and in respect of business already on the books. This contract is defined as a retrospective deal as it covers business already written.

The contracts are usually placed in an offshore fund to obtain the benefit of a tax free roll up.

The prospective contracts which are now available in the London market are to cover business to be written in the future and for the most part are relatively risk free. They will be framed in such a way that the reinsurer can limit his loss to that of loss of interest. A typical contract will be for a premium of say £1 million per annum where the reinsured has the right to recover £5 million in excess of £10 million aggregate in any year. If a claim did not occur a profit commission would be paid of 95% of the premium and if a claim did occur the reinsured would have to pay back any funds drawn over a period of two or three years.

Many of the contracts in the market have now got much more sophisticated and elements of real insurance risk are being introduced, but to a limited extent for a limited amount.

The question which immediately comes to mind is: "Why do companies feel these financial reinsurance contracts are worth taking out?" On the surface they appear almost to constitute banking type arrangements where the reinsured has a guarantee to borrow money if claims experience is poor. The immediate answer is that as reinsurance rates, especially in such areas as the property market, are so high the companies feel they will be better off taking out this form of transaction. To give an example, the cost of cover on a conventional reinsurance contract could be what is known as 30% on line, for every £1 of gross cover provided the reinsurer would want 30p for reinsurance. The direct writer would argue that if he put the 30p in the bank and did not have a claim for two years he would be significantly better off bearing in mind that there would be interest being earned and that one third of his premium would have been spent on expenses and commission. If the insured did have a claim in year two he would be no worse off. Thus this type of deal is very dependent on the probability of a catastrophe claim occurring, and its size.

In broad terms a financial reinsurance transaction is another way of setting up a claims equalisation reserve, with the added advantage of being able to generate gross investment income on the funds if the transaction is with an offshore company. There are, as you can imagine, potential tax problems with this type of transaction; whether the transaction is

a genuine reinsurance contract and whether the premiums paid are deductible for tax purposes. Concerns on the latter front have led to a true element of reinsurance risk being introduced into the contracts.

Many issues arise when taking out financial reinsurance which include:

- a) is the contract a genuine reinsurance contract;
- b) are there potential tax implications;
- c) how should the contracts be accounted in the books and to the DTI;
- d) how should reserves be set and at what point should profits/losses be taken;
- e) are there other realistic alternatives;
- f) what happens if the business is subject to several significant claims;
- g) what is the status of the reinsurer taking on this business;
- h) how secure are the funds;
- i) what additional safeguards should be taken to protect funds placed offshore;
- j) where is the best place to reinsure, ie Bermuda, Dublin, Luxembourg, Isle of Man, etc.;
- k) does the company taking out the reinsurance really understand its workings; and
- l) what real protection is being given to the company, especially if a claim occurs almost immediately after taking out cover.

The answers to these questions depend on the individual company, the nature of the risks being covered and what the company is aiming to achieve financially from the transaction. The financial reinsurance market is large and has grown significantly, initially in the States and more recently here. Concerns have been expressed about significant sums of money ending up offshore. The DTI are attempting to tighten up the ways in which the business is accounted by emphasising the recommendation laid down in the ABI SORP on general insurance accounting. This basically states that these contracts should be accounted for

showing "substance over form", in other words these contracts should be realistically reflected in the accounts and not used for "off balance sheet" transactions.

Like many other issues, the UK tends to follow the US. They are openly discussing these contracts and the Financial Accounting Standards Board have produced a discussion draft which has considered four main elements of risk as they see it with these contracts being:-

- Timing,
- Investment Yield, ie that the fund will not be rolled up at the guaranteed rate,
- Credit Risk, and
- Expense Risk, ie that the expense loadings in the premiums will be exceeded in practice.

There is a general view in the US that if there is a genuine element of risk of, say, 20% then the contract would be viewed as a genuine reinsurance contract.

The development in the UK of the reporting, reserving, regulatory and taxation of these types of contract is still evolving. Great care needs to be exercised before entering into any transactions of this form!