The Optimal Risk Transfer

by Jon Roberts

Financial reinsurance, once controversial, has become increasingly more visible and utilized. Many early "financial reinsurance" transactions did not transfer any risk other than investment or credit risks and so were not really reinsurance. These agreements often were between public stock companies, which reported distorted earnings as a result of the transactions. The historical prevalence of financial statements improperly improved by these riskless investment arrangements paved the way for tighter regulations in this area.

However, as it is used today, financial reinsurance does involve the transfer of risk. Specifically, financial reinsurance is a reinsurance agreement to transfer those insurance risks that could affect the realization of potential future profits. Traditional reinsurance, on the other hand, transfers insurance risks which could cause the realization of potential future losses. All reinsurance contracts are agreements to transfer insurance risk from the ceding company to the reinsurer, serving a financing function by providing capacity.

Far from a mere loan, financial reinsurance is a prudent risk management technique that can make a significant contribution to an insurer's capitalization. It provides capacity for growth, capital for acquisitions, reductions in both leverage and risk, improvement in underwriting results, earnings stability, better tax planning and coverage that is cheaper, more responsive and more stable in availability and price than the alternatives.

The single most damaging misconception about financial reinsurance from the industry's standpoint had been the belief that it deceives creditors by enabling troubled ceding companies to misrepresent their perilous condition, thereby delaying an otherwise imminent insolvency and aggravating the deficit once the insolvency finally occurs. In truth, the reinsurer's support of the ceding company justifies the new financial statement's representation of added strength, just as the government's support of the Chrysler Corporation in the 1980's gave added strength to that company. No one can deny that the financial reinsurance helps the cedent to avoid immediate insolvency, but no one can blame any later aggravation of the insolvency upon the reinsurer.

It is another matter, however, when otherwise insolvent insurers are allowed to discount loss reserves or unearned premiums without buying financial reinsurance, or are otherwise allowed to enjoy freedom from the accounting and regulatory burdens that fall inequitably upon healthy insurers. When this occurs, financial statements are altered without the slightest corresponding change in the exposure to risk. This sham is the worst kind of misrepresentation because the perpetrators fool themselves as well as outsiders and fail to recognize underlying deficiencies promptly.

Ceding companies reduce retained risk quickly by distributing it among many homogeneous insureds. Reinsurers, however, need much more time to spread their risks because ceded risks are less homogeneous and fewer in number than primary insureds. Thus the reinsurer, especially the high excess reinsurer, counts on the ceding company's ability to produce future profits to absorb today's loss.

One skill that reinsurers do not bring to a reinsurance partnership is the management of the underlying primary business. Reinsurers influence only the timing or incidence of profits and do not materially affect the ultimate total profitability of the primary business. So, by buying reinsurance, especially financial reinsurance, the reinsured is buying time; what the reinsured does with that time can either aggravate, mitigate, or obliterate any existing financial problems. Reducing the ultimate deficit if there is an insolvency remains the ceding company's responsibility.

The transfer of insurance risk is intrinsic to any reinsurance transaction, including financial reinsurance. But what exactly is insurance risk? It can be defined as the uncertainty of suffering monetary loss caused by the occurrence of random events which are not wholly within the control of the reinsured. Loss is measured in money, and money has two dimensions: amount and time. A cash flow is completely described by specifying when and how much, and both dimensions are equally important.

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Insurers' risks, created by insurance contracts, can be grouped by the nature of the random events not wholly within their control. Although only the transfer of insurance risks is necessary to a reinsurance arrangement, other risks, described in the following categories, also may be protected, either under a traditional or a financial reinsurance arrangement.

- Insurance risk is uncertainty of the amount (underwriting risk) and timing (timing risk) of claim payments under the contract.
- Premium risk is the uncertainty of the amount and timing of consideration payments due the insurer under the contract.
- Expense risk is the uncertainty of the amount and timing of acquisition and operating expense payments related to the contract.
- Investment risk is the uncertainty of the amount and timing of investment income and principal repayments on invested consideration under the contract. Investment risk can be split into yield, duration and default risks.
- Credit risk is the uncertainty of the collectibility of amounts due the insurer under the contract.
- Contract risk is the uncertainty concerning whether, when, and to what extent the insured exercises rights granted under the contract.

Insurance risk and investment risk generally are transferred under insurance contracts. Premium, expense, credit and contract risks generally are not transferred from the insured under an insurance contract, but rather are assumed by the insurer by virtue of the contract's existence. All of these types of risk, however, may be transferred under a reinsurance agreement.

Timing risk is identified as an integral part of an insurer's risk in the Financial Accounting Standards Board's Statement No. 60: "When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will he paid under the contract." In fact, some insurance contracts transfer nothing but timing risk. Ben Franklin expressed this principle with regard to whole life insurance when he said that death is as certain as taxes.

To rule that retroactive insurance is not insurance for tax purposes in Revenue Ruling 89-96, the Internal Revenue Service merely states that timing risk is an investment risk, but makes no attempt to justify its statement. But timing risk is not an investment risk. Although changes in claim payment timing can change the length of time assets can be invested, the random event that could cause a possible loss of investment income in this case would be the acceleration of claim payments, and not adverse yield, duration, or default experience.

The U.S. Supreme Court drew an analogy between ceding commissions and investments in future income streams when, in *Colonial American Life vs. Commissioner,* 109 Sup. Ct. 2408 (1989), it held that ceding commissions paid are nondeductible capital expenditures. However, the uncertainty of the "return on investment" is not an investment risk. It is largely insurance risk, the treatment of which is specifically addressed in our tax code.

Increasing Complexity

From the time an insurance contract is issued, some or all of the risks described above are present. Risk declines as time passes and more information is revealed, until finally all of the insurer's obligations have been ascertained.

The transactions involving these risks have become increasingly complex, and regulators have done a fantastic job of keeping up with them and distinguishing what is truly reinsurance (whether financial or traditional) and what is not. FAS 113 and New York's Regulation 108 on loss portfolio transfers offer excellent methods of distinguishing reinsurance from investments.

The National Association of Insurance Commissioners merits praise for the reinsurance section in the *Examiners Handbook*, which alerts regulators that guaranteed profit contracts, retroactive premium adjustments and termination with risk elimination may not necessarily be part of a true reinsurance agreement and may simply represent a loan. Most of all, regulators should be commended for enforcing accounting discipline by rejecting wholesale discounting of loss reserves, despite industry pressure because of tax laws which no longer promote solvency.

FAS 113, Chapter 22 of the NAIC's *Accounting Practices and Procedures Manual* and Revenue Ruling 89-96 all distinguish between prospective and retroactive contracts. However, there is no reason to separate arbitrarily the time between policy issuance and claim payment at the instant the claim has occurred. Claims-made coverage should not be given special treatment: risks are present, albeit declining, during the entire period, until settlement is made.

In view of these risks, financial reporting principles are intentionally conservative. Income is recognized as the risks that could affect its realization diminish. This is accomplished by requiring that reserves be held for any risks that still remain attached to the realization of the income.

For example, under both generally accepted and statutory accounting principles, unpaid loss reserves for most lines are not discounted for expected future investment income. This reflects the fact that underwriting, timing and investment risks are present until the last claim is paid. It is equivalent to allowing discounting, but requiring that an offsetting insurance risk reserve be booked in the amount of the discount. This conservatively assumes an immediate payout of all loss reserves.

Similarly, under SAP unearned premium reserves are established without credit for prepaid acquisition costs. This reflects the fact that the loss amount risk is present at least until the premium is earned (and the losses incurred). This is equivalent to allowing a deferred acquisition cost asset, but requiring a reserve for amount risk that exactly offsets it. This conservatively requires booking an unearned premium deficiency reserve that is sufficient to cover the risk of a 100% loss ratio.

If a reinsurer, under a financial reinsurance contract, agrees to indemnify a ceding company for losses incurred during the unexpired portion of a group of in-force policies (portfolio runoff), then the reinsured need not post a premium deficiency reserve. Since insurance risk has been transferred, loss ratio variability is only the reinsurer's problem. If the reinsurer charges less than the amount of reinsured unearned premium reserve, the ceding company's pretax income and surplus according to SAP are increased by the difference.

Similarly, if the ceding company bought financial reinsurance for losses incurred but not paid on a group of policies (loss portfolio), insurance risk has been transferred. If the reinsurer charges less than the amount of reinsured unpaid loss reserve, the ceding company's pretax income and surplus according to GAAP and SAP should theoretically be increased by the difference.

In both cases, the actual or theoretical surplus relief equals the difference between the book value (according to accounting principles) and the market value (assessed by reinsurers) of the insurance liabilities reinsured. The difference (equity) represents expected future profits unbookable without reinsurance. For unpaid loss reserves, these profits usually are expected investment income to be earned while the losses are not yet paid (equity in the loss reserves). For unearned premium reserves, they usually are expected underwriting income to be earned if the combined ratio is under 100% (equity in the unearned premium reserves).

These profits should be bookable once they are guaranteed through the transfer to the reinsurer of the remaining risks attached to their realization. Insurance risk must be transferred for the ceding company to obtain "sale" accounting treatment of the related reserves, and, at least theoretically, immediate recognition of the equity.

By accepting consideration that is less than the book value of the liabilities, the reinsurer assumes the ceding company's insurance risk that these expected future profits may never materialize to cover the shortfall. This guarantee of profits gives the ceding company immediate surplus relief upon execution of the treaty.

Advance Agreement

A financial reinsurer's guarantee of potential future profits might be agreed upon in advance. For example, financial reinsurance can indemnify for losses incurred on policies to be written in the future, instead of only those now in force, thereby allowing recognition of the equity in the future premiums as they are written, instead of just in the written but presently unearned premiums. Similarly, financial reinsurance can indemnify for losses incurred in the future (prospective aggregate), instead of only those now already incurred, thereby allowing recognition of the equity in the future losses as they are incurred, instead of just in the incurred but presently unpaid losses. Both of these examples are commitments to definitely provide surplus relief in the future.

Spread loss is a type of financial reinsurance whereby the reinsurer agrees to guarantee potential future profits in the contingent event that the ceding company suffers monetary loss due to insurance risk. The guarantee spreads this loss for one period over the longer period during which the profits are expected to emerge. The reinsurer, again, bears the insurance risk that these profits might never materialize. This example is a commitment to provide surplus relief upon the occurrence of specified future events.

Financial reinsurance can guarantee the worth of salvage, subrogation, reinsurance recoverables, or any asset or liability whose economic value is uncertain due to insurance risks which could be transferred under such an agreement. Recent attempts by banks to securitize future premiums or deferred acquisition costs with nonrecourse financing, however, have not been enough to produce surplus relief. Although contract risks (early lapse) are transferred, insurance risks remain which could interfere with profit realization.

Under financial reinsurance transactions, the reinsurer accepts a transfer of insurance risk that is secured with only the cedent's potential future profits as collateral. If these profits fail to emerge, the reinsurer must have no recourse to the ceding company; to do otherwise would vitiate the arrangement's purpose. Even so, the financial reinsurer is a more senior creditor than the traditional reinsurer, which is not secured with any collateral; however, all reinsurers must be subordinate to policyholders.

Defeat The Purpose

There is an enormous difference between entering into a financial reinsurance transaction and merely discounting loss reserves or amortizing acquisition costs. In the latter, the ceding company is still at risk but has been allowed to defeat the purpose of sound accounting principles. These principles rightfully require that contingency reserves be maintained as long as contingencies are maintained. The purchase of financial reinsurance, however, is a critical event which effects a fundamental change in the economic position of the ceding company: a guarantee has been secured, risk has been transferred, uncertainty has been reduced. Without reinsuring contingencies, the financial benefits of surplus relief are impossible and improper.

This position is adopted by existing and newly emerging accounting literature. This literature requires the following: for reinsurance-indemnification of insurance risk; for asset securitization-equity/residual value risk transfer to achieve balance sheet relief; for factoring (versus discounting) accounts receivable-shifting risk to lenders; and for debt extinguishment-transfer of all yield, duration and default risks before allowing defeasance. Under tax accounting, risk transfer also is required for deductibility of insurance premiums, and "at risk" depreciation rules must be followed for limited partnership financing.

The stock market presents an analogy. If an investor expects a company to outperform market expectations, then current shareholders will immediately realize the extra future performance once it is guaranteed by the investor through a buyout. Investors can then transfer (like retrocession) some of the assumed risk to financiers counting on future cash flow, or to others willing to buy some of the assets (for example, premiums receivable) or liabilities (unpaid loss reserves) of the acquired company.

Mergers, restructurings, securitization, financial reinsurance, and many other transactions all accelerate recognition of contingent future profits by removing the future contingencies. The transfer of these contingencies is the *sine qua non* in this process. Leverage reduction and financial statement relief can be achieved truthfully only by the transfer of risk.

As retentions grow faster than inflation, and the underwriting cycle's peaks and troughs become more protracted, reinsurers will rely on longer time horizons for the adequate operation of the law of large numbers. In the future, therefore, more reinsurance will be financial, since financial reinsurance offers the security to both ceding companies and reinsurers that is necessary to recreate the long-term partnerships that once characterized reinsurance relationships.