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Finite Risk Reinsurance

Finite risk reinsurance has been in the news recently as a result of investigations into insurance industry accounting practices. Reinsurance is insurance for insurance companies, a way of spreading more widely the risk insurance companies assume in writing home, auto and business insurance policies. To be considered reinsurance for accounting purposes, a reinsurance contract must involve some transfer of risk to the reinsurer. If there is insufficient risk transfer, the transaction is considered a financing mechanism and is booked as a loan or liability instead of an asset.

Finite risk reinsurance is a form of reinsurance that specifically incorporates the time value of money. Unlike most reinsurance contracts, finite risk contracts are usually multiyear. In other words, they spread risk over time and generally take into account the investment income generated over the period.

In one type of finite risk reinsurance, for example, an insurance company transfers its claims to the reinsurer, paying a premium that corresponds to the present value of the claims transferred. Present value is a financial formula that recognizes the potential investment income generated by the premium dollars. Generally the claims transferred are for medical malpractice or other so-called long-tail coverages, where the harm caused may not be apparent for some time and the final cost of claims may not be known for years. The timing risk is the key element here. If the claims are settled earlier than anticipated, investment income will be lower and the reinsurer could lose money on the transaction.

In another type of finite reinsurance, claims that have not yet been settled are transferred. The risk to the reinsurer is that the claims will be more expensive than expected over the long-term ? that injured workers? medical expenses will be twice as high as anticipated, for example. The main benefit of this kind of finite reinsurance contract is that they facilitate mergers since the acquiring company no longer has to be concerned about whether reserves for losses are adequate.

Other types of finite reinsurance involve a greater element of financing losses but the contract must meet requirements as to the amount of risk transfer to qualify the arrangement as reinsurance for accounting purposes.

Finite risk contracts are reported to regulators along with traditional reinsurance contracts. They are not broken out separately. Finite risk products are estimated to represent less than five percent of total reinsurance premiums.

The alternative risk market (ART) is composed of two segments ? risk transfer through alternative risk carriers such as captives and the capital markets, and risk transfer through alternative products. Finite risk reinsurance is an alternative risk transfer product. ART products can be customized to meet a client?s specific need and can include a large finance component.

Finite risk reinsurance represents a shift in the risk management spectrum from traditional risk transfer towards risk financing. Finite risk coverages are multiyear contracts which, by taking into account individual loss experience and investment returns, reduce the client?s cost of risk management. However, while the year-to-year volatility in loss payments is reduced, the total amount of risk transfer over the contract period is limited.

It is difficult to provide a satisfactory general definition of finite reinsurance. Essentially, the products

typically have the following features:

- Risk transfer and risk financing are combined and the time value of money is emphasized in the contract
- Limited assumption of risk by the (re)insurer
- Multi-year contract term
- Explicit inclusion of investment income in the contract
- Sharing of the results with the insured/cedant.

One basic principle of (re)insurance is spreading risks over time?in addition to spreading risks geographically and over lines of business. In ?the old days? when the (re)insurance transaction was considered a gentleman?s agreement, relationships were long-term, and it was understood that temporary imbalances in the results would be recouped in future years through adjustment of rates, terms and conditions. Today, given global competition and frequent entries and exits by insurance companies from markets these informal agreements must be formalized and legally binding. Finite (re)insurance has become an instrument that can be used in many different circumstances.

With **loss portfolio transfers** (LPTs), a type of finite reinsurance, the policyholder transfers outstanding claims to the insurer. This makes LPTs a retrospective form of (re)insurance. The policyholder pays a premium corresponding to the net present value of the outstanding claims plus a charge for administrative expenses, risk capital and profits. Long-tail lines of insurance, such as medical malpractice, where the harm caused may not be apparent for some time and the final cost of the claim may not be known for years, lend themselves particularly well to LPTs, as timing risk is their key element. The insurer assumes the risk of unexpectedly rapid claims settlements. A faster than expected claims settlement implies a lower investment income earnings potential on the cash-flow. The ultimate total nominal amount of claims indemnification is usually contractually limited.

Adverse development coverages offer a broader spectrum of coverage than LPTs, since they usually also include incurred but not reported (IBNR) losses, losses not filed with the (re)insurer until years after the policy is sold. With this kind of coverage, the insured entity does not retain the risk of incurred but unreported claims for which it is liable, but passes it along to the (re)insurer. Unlike LPTs, there is no transfer of claims reserves. Instead the policyholder pays a premium for the transfer of losses exceeding the level at which reserves have already has been set up?in other words, the adverse loss development. This type of coverage can be arranged by either a stop-loss treaty, which protects the cedant from losses over an aggregate amount or as a working or catastrophe excess-of-loss treaty. The working layer of the reinsurance contract is the first above the insurer?s retention where losses are likely to be highest. The main benefit of adverse development coverages is that they facilitate mergers and takeovers since the insured company can offload both the timing and the reserves development risk. The acquiring company can assess the target company without performing actuarial due diligence. The existence of adverse development coverage improves analysts? and rating agencies? views of the acquisition in that it reduces the potential volatility of financial results.

The term **run-off** is used to refer to a special segment of managing retrospective liabilities. Unlike retrospective finite products, which usually substantially limit the amount of underwriting risk transfer, run-off products focus on the full-scale transfer of reserve development risks. Run-off solutions are tools that address a firm?s earnings volatility arising from past activities. There are a number of special situations that motivate a company to choose a run-off option, like corporate restructuring, mergers & acquisitions, discontinuation of lines of business, erratic changes in the valuation or cost of a liability, or regulatory, accounting or tax changes. The biggest run-off transactions to date in the United States have involved either asbestos & environmental (A&E) or workers? compensation liabilities. Most transactions have involved insurers, but the economics also work for corporations and captives.

For **spread loss coverages**, the insurer pays annual premiums or a single premium to the reinsurer for coverage of specified losses. These premiums? less a margin for expenses, capital costs and profits?are credited towards a so-called ?experience account,? which serves to fund potential loss payments. The funds earn a contractually agreed investment return. The balance of the experience account is settled with the client at the end of the multi-year contract period. The reinsurer limits the payments for each year and/or over the entire duration of the contract. The reinsurer is exposed to the credit risk of the insurer, the possibility that it will not cover its financial obligations, if the balance on the experience account turns negative. Usually these types of contracts involve very limited underwriting risk but offer the insurer the benefits of the liquidity and financial security of the reinsurer. The reinsurer assumes the (contingent) credit risk of pre-financing losses. The amount of risk transfer is frequently low but must meet the requirements necessary to qualify the arrangement as a reinsurance contract.

The **financial quota share**, which is a quota-share agreement with implicit financing via ceding commissions, is one of the oldest types of finite risk (re)insurance. Policies are usually prospective and cover underwriting risks in current and/or future underwriting years. Depending on the nature of the commission arrangements, these types of treaties provide financing and/or risk management. Financing can be achieved by overcompensating in the initial period(s) and under-compensating over a prearranged period of time.

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