Introduction to
Financial Reinsurance

Dieter Kroll
Associate Director – Hannover Life Re International

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Introduction to Financial Reinsurance

CONTENT

→ Terminologies
→ Financing Reinsurance
→ Motivation and drivers
→ Reinsurance structures
→ Legal and regulatory aspects

Focus is on Life Insurance and Life Reinsurance Business
Introduction to Financial Reinsurance

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Focus is on Life Insurance and Life Reinsurance Business
"Definition"

→ Reinsurance, with primary focus to generate a financial benefit

→ Risk transfer / risk management purpose rather a side aspect

→ Financial benefit could be a(n)
  • monetary
  • economic
  • tax
  • accounting
  • rating
  • or some other kind of "desired" effect
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Focus is on Life Insurance and Life Reinsurance Business
Financing Reinsurance enhances the surplus of a company

Cedant's Balance Sheet
(simplified, statutory reporting)
FINANCING REINSURANCE

Introduction to Financial Reinsurance

Illustration 2

Financing Reinsurance enhances the surplus of a company

Cedant's Balance Sheet
(simplified, statutory reporting)
→ New business financing or Block Assumption Transaction (BAT)

→ Asset or liability financing
  • Increase of assets or reduction of liabilities

→ Cash or non-cash financing
  • Transfer of liquidity or not

→ Immediate versus deferred financing
  • Financing at inception or – later – in the course of the transaction

→ Optional, contingent, contingent-optional financing
  • Cedant may opt to draw on financing subject to certain caveats
  • Financing rendered upon certain trigger events
  • Hybrid forms
Technical results before and after financing of new business
→ Initial strain is taken over through high first year ceding allowance

→ Expense allowance to Cedant to support renewal commissions and administration expenses

→ Popular: Recuperation of the initial financing monitored via a Deficit Account

→ Recapture option or conversion to traditional YRT arrangement possible after recuperation of financing
Technical results **before** and **after** financing of multiple years

Results
Reinsurance of an inforce block of business

Initial financing (ceding allowance) generates an immediate gain

Liquidity increases (if cash transaction)

Future gross margins reduced by cession of future margins

Recuperation contingent on the emergence of margins

Allows for a substantial immediate gain since inforce volume is available

Recapture option possible after recuperation of financing
Technical results **before** and **after** Bock Assumption Transaction*)

*) 100% reinsurance share for illustration purposes only
Asset financing

Cedant's Balance Sheet
(simplified, statutory reporting)
Liability financing

Cedant's Balance Sheet
(simplified, statutory reporting)
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MOTIVATION AND DRIVERS
Reasons for using Financial Reinsurance

→ Reduce new business strain (balance sheet, surplus, cash, reserve)
→ Surplus enhancement
→ Boost return on capital
→ Strengthen ratings
→ Support Mergers & Acquisitions, New ventures
→ Improve solvency ratios (capital adequacy, RBC)
→ Avoid investment restrictions (e.g. limits on derivatives)
→ Tax management (e.g. utilisation of tax loss carried forward)
→ Arrange with changes in regulation (reserving, solvency)
→ Smoothening or stabilising of results
# MOTIVATION AND DRIVERS

Product Offerings and Provider of Financing

<table>
<thead>
<tr>
<th></th>
<th>Banking</th>
<th>Reinsurance</th>
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<tr>
<td><strong>Products</strong></td>
<td>Debt or Equity</td>
<td>YRT, Coinsurance, ModCo, Coins Funds withheld, Hybrid forms</td>
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<td><strong>Duration</strong></td>
<td>Short</td>
<td>Flexible</td>
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<tr>
<td><strong>Covenants</strong></td>
<td>Restrictive</td>
<td>Flexible</td>
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<tr>
<td><strong>Appetite for (insurance) risk</strong></td>
<td>LOW</td>
<td>HIGH</td>
</tr>
<tr>
<td><strong>Execution time</strong></td>
<td>3-6 months</td>
<td>1-3 months</td>
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<td><strong>Insurance experience</strong></td>
<td>Low – few actuaries and underwriters</td>
<td>High – similar business and risk</td>
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<td><strong>Accounting</strong></td>
<td>Non-insurance</td>
<td>Insurance</td>
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REINSURANCE STRUCTURES

Basic types

→ Coinsurance (Original Terms)
  • Reinsurer participates proportionally in premiums, claims, reserves and the accumulation of reserve-backing funds

→ Coinsurance funds withheld
  • Like coinsurance, but the funds backing the reinsured reserves are deposited back with the Cedant

→ Modified coinsurance (ModCo)
  • Like Coinsurance, but both reinsured reserves and respective funds are deposited back with the Cedant

→ Yearly Renewable Term (YRT)

→ Hybrid forms (e.g. Co-ModCo) and non-proportional solutions

Most of the reinsurance types are implemented on a quota share basis
At inception, the Reinsurer assumes on q/s basis a closed block of business with underlying statutory reserves of 100 m

- 10% of the business on Coinsurance basis
- 90% of the business on Modified Coinsurance basis
- A Ceding Allowance of 10 m is paid at inception
REINSURANCE STRUCTURES
Example: Co-ModCo Non-Cash Financing

Result:

→ The life insurer’s assets remain unchanged

→ But its liabilities have fallen by 10 m

What happens next?

→ Each year, a (high) portion of the reinsured statutory profit is refunded as a ModCo-Adjustment and added to the deposited ModCo-Reserve

→ Over time the Co-ModCo treaty converts into a pure ModCo treaty

→ Eventually the deposited reserve represents 100% of the reinsured statutory reserve

→ (if the underlying business performs favourably enough!)
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Focus is on Life Insurance and Life Reinsurance Business
THE REGULATOR'S PERSPECTIVE

- Ensure the protection of policyholders
- Strengthen the financial security of the insurance industry
- Encourage good management of insurance companies
- Limit tax avoidance
- Promote certain trade policies
- Support innovation and development in the insurance industry

Financial Reinsurance is a very globalised and international business. Financial centres usually have "favourable" regulatory and tax regimes.
POSSIBLE REGULATORY REGIMES
Extreme restrictions on Financial Reinsurance

→ Allow only domestic companies to provide reinsurance
→ Subject reinsurance companies to the same regulations as insurers

Consequences of Regulatory Regime:
→ No reduction in total statutory liabilities due to reinsurance
→ No reduction in total statutory solvency margin requirement
→ Tax advantages of reinsurance are limited
→ Scope for capital optimization in the insurance industry is restricted
POSSIBLE REGULATORY REGIMES
Extreme restrictions on Financial Reinsurance

**Regulator**
- Full Oversight & Control

**Insurance Company**
- Solvency Margin
  - Liabilities

**Reinsurance Company**
- Solvency Margin
  - Liabilities

Reinsurance
POSSIBLE REGULATORY REGIMES
Few restrictions on Financial Reinsurance

→ Allow domestic and international companies to provide reinsurance

→ Subject international reinsurance companies to no regulation

Consequences of Regulatory Regime:

→ Total statutory liabilities are reduced by reinsurance

→ Total statutory solvency margin requirement is reduced

→ May be major tax advantages to international reinsurance

→ Reinsurance will encourage capital optimization in the insurance industry

→ Considerable uncertainty as to security of reinsurance arrangements
Introduction to Financial Reinsurance

POSSIBLE REGULATORY REGIMES
Few restrictions on Financial Reinsurance

Regulator

Full Oversight & Control

Domestic Insurance Company

Solvency Margin

Liabilities

No Oversight & Control

International Reinsurance Company

Solvency Margin

Liabilities

Reinsurance
POSSIBLE REGULATORY REGIMES
Reasonable restrictions on Financial Reinsurance

→ Allow domestic and international companies to provide reinsurance
→ Subject reinsurance companies to a reasonable amount of regulation
→ International reinsurers must be authorised, approved and provide financial guarantees

Consequences of Regulatory Regime:
→ Amount of capital backing insurance liabilities is unchanged
→ The form of the capital backing insurance liabilities is changed
→ May be tax advantages, some scope for capital optimisation
→ More certainty as to security of reinsurance arrangements
POSSIBLE REGULATORY REGIMES
Reasonable restrictions on Financial Reinsurance
THE REGULATOR'S PERSPECTIVE

Important issues

→ "Definition" of reinsurance and risk transfer requirements
→ Acceptable forms of reinsurance
→ Approved reinsurance companies
→ Rules for non-approved companies
→ Contract wording requirements
→ Capital and solvency requirements
→ Collateral requirements for reinsurers
→ Tax rules, accounting rules
→ Extent and frequency of oversight
Introduction to Financial Reinsurance
REGULATION AND ACCOUNTING
Some Developments and Outlook

→ Solvency II Regulatory Regime in Europe (Implementation in 2012?)
→ International Financial Accounting Standards (IFRS)
→ New Collateral Rules in the United States
→ Possible Federal Regulation in the United States
→ Impact of the Financial Crisis and Credit Crunch
Scenario I

- IFRS adopted worldwide
- Solvency II adopted worldwide
- Restrictions on tax havens
  - No regulatory capital arbitrage
  - No tax arbitrage

Limited demand for Financial Reinsurance

Scenario II

- Different accounting standards
- Solvency II not widely adopted
- Continued existence of tax havens
  - Ongoing demand for Financial Reinsurance

High importance of reinsurance regulation
Thank you for your attention!