Financial Reinsurance : Experiences and Lessons

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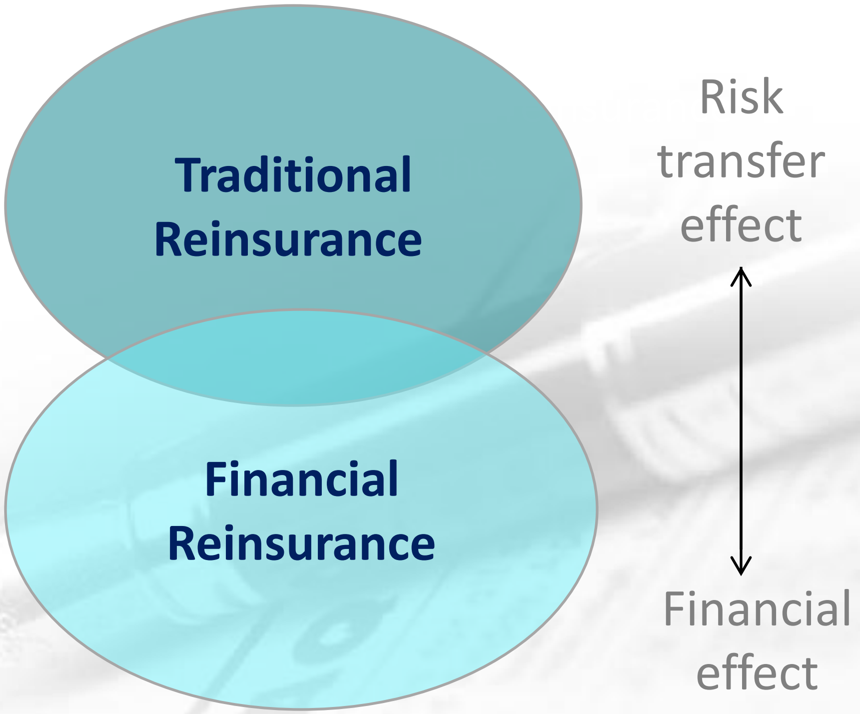
Myth 1: Financial Reinsurance differs materially from Traditional Reinsurance

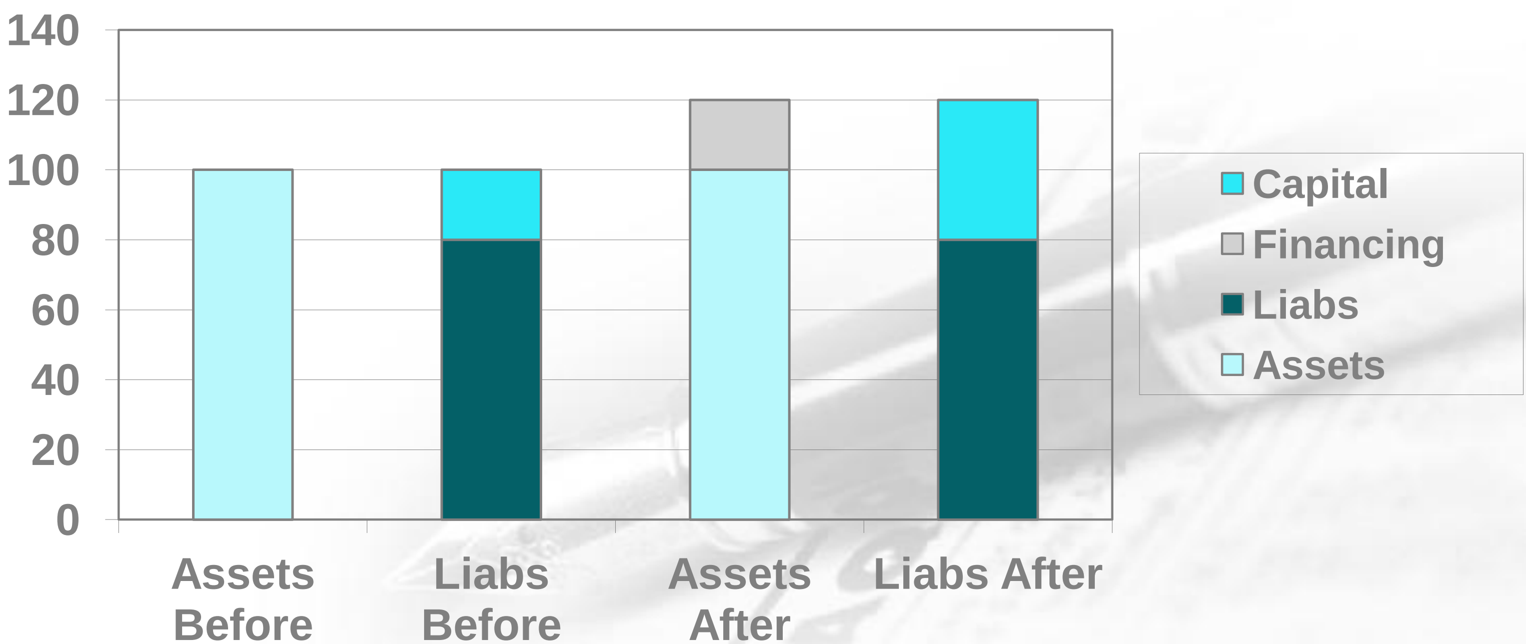
- Traditional Reinsurance: The transfer of insurance risks from the ceding company to the reinsurance company, to reduce the risk and volatility in the ceding company's results.
- Financial Reinsurance: A type of reinsurance transacted for the purpose of achieving a desired effect on the ceding company's financial statements, e.g. to improve the balance sheet position.

- Both Financial and Traditional Reinsurance achieve risk transfer and financial objectives
- Financial Reinsurance is best defined according to the intent of the transaction



Myth 2: Financial reinsurance is "cooking the books"

- Cash financing: The initial transaction involves a cash payment from the reinsurance company to the ceding company. Subsequent transactions involve the repayment of this financing, plus a fee, from the ceding company to the reinsurance company
- Comparable to "sale and lease back" arrangement
- Cash financing adds an <u>asset</u>



Myth 2: Financial reinsurance is "cooking the books"

- Non-cash financing: The initial transaction involves no net cash flow between the reinsurer and the ceding company. Subsequent transactions involve the payment of a fee from the ceding company to the reinsurer
- Comparable to a "stop loss" arrangement
- Non-cash financing removes a liability

Myth 3: Financial reinsurance contains no risk to the reinsurer

Risks faced by reinsurer

- Actual experience (mortality/morbidity/lapses) worse than anticipated best estimate → takes much longer to repay and might not repay at all → losses in excess of initial financing amount
- Insolvency of ceding company → ranks below policyholders benefits and alongside all other unsecured creditors of company
- Remote risks taken on materialize → pay losses far exceeding any fee earned prior to that

Myth 4: Financial reinsurance provides no benefits to policyholders

Financial reinsurance optimize the ceding company's capital position:

- Greater capital freedom leads to enhance products e.g. enhanced guarantees & additional product features
- Supports high initial distribution cost leading to even distribution of charges
- Lower cost of capital leading to more competitive prices
- Improved solvency ratio leads to better policyholder protection

Myth 5: Financial reinsurance causes the failure of insurance companies

Equity Funding US:

- Ceding company falsified policies which were then reinsured on a cash basis with the reinsurer
- Problem = IT fraud by insurer

Chiyoda Mutual Life Japan

- Reinsured profitable blocks of business to hide investment losses arising on other blocks
- Problem = How long should directors try to “save” company before they are deemed to be committing fraud?

Equitable Life UK

- Entered into a reinsurance contract which allowed them to get reserve relief
- Problem = Side letter was put in place between ceding company and reinsurer to negate effect of the contract

Myth 6: Financial reinsurance can save failing companies

- No expected future profit = No financing opportunity

- Ceding companies need to pay attention to:
  - flawed product design which will increase lapses
  - underpriced/cross subsidized business
  - expense overrun

- Financial reinsurance can't change the underlying economics of the business

Myth 7: Financial reinsurance does not require additional regulatory considerations

Important considerations for Regulators:

- Definition of reinsurance
- Approved forms of reinsurance
- Approved reinsurance companies
- Rules for non-approved companies
- Contract wording requirements
- Capital and solvency requirements
- Collateral requirements for foreign reinsurers
- Tax rules
- Accounting rules
- Extent and frequency of oversight

Myth 8: All regulatory regimes should be equal

- Import and export play important roles in our economies
- Reinsurance is “just another” form of International trade
- Regulatory arbitrage doesn’t equal improper conduct
- Regulators should choose to implement a regime which:

a) Allows the Regulator to remain “in control”

b) Allows Industry to benefit from additional solutions

c) Allows the most suitable companies to provide solutions in a professional way

Myth 9: Financial reinsurance dilutes the shareholders investment

Why does a shareholder buy shares in a company?

- Receive the future profits through a dividend
- Expect an increase in the share price which leads to capital appreciation
- Right to "control"/influence company direction through voting rights

What impact does financial reinsurance have on these items?

- Capitalize future profits and make it available to company in cash
- Protects shareholders downside risk that actual future profits are less than anticipated
- Makes available additional capital from within the company without the need to sell more shares and therefore diluting current investments
- Could be utilized as a temporary source of capital
- Could be a cheaper source of capital
- Lead to expansion of business and potentially more profits for existing shareholders