FIN RE – WHY DO COMPANIES NEED IT AND WHAT ARE THE REGULATORY CONCERNS?

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***Abstract*:** This paper provides two perspectives on financial reinsurance contracts – one, the insurer's perspective, on the need for financial reinsurance contracts and two, the regulator's perspective, on the regulatory concerns and regulations. Section 1 provides a rudimentary introduction to financial reinsurance products and their utility as an alternate source of capital. Section 2 deals with regulatory concerns and relevant regulations on financial reinsurance contracts in the UK, EU, China and the US. Section 3 is on financial reinsurance in India. Section 0 provides an executive summary of the discussions and hence defines the scope of this paper.
I intend to place on record that the views expressed in this paper are my personal views. I also wish to state that I have not made any conscious attempt to express my employers' view on this issue and hence, the paper may not reflect the views of Life Insurance Corporation of India, where I am employed and Swiss Re Life & Health, where I am placed, at present on secondment.
Keywords: Alternate Risk Transfer contracts (ART), cashless financing with virtual capital, cash with deficit account, Consultation Paper 144 (CP144), financial reinsurance (Fin Re), financial engineering, Financial Reporting Standard No. 5 (FRS 5), New York Regulation 102, nil-premium period, surplus relief, quota share reinsurance.

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SECTION 0
SCOPE OF THE PAPER
Executive summary
A financial reinsurance (Fin Re) contract is motivated by financial as well as risk transfer goals. Fin Re attempts to address some of the financial objectives of a direct writer, one such objective being generation of capital for writing new business, either by a cash injection from the reinsurer or by re-engineering future profits contained in a block of new or in force business.
Fin Re products are tailor made to suit the needs of direct writer and may or may not involve cash transfers from reinsurer. When there is a cash transfer to the direct writer, the repayments are made contingent on the emergence and/or the sufficiency of future surplus. This allows the direct writer to maintain a reserve that is lesser than the initial cash liability. Variations in product design include unbundling of the risks involved say, credit and insurance risk, so that these risks can be covered by different parties involved in the transaction – say credit risk by a bank and insurance risk by a reinsurer.
Apart from being an additional source of capital, Fin Re products can improve investment freedom, increase internal rate of return on products and some Fin Re products guarantee

future surpluses. (**Section 1** of this paper introduces the reader to financial reinsurance products.)

However, there is a potential danger of these products being misused to window-dress balance sheets, mislead regulators, financial advisers and policyholders regarding solvency levels. Thus, the regulatory concerns are two-fold: firstly, the effect of Fin Re contracts on the solvency levels of the direct writer and secondly, accounting issues and the issue of disclosures.

In the US, regulations are in place that cover issues like minimum prescribed level of risk transfer so as to be eligible for reserving credits. In the UK, consultations are being made on the new regulatory approach to financial reinsurance contracts which include issues like accounting, statutory disclosures and regulatory supervision. (**Section 2** of this paper briefly summarises the regulatory set up in the UK, EU, China and the US.)

In India, it is understood that there are no explicit regulations favouring or disallowing Fin Re products. **Section 3** looks at some arguments for and against use of Fin Re products in India. It also raises the issues and concerns the Indian regulator might have to deal with, in case the regulator favours use of Fin Re products. It also lists out the main aspects that need to be covered by the regulation with comments on the level of detail required in each of these aspects of regulation.

SECTION I

1. FINANCIAL REINSURANCE

1.1 A traditional reinsurance contract is driven by the primary motivation of competitive risk transfer. However to view reinsurance contracts as simple risk transfer contracts would be as naïve as it would be to restrict the definition of insurance contracts to term insurance contracts. Reinsurance contracts to remain attractive and competitive address other needs of the insurers, some of which are

- Need for capital to write new business or to develop and write new lines of business
- Need for capital to address the issue of sagging statutory solvency levels
- Early profit recognition
- Free capital tied in "inadmissible" or "virtual" assets
- Increase the internal rate of return on capital employed and/or the economic value of the company.

1.2 A financial reinsurance (Fin Re) contract is motivated by financial as well as risk transfer goals. Fin Re attempts to address some of the financial objectives of a direct writer, one such objective being generation of capital for writing new business, either by a cash injection from the reinsurer or by re-engineering future profits contained in a block of new or in force business. Before we deal with Fin Re contracts that employ future profits, let us see how traditional reinsurance forms like quota share reinsurance can also be used to meet the financial needs of a direct writer.

1.3 In a traditional quota share arrangement, a predefined proportion of risk on each contract is transferred to a reinsurer. The direct writer pays the same proportion of premium (as the proportion of risk transferred) as reinsurance premium. However a typical financing arrangement is possible where the insurer pays no reinsurance premium for the first few years (called the "nil premium period") and pays a higher proportion of insurance premiums as reinsurance premiums in later years. The direct writer thus saves capital on two counts: firstly, on reinsurance premium in the initial years and secondly, by lower reserving requirement on the reinsured contracts. Such arrangements improve cash flow and may also reduce the capital required to write the product. It may be noted that the direct writer may not reserve for the higher reinsurance premium liability, which arises after the nil-premium period, if the retained premium, after the nil-premium period, is sufficient to cover the retained risk.

1.4 A form of Fin Re arrangement which does not involve cash transfers from the reinsurer but provides additional capital to the direct writer is the "cashless financing with virtual capital" arrangement.

The basic structure of these contracts, in essence, is a whole-account stop-loss reinsurance. A block of business is chosen and reinsured. Typically the last X of claims (which is expected to be payable in say, 30 or more years from now) is reinsured. This reinsurance arrangement provides capital in the following ways:

- X of claims being reinsured, the direct writer has a reduced reserving requirement on this tranche of business and hence the capital that would have been tied up as technical reserves and solvency margin is released.
- Under this reinsurance agreement, the direct writer notionally books a claim for X with the reinsurer. The claim is not paid immediately, but held as a "reinsurance receivable" by the direct writer to be paid when the direct writer needs to settle the primary liability. Thus the direct writer can take immediate credit for this reinsurance receivable as an asset in its regulatory statement which would reduce its liabilities.

The reinsurance is arranged in such a way that the initial reinsurance cover is run-off over a pre-determined period, keeping in mind that the main purpose of these arrangements is to raise capital rather than large scale transfer of risk. This would also reduce the cost of reinsurance which is dependent on the reinsurance cover. The run-off is structured as a first charge on surplus arising in any year. This process of reducing the reinsurance cover is also called "recapturing" of liabilities. To further enhance efficiency of these reinsurance contracts, the reinsurer's charges are added to the reinsurance cover and are payable out of emerging surplus when the liabilities are recaptured.

Thus, there are no cash transfers from reinsurer to the direct writer in generating additional capital and hence the name "virtual capital".

To summarise, these arrangements

- Release excess reserves
- Provide reinsurance with no initial premiums (as these are payable as charge on surplus arising)
- Allow for "recapture" of reinsured amounts to reduce future reinsurance costs.

1.5 There are various forms of Fin Re arrangements that involve cash transfer. One such Fin Re arrangement where reinsurer provides cash advance to the direct writer is the "cash with deficit account" arrangement.

The basic structure of this arrangement is that the reinsurer pays the insurer a large reinsurance advance in the first year. This advance is then repaid either as increased reinsurance premium in the later years or as first charge on surplus arising in future years. A typical arrangement is described below.

A block of business is chosen and reinsured. The reserve backing this liability is paid as reinsurance premium which may then be deposited back with the reinsurer. A cash advance which reflects the value of future surpluses expected to emerge from that block of business (or any other block of business) is paid by the reinsurer to the direct writer. This cash advance is held as a deficit account and the interest and the capital payments on the outstanding balance in this account are made as first charge on future surpluses that emerge out of the reinsured block of business or from that block of business on which the cash advance was calculated. Due to the contingent nature of loan servicing, the insurer need not provide for this liability in the statutory valuation. However the deposit received back from the reinsurer is a liability and hence has to be provided for. Thus the insurer raises capital through cash advance without having to provide for it as a liability.

To summarise,

- Direct writer is able to increase assets through reinsurance advance
- Loan servicing contingent on surplus arising and hence no need to provide for this liability in the statutory returns
- Thus regulatory capital increased by the amount of cash advance (less provision for deposit-back, if any)
- - which means that future surpluses are swapped for immediate cash.

1.6 The amount of cash involved in these transactions could be very large and in such transactions involvement of other financial institutions like banks might be necessary. In such cases, the risks are unbundled as say, credit and insurance risks so that the reinsurer covers the insurance risks, leaving the other risks to other financial institutions involved in the transaction. Some such examples are:

- A bank offers loan to the reinsurer which is then used to provide the cash advance to the direct writer. The reinsurer then services the loan to the bank out of the payments received from the direct writer. For these arrangements to be capital efficient, the loan servicing by the direct writer is done as a first charge on future surpluses that may arise from the reinsured portfolio of business. In such a situation the reinsurer takes the risk of non-emergence or inadequacy of surplus, while the bank takes the credit risk of non-repayment of the loan it had offered to the reinsurer.
- The bank offers the necessary capital to the direct insurer. The loan repayments are made by the direct writer as first charge on future surplus. The reinsurer provides a financial reinsurance with a cash advance – this cash advance being payable only when the direct writer is unable to service the loan to the bank (say due to shortfall in surplus). This arrangement converts the insurance risk (volatility of surplus arising) that the bank would face in the absence of the financial reinsurance, to a credit risk (default by reinsurer to provide the necessary cash shortfall). For the direct writer, the servicing of such cash advances made by the reinsurer is contingent on future surplus so that no provision is required for this liability.
- The efficiency of such arrangements can be enhanced by a variety of repayment structures – like nil-repayment for a few years, providing

flexibility to the direct writer in servicing the loan by imaginative repayment methods etc.

1.7 As it is obvious from the discussions above, one of the reasons for using Fin Re is that it is an alternate source of capital.

1.8 It also helps in improving the internal rate of return achieved on the capital employed.

- Fin Re improves investment freedom by releasing assets that might have otherwise been tied up as technical reserves. Higher investment freedom might lead to higher returns. (For a detailed study of how Fin Re improves with profit fund returns, "Financing investment freedom: A Stochastic Asset-Liability Study into the use of Financial Reinsurance to improve With-Profit Fund Returns" by Mary R Hardy and Richard A Rae, which was presented to the Staple Inn Actuarial Society on 31st March 1998, may be referred.)
- As the cost of Fin Re is less than the rate of return achievable on the product (otherwise Fin Re becomes an unattractive source of capital), the internal rate of return after reinsurance is higher.

1.9 For a company which expects the rate of growth in new business to exceed the internal rate of return on the products sold, the new business strain arising each year would exceed the profits emerging from the business sold in the earlier years. Hence it cannot finance from its internal sources. Fin Re eases the pressure on internal capital by reducing the technical reserves and by increasing the return on the capital employed.

1.10 Some Fin Re arrangements capitalise future surpluses. In such arrangements, the risk of non-emergence of surplus or lower-than-expected surplus is partly transferred to the reinsurer and hence such Fin Re arrangements effectively guarantee future profits up to the amount of financing.

1.11 The other aspects where Fin Re is better than some of the other alternate sources of capital are:

- It is often easier to raise capital through Fin Re especially when the statutory solvency level is low.
- Risk transfer opportunities.
- Tailor-made contracts which offer more flexibility.
- Leveraging opportunities.
- Improves ties with the reinsurer.

SECTION II

2 REGULATORY CONCERNS AND REGULATIONS

2.1 The second part of this paper is structured as:

- Regulatory concerns
- Difficulties in regulating Fin Re
- Regulatory issues
- Regulatory regimes.

2.2 The main attractions of Fin Re are:

- Additional source of capital as it provides cash injection or provides access to overly prudent "economic reserves"
- A method of improving the apparent solvency position.

2.3 However, a regulator might be concerned about the following aspects when this tool is used as a financing option.

- Some arrangements capitalise future profits that might include policyholders' share of with profit business also
- The capital thus raised might be used (either directly or indirectly) to finance dividends to shareholders
- This financing tool can be used by a genuinely "in-problem" company to continue to write new business for a longer period than it should.
- This tool allows leverage and hence an increased risk in case of a loss.
- Some of these arrangements also introduce additional risks like credit and legal risks.

2.4 Fin Re, when being used to improve the apparent solvency position of the company, if not reported properly in the returns and the accounting statements obscures the financial position of the company. There is a possibility that this might often be designed and used to mislead regulators, the financial advisers and the policyholders.

Hence regulations are required on two broad issues: one, the issue of the financial arrangements affecting or obscuring the solvency levels of insurers and two, the issue of these arrangements not being properly reported, either intentionally or otherwise to mislead the regulators and other parties involved.

2.5 The first concern of the regulator is whether to allow this financial tool or prohibit the use of it. Some of the reasons against prohibition of this financial tool are:

- It is a financial tool that would immensely improve the functioning of a company as is evident from the legitimate uses listed in the previous section.
- It improves the efficiency of the overall financial market by developing a synergy between insurance companies, reinsurance companies, banking sector and other financial institutions.
- It is to be appreciated that one of the fundamental reasons for capital is to satisfy the regulatory requirements of reserves and solvency margins. From the companies' perspective these regulatory requirements, in some individual cases, "artificially" over estimate the capital requirement in relation to the risks that the individual firms run and such firms require a legitimate way of countering this artificial deferment of surplus. Regulators in some countries have accepted this argument and have allowed the use of future surplus as "implicit item" in counting towards the solvency margin.
- It is generally accepted that the disclosures based on the statutory returns do not provide a fair value of the company. If that is accepted then it could be argued that this financial tool cannot be prohibited for the reason that there is a possibility of it being used to produce misleading disclosures.

Thus there are valid arguments to allow the use of financial reinsurance instruments at least until there is a statutory move towards risk-based capital and a consensus in the definition and use of fair-value accounting.

2.6 The next concern of a regulator, assuming that financial reinsurance is to be allowed, is to formulate a set of regulations that would counter all possible misuses of this tool. The difficulties arise from the nature of these contracts, some of which are:

- Most of them are bespoke, with complex arrangements relating to term of contracts, renewals etc. and built on non-standard documentation.

- They might also be built as series of related contracts, sometimes involving different counterparties with different risk-taking arrangements.

2.7 The regulatory issues raised by such arrangements vary, depending mainly on the following

- The extent of risk transfer
- The price paid by the direct writer
- The value taken in regulatory and other reporting, as arising out of such arrangements.

2.8 Currently, there is no international accounting standard covering the treatment of financial reinsurance contracts. The International Accounting Standards Board is in the process of developing an internationally accepted accounting practice under its Insurance project.

2.9 In the UK, accounting of non-life financial reinsurance products is standardised through the Financial Reporting Standard No. 5 (FRS5). These standards have been adopted by the Association of British Insurers (ABI) and have been incorporated in their Statement of Recommended Practice (SORP). This also sets out the main accounting issues relating to life financial reinsurance products. However following an expression of dissatisfaction from the FSA, the ABI is in the process of developing amendments to the accounting procedures for life Fin Re products.

2.10 In the US, regulations on use of financial reinsurance products were put in place, as there were concerns about some typical financial loans being characterised as financial reinsurance products. These products were basically surplus relief products; however repayment of the initial loan was not dependent on emergence of surplus but was repayable on all conditions.

2.11 To counter this, the New York State brought out a regulation (New York Regulation 102) that provided reserve credit on reinsured contracts only if

- There is a genuine transfer of risk to the reinsurer
- A significant proportion of the reserves are ceded and there is a transfer of "significant" risks (which initially meant insurance risk)
- The treaties are not cancellable by the reinsurer for reasons other than non-payment of premiums.

This was adopted as a model regulation by the National Association of Insurance Commissioners (NAIC).

2.12 However later this regulation was modified by the State of California, to expand the implication of "significant" risks to include interest, credit and reinvestment risks. This was then expanded by the NAIC to apply the regulation to all life and non-life reinsurance contracts (not necessarily financial reinsurance contracts).

2.13 In the United Kingdom, the Financial Services Authority, in the year 2002 had issued a Consultation paper (CP144) – "A new regulatory approach to insurance firms' use of financial engineering". The purpose of this paper was to include some new rules and guidance in the Interim Prudential sourcebooks for insurers and friendly societies, with regard to the use and reporting of financial reinsurance contracts. The FSA intends to bring reporting changes for life business into effect for the financial year ending 31 December 2002, and those for the new Guidance Note and non-life business for the financial year ending 31 December 2003. The use of financial arrangements either to improve the solvency position or to have access to the economic reserves is termed in this paper as “Financial engineering”.

2.14 The new regulatory approach has the following elements

- Insisting on legitimate purpose and effect in using the financial engineering, be it financing through risk transfer or accessing economic reserves
- If the arrangement involves risk transfer, then restricting the credit taken in the regulatory return to be not more than the risk transferred and value added
- Emphasising that the firms should review the effect of financial engineering within the context of their overall risk management strategy, with specific reference to the credit risk arising out of such arrangements
- Improving transparency in reporting
- Formulating rules for appropriate supervisory scrutiny.

2.15 The FSA proposes to attain its objectives in regulating this market by setting up high-level standards to those who manage these regulated firms. These high-level standards, concentrating on how firms should use and control this type of business, are to be set out in a guidance note which would be inserted into the existing Principles of Businesses (PRIN) and Senior Management Arrangements, Systems and Control (SYSC).

2.16 These high-level standards covers four main areas:

- Description of financial engineering arrangements, their valid use and regulatory concerns over their misuse
- Criteria to be used by the insurers when deciding whether the purpose and effect of a financial engineering transaction is consistent with the PRIN
- Obligation to set up and maintain adequate systems and controls to manage, control and record financial engineering
- Obligation to ensure that such arrangements are accounted for and reported correctly.

While this guidance note insists on legal review and sign off procedures at a high level within the firm, it does not place any specific limits on the level of use of such arrangements and any requirement on risk-based capital.

2.17 The FSA have also proposed rules on limiting credit exposure. The proposed rule imposes a requirement to spread reinsurance across reinsurers, placing limits on reinsurance concentration with a single reinsurer and providing regular reports to the regulator on the firms’ reinsurance arrangements including exposures. The exposure limits are calculated as proportion of total business and as a proportion of the firm’s capital. The proposed limits are such that no more than 20% of a firm’s business (proxied by premium income) should be covered by a single reinsurer and the exposure to a single reinsurer does not exceed 100% of the firm’s capital. However, a breach of these limits is not prohibitive but only triggers a requirement to intimate the regulator on how the firm is planning to mitigate this credit risk.

2.18 The FSA has also proposed a few changes to the reporting regime by inclusion of additional forms to its existing statutory forms for disclosure. They are:

- Form 9A indicating the effect of financial engineering on the financial condition of the firm. This proposed new form reverses the effect of financial engineering arrangements at the firm level and hence provides information on the level of relief the firm was able to gain in the calculation of solvency margins. This is expected to produce clearer disclosures and hence allow direct comparison of firms.

- Form 9B showing equivalent disclosure at an individual with-profits fund level.

The FSA has also amended the Abstract to valuation report to include a statement that all financial engineering products have been covered and clarification regarding any material contingencies, including the credit and legal risks that the reinsurance arrangements may be subject to.

2.19 In the European Union, the Internal Market Directorate General of the Commission of European Communities commissioned a report on Alternative Risk Transfer (ART) vehicles most of which are financial reinsurance products; the treatment of these products tends to be focused on the non-life products and comparison of treatment of certain issues is made to the practices in the US. Among various other aspects of discussion, the paper spells out the areas of regulatory concern which to a large extent reflect the concerns of the FSA in the UK. The key areas of concerns as spelt out in this paper are:

- Need to incorporate a measure of risk transfer – this would be required to test the legitimacy of the financial reinsurance arrangements and to decide on whether to allow reserving credit to such arrangements.
- Specific arrangements which are investment related products but are arranged in a format that would allow such arrangements to be accounted for as insurance contracts.
- Supervisory control over certain large contracts.
- Restrictions on some financial institutions like banks in carrying out other activities. Such restrictions providing a control over such activities would be required as the regulations within the banking and the insurance industries are different. This might induce designing contracts primarily to take advantage of regulatory differences and write contracts either as investment related products or insurance products depending on the sympathetic regulatory environment. This process of tailoring products to suit the regulatory environment is called the "regulatory arbitrage".

2.20 It is interesting to note that the paper also deals with the issue of over regulation and raises an additional concern for the EU – that of over regulation driving this type of business to other markets, especially the US. It places this potential danger of driving out business against the backdrop of NAIC's proposals to ease restrictions on insurers' issuing securitised and other related products and the proposal to make amendments to the accounting framework permitting accounting of securitisation as insurance. The paper states that in many of the areas where it has found reasons for regulatory intervention it is in the form of relaxing existing constraints rather than taking regulatory actions that are prescriptive in nature.

2.21 In China, the Ministry of Finance, in February 2002, promulgated the General Principles of Insurance Industrial Finance Reinsurance. The purpose as stated in the promulgation is to help the domestic insurance companies in establishing new finance management schemes and in increasing the flexibility of manipulation of the capital and assets. The promulgation in effect prohibits use of reinsurance in financial reporting if the principal purpose of reinsurance contracts is for improving the prima facial reports.

2.22 Some of the aspects which are dealt in the promulgation are:

- Definition of Fin Re contracts which includes minimum risk transfer criteria.
- Clauses that need to be included in a Fin Re contract like reinsurer's responsibility and scope, termination clauses, clauses on actions to be taken on reinsurer's or insurer's insolvency.
- Procedures to be followed in arranging such contracts, accounting principles and methodology, disclosures to be made and responsibilities of the board of directors.
- Minimum rating requirement of reinsurance companies.

SECTION III

3 FINANCIAL REINSURANCE IN INDIA

3.1 This section places financial reinsurance in the Indian context. This section is structured as:

- Need for financial reinsurance in the Indian context
- Issues and concerns for the Indian regulator.

3.2 It is acknowledged that at present, there are no explicit regulations allowing or prohibiting financial reinsurance contracts. However, it is felt that the regulations do not, at present, favour the use of these financial engineering arrangements in raising capital or improving solvency levels.

3.3 The need for financial reinsurance is to a large extent based on the insurer's need for alternative sources of capital. There would be a strong case for introduction of financial reinsurance if there are strong arguments to show that the regulations shut down some of the other legitimate sources of capital or that the regulations force companies to hold capital which is disproportionate to their risk profile.

3.4 It would be interesting to check whether the regulations exacerbate the need for capital when companies wish to write more business. New business strain arises due to two main reasons: one, acquisition cost and two, reserving requirements. In UK, where a net premium valuation basis is the minimum standard, the valuation method and the prescriptive minimum basis regulations aggravate new business strain. However, the valuation regulations in India are neither as prescriptive nor as restrictive as those in the UK.

3.5 Having said that, it is to be noted that reserving using traditional methods, by nature, is onerous when a contract is written. This is because of the regulatory need to finance, on a prudent basis, the excess of present value of benefits and expenses over present value of future premiums at time 0, even though part of this liability is accrued over the term of the contract and not at inception. This strain is magnified by the regulatory need to reserve for terminal bonuses also.

3.6 Regulations are not company specific and some regulations are not product specific. Thus, for some companies, regulations force excess reserves which are disproportionate to the risks the companies run and hence intensify the need for capital.

3.7 The regulatory strain mentioned in the paragraphs above would only be eased if reserving is done on risk based capital methods and some form of fair value accounting is allowed in disclosing the liability of insurance companies. Until then companies would require additional tools to manage their capital needs and risks.

3.8 The need for capital for the Indian insurers arises, to a large extent, from the fact that many of them are new companies with large preliminary expenses. The asset valuation regulation stipulates that these preliminary costs can not be treated as an asset, thus ruling out amortisation of preliminary expenses.

3.9 Limit on the share holding by the foreign partner in a private insurance company indirectly restricts capital raising capability of private companies as any injection by the foreign partner would require additional injection by the Indian partner also.

3.10 The other arguments that favour allowing financial reinsurance are those mentioned as the legitimate uses in Section 1 and Section 2 of this paper. It is also accepted that in the face of globalisation of financial markets the insurance industry can not remain insulated from the occurrences worldwide. Alternative risk transfer techniques and financial reinsurance methods are widely used in many of the major markets and the proposed regulations in the major economies tend to regulate rather than prohibit the use of such tools.

3.11 While setting regulations for Fin Re contracts, the following are some of the issues that would require the regulator's attention and some of the aspects that would need to be incorporated in the regulations.

- One of the issues that would require a review is the existing regulation on original terms arrangements in reinsurance. The regulator might consider allowing original terms reinsurance. This would improve the prospects of Fin Re contracts and also encourage some bold product designs in areas where the insurer would prefer sharing pricing risk with the reinsurer. To discourage insurers from ceding a large proportion of their business, the regulator may impose a cap on proportion of business that can be ceded, which might depend on the nature of product, the purpose of reinsurance etc., and on reserving credit allowance on reinsured contracts.
- Definition of Fin Re: The definition needs to cover issues like
    - The contracts that would be defined as Fin Re contracts and hence that would be governed by these regulations
    - The contracts that are excluded from this definition and hence that are disallowed from being used as reinsurance contracts
    - Nature of risks that are to be transferred and minimum level of risk transfer required in a Fin Re contract
    - Insurers and reinsurers who would be allowed to use these contracts and regulations for other financial institutions being a party in such contracts.
- Standardisation of Fin Re contracts: This would cover issues like
    - Statement of purpose of the reinsurance arrangement, nature of the commercial purpose and its fulfilment
    - Parties involved in the transaction with their level of involvement
    - Block of business reinsured, level of financial assistance and terms of arrangement including term, repayment schedule and any contingencies involved in the arrangement.
    - Special clauses that may apply like lapsation, events on which the contract becomes unenforceable etc.

- Termination clauses and action to be taken on insolvency of any of the parties involved in the transaction.

- Legitimate uses of financial reinsurance: This would include the purposes for which Fin Re contracts might be employed and how such contracts need to be designed to be eligible for the benefits.
- Value shown in the statutory returns: This would be required to restrict the credit taken in the statutory returns to the actual value added by these contracts to the company or the risk transferred using these contracts.
- Accounting and other disclosures: This would be required to avoid misleading disclosures. The accounting, statutory and other disclosures should also provide information in formats that facilitate comparison of financial performance of companies using different levels of financial reinsurance.
- Limits on credit exposure, procedures for mitigation of credit risks and legal risks.
- Responsibilities of board, actuaries, accountants and auditors.
- Penalties that would be imposed on non-conforming arrangements and companies.

3.12 There are some factors that might hinder development of Fin Re in India.

- Most of the insurers are new to the insurance market and hold immature blocks of business that have not yet started producing stable streams of surpluses. The reinsurer may find it more difficult to value immature block of business held by new insurers to provide financial assistance based on future surpluses.
- The reinsurers have also felt shortage of capital due to higher reserves for the claims on incidents on 11th September and falling equity markets. These might have forced reinsurers to take a fresh look at their capital capacity to write new business and that too in an emerging market with no reliable experience.
- Reinsurers usually have exposure limits to each of the insurer on their business worldwide. This might put a restriction on the level of exposure that any reinsurer might wish to have in the business written by these insurers in India.

3.13 ***Conclusion***: For the new life offices, which are at present concentrating on consolidating their positions, scarcity of capital might become a serious issue, once they start growing rapidly. In such a situation, life offices may be attracted to Fin Re contracts. Hence, it would be prudent for the regulator to position itself to address the future needs of the life offices by placing a regulatory set up for Fin Re contracts even before the life offices start using Fin Re contracts.

3.14 The regulator might consider setting up a committee to report on the need for and the regulatory concerns regarding Fin Re products. It might also consider commissioning a study by an independent consultant to report on this issue which might then be published as a consultative paper inviting views from the insurance industry. Regulations might then be put in place based on such extensive consultations.

3.15 The purposes of such regulation would be

- to provide insurers an access to another efficient source of capital
- to effectively supervise insurance market where insurers run their businesses on sound financial lines having due regard to policyholders reasonable expectations and

- to protect policyholders’ right to accurate information on the financial status of insurers.

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