

Life Financial Reinsurance Overview

The “statutory” financial reporting life insurance accounting system is a conservative accounting system to ensure the solvency of life insurance companies. In addition to reserves based on conservative reserve requirements, life insurers also have to establish and maintain sufficient surplus based on a regulatory solvency margin standard. When accounting is adjusted to a GAAP basis, resulting capital will often exceed an equity requirement based on the economic value of the risks in the business.

These accounting practices generate an opportunity for financially motivated reinsurance transactions. Financial reinsurance represents reinsurance which allow insurance companies to obtain accounting relief from the conservatism of the statutory reserve and capital requirements or financial optimization. In a financial reinsurance transaction, excess statutory reserves (redundant reserves not needed to support the economic risks in the business) and a large part of the solvency margin associated with reinsured business is transferred to a reinsurer. Properly designed financial reinsurance should allow insurance companies (the ceding companies) to maintain capital at levels closer to the true level of economic risk equity. The lower level of reserves and statutory capital is appropriate because reinsurance represents a guarantee by the reinsurer that the lower (closer to GAAP) level of reserves is sufficient to meet all benefit obligations.

Alternatively, financial reinsurance is sometimes considered a fronting of future profits and that profit level is guaranteed by the reinsurer thereby justifying a capital benefit. In this respect, financial reinsurance can also be referred to as embedded value financing. Another way to think of financial reinsurance is as commission financing (front end commissions are typically fully expensed resulting in surplus strain).

Financial reinsurance requires transfer of risk to the reinsurer, usually in accordance with regulatory or accounting requirements. The risk transfer requirements relate to transferring the risks that are present in the business and the general rule is that there should be some way to demonstrate a loss and that “if there is a loss, the reinsurer is required to pay”. For example, in life insurance contracts, there might be requirements to pass mortality, investment, and lapse risks. However, there typically is no probability of loss standard under the statutory accounting guidance. In fact, financial reinsurance transactions with life insurers typically are well collateralized so there is no significant risk transfer under GAAP accounting standards and the transactions are “collapsed” for GAAP accounting purposes.

The amount of financing provided by the reinsurer is usually a function of the embedded value (renewal profits). An upfront commission of 35-45% of the value of 10 years of future profits is not uncommon. The extra profits serve as collateral for the reinsurer to absorb adverse experience in the order of 150% of expected mortality, 200% of expected lapses, and some deterioration in investment performance.

A common structure used for financial reinsurance transactions for life insurance companies is modified coinsurance or sometimes referred to as “deposit back” arrangements. Modified coinsurance is very similar to coinsurance funds withheld but there are subtle differences in the cash flows that can impact insolvency offset procedures. With modified coinsurance, the ceding company retains any funds backing up the reserves for the life insurance products and invests them on the reinsurer’s behalf. Interest on the assets backing the reserves are paid to the reinsurer and premium and claim payments are offset by changes in the reserves. The surplus relief is generated by a commission, that can be paid in cash or withheld. If withheld, the ceding company books a receivable and that generates the surplus improvement. Even though the assets and reserves remain on the ceding company’s books, the business is treated as reinsured so there is corresponding solvency relief to the ceding company.

The reinsurer is paid the profits in the business (premiums plus interest less claims less expenses less reserve increases). Out of the profits, the reinsurer deducts a risk charge (“fee”) and repayments of the outstanding relief. Transactions are structured so that the relief is repaid within a short time, typically five years. The repayment pattern might be on a scheduled basis. If that is the case, any profits payable to the reinsurer that are not needed for risk fees or repayment of relief are experience refunded to the ceding company. Once the relief is repaid, the business can be recaptured by the ceding company. Typically the reinsurer will have incentives for the ceding company to recapture. The ceding company may elect to extend the relief for subsequent periods through renegotiation.