

Finite Reinsurance

IAIS Guidance Paper



ASSAL XVII Annual Meeting
VII Conference Insurance Regulation / Supervision Latin America
Lisbon, Portugal, April 24 – 28, 2006

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Introduction / Introducción / Introdução

¡Estimados señoras y señores!

Perdónenme que mi presentación sea en inglés. Mis escasos conocimientos del español y portugués me permiten solamente decirles que pueden sentirse dichosos de que me estoy limitando a esta sola página.

¡Muchas gracias!

Estimados senhoras e senhores,

Peço desculpa por proferir a minha conferência somente em língua inglesa, mas os meus escassos conhecimentos das línguas portuguesa e espanhola são apenas suficientes para lhes comunicar que se podem considerar felizes que agora acabo por continuar a falar apenas em língua inglesa.

Muito obrigado!



Importance of finite reinsurance ...

... for insurance companies and supervisors

→ **Background concerning recent development:**

- Inappropriate accounting at insurer AIG
- Possible shortcomings are neither product nor industry specific
- Inadequate corporate governance
- Attorney Spitzer





Today's schedule on finite reinsurance

Index of contents

- IAIS and finite reinsurance (FinRe)
- Characteristics of FinRe
- Risk transfer and FinRe
- Accounting and FinRe
- Example: Germany's approach

- IAIS – Beyond FinRe





Importance of the IAIS

IAIS Mandate

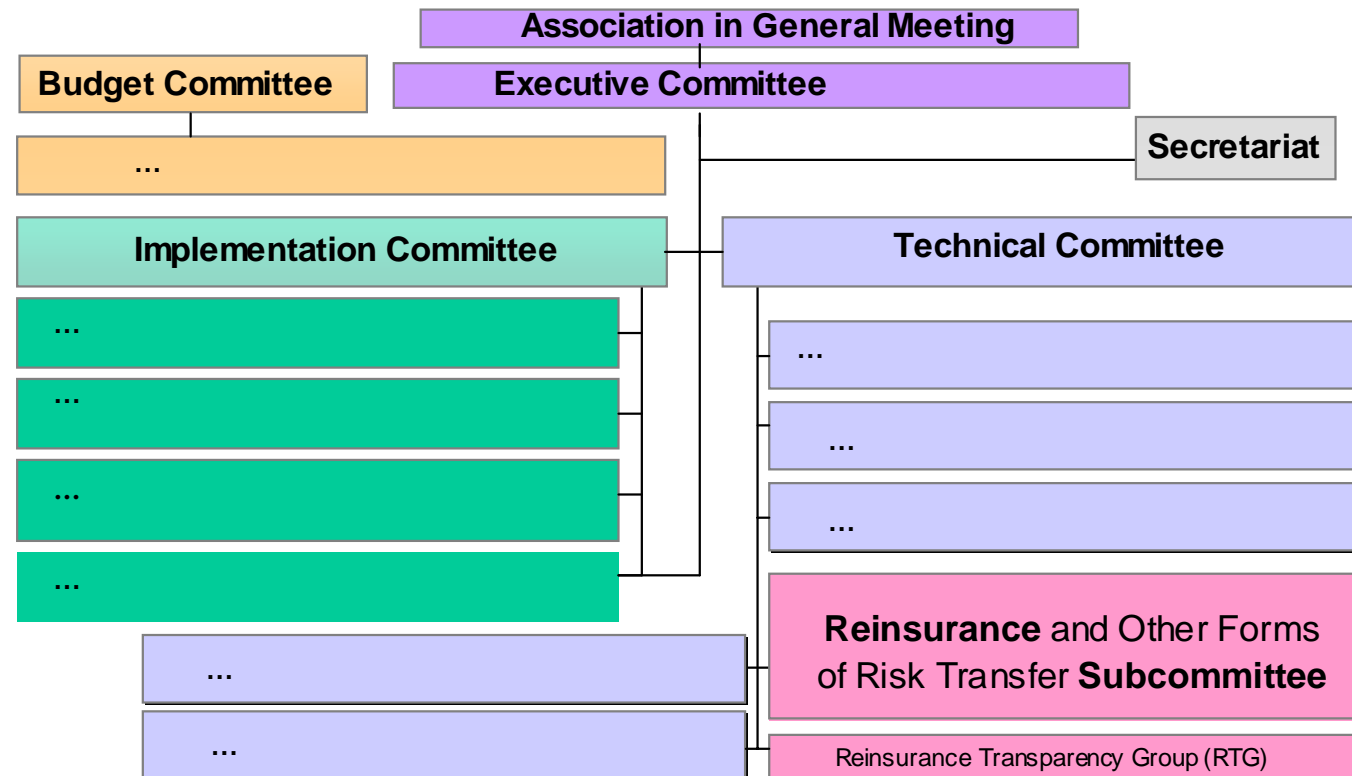
- Standards and **guidance** for insurance supervision
- Assist national supervisors
- Promote cooperation among insurance supervisors
- Coordinate with other financial sector and international organizations (Basel Committee, IOSCO, Joint Forum, Financial Stability Forum, etc.)





Structure of the IAIS

IAIS and Reinsurance Subcommittee





IAIS and finite reinsurance

Background

- Secretariat released first draft of FinRe paper, 25 May 2005
- “Guidance Paper on Risk Transfer, Disclosure and Analysis of Finite Reinsurance”
- Released 21 October 2005 at Annual IAIS Conference, Vienna



- Ongoing work (2006)
 - February, Basle
 - April, Boston
 - Mai, Ottawa
 - October, Peking



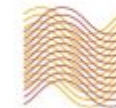
Finite reinsurance

Synonyms

- Finite reinsurance: Generic Term
- In some jurisdictions also known as, e.g.:
 - Financial reinsurance
 - Structured reinsurance
 - Non-traditional reinsurance



FINANCIAL REGULATOR
Rialtóir Airgeadais



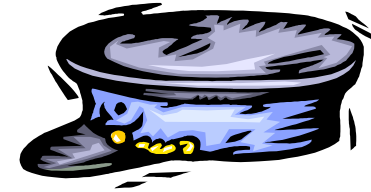
BaFin





Finite reinsurance

Definition



- So far there is no accepted global definition
- IAIS guidance paper uses generic term –
Finite reinsurance:

“An entire spectrum of reinsurance arrangements that transfer limited risk relative to aggregate premiums that could be charged under the contract”



Characteristics of finite reinsurance ...

... may be present at traditional and finite

- Assumption of limited risk by reinsurer
- Inclusion of future investment income in the price
- Potential profit sharing between parties
- Ceding entities' results determine pricing



Finite reinsurance

Legitimacy

- Finite reinsurance transactions are legitimate
- It is necessary to have:
 - Significant risk transfer
 - Appropriate accounting





Risk transfer (1/4)

Is a complicated issue

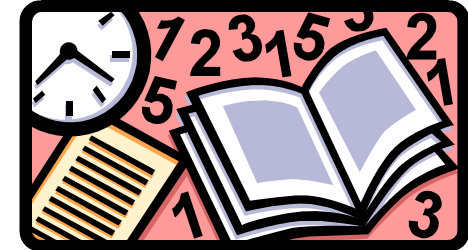
- There is a wide spectrum of risk transfer agreements ranging
- *From:* Purely financial arrangement
→ No underwriting or timing risk is transferred to reinsurer
- *To:* Quota share agreement
→ Risk transfer only limited by original underlying policies



Risk transfer (2/4)

Types

- Underwriting risk
 - Possibility of losses and expenses
 - Recoverable from the reinsurer
- Timing risk
 - Uncertainties about timing, for example:
 - Payments of net cash flows from premiums





Risk transfer (3/4)

When is it significant ?

- Question is important for a supervisor
 - Transferred risk determines
 - The appropriate accounting
- Determining “transfer of risk” requires complete understanding of
 - The contract between ceding company and reinsurer
 - All contractual features



Risk transfer (4/4)

“10 – 10” rule

- So called “10-10” rule is a “rule of thumb”
- 10% probability of a 10% loss on ceded reinsurance premium
- Test which checks “10-10”: “Risk transfer test”
- “10-10” is not codified under current statutory, GAAP or IFRS
- U.S. insurance industry routinely follows it
- But there are clear drawbacks concerning “10-10” approach

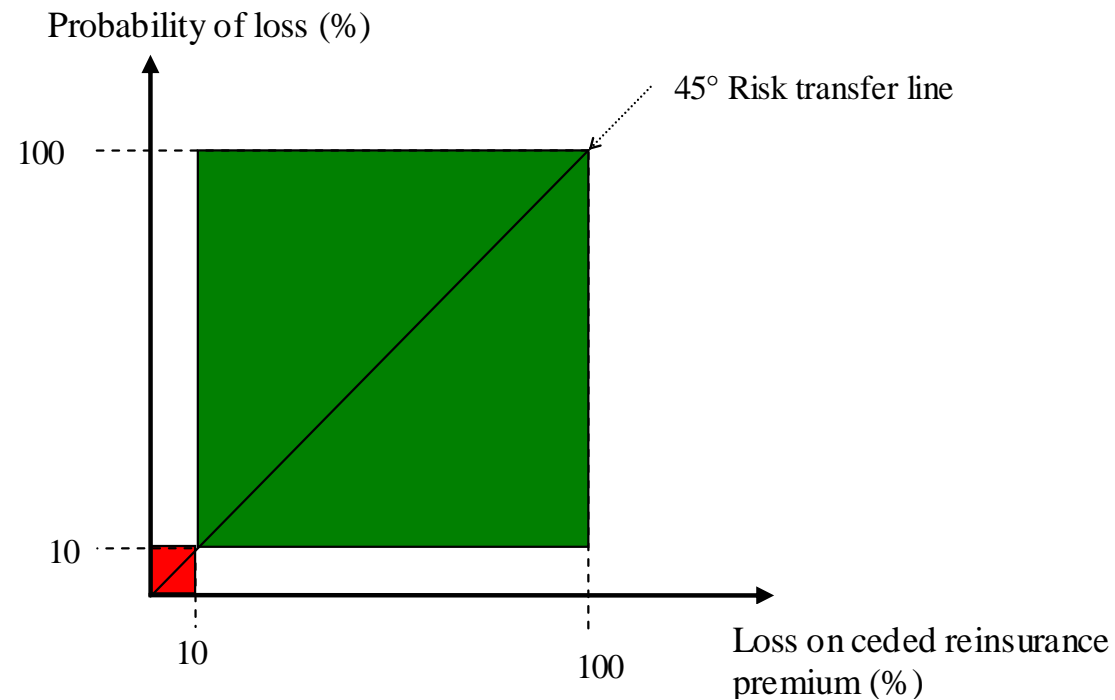
→ Important: Above considerations are made concerning “non-life” reinsurance – it would be inappropriate to directly apply these considerations for “life” reinsurance





Risk transfer test

Illustration of the “10-10” approach

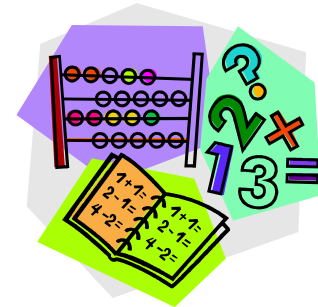




Determine risk transfer

Modeling

- Insurers should undertake an analysis of risk transfer (if necessary):
 - E.g. by using specific software tools
 - Results should be available to supervisors
- Modeling to determine risk transfer usually involves
 - Cash flow projections
 - Various scenarios

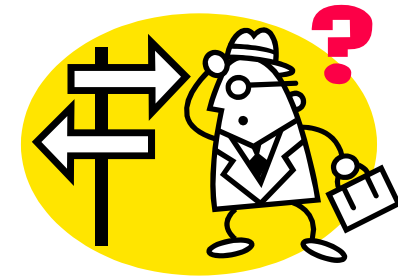




“10-10” approach

Question

- Are there situations in which the “10-10” approach could be inappropriate ?





“10-10” approach

Answer

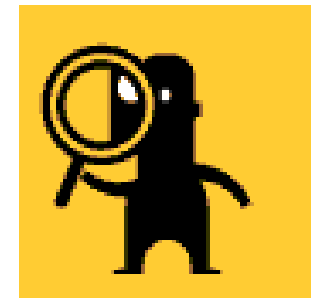
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Accounting for finite reinsurance (1/3)

Should display true and fair presentation

- Of the economic value of a transaction by insurers and reinsurers
- This should be ensured by well developed rules and effective enforcement





Accounting for finite reinsurance (2/3)

If acceptable risk transfer

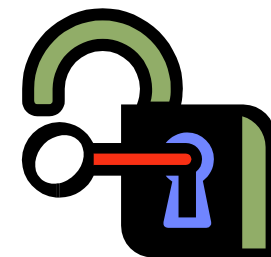
- Finite reinsurance arrangement is accounted for as reinsurance
- Benefit: Risk transfer is then recognized by supervisors
 - Via a reduction of capital requirements
 - In the capital adequacy calculation



Accounting for finite reinsurance (3/3)

If risk transfer criteria are not met

- Transaction should be accounted for as
 - Deposit or
 - Financing transaction
- Effect of inappropriate risk transfer
 - Amounts received from the reinsurer
 - Can reduce the deposit asset





A national example: Germany's approach

Accounting

- German commercial accounting law: principle-based
- Insurers are obliged to establish technical provisions
 - To ensure that funds are available at any time
 - To meet present and future policyholders' liabilities
- Federal Financial Supervisory Authority (BaFin) is entitled by law to enforce an adequate accounting



A national example: Germany's approach

Supervision



- Risk transfer
 - All reinsurance contracts (not only FinRe) have to comprise a sufficient risk transfer
- Collection of data and transparency
 - Adequate internal risk management for all contracts
- BaFin's possibilities of intervention include
 - BaFin may impose sanctions and fines
 - Moreover BaFin may replace the board of management



IAIS – Beyond Finite Reinsurance

Insurance Core Principle 26

- Exchange of information
 - Home supervisor should inform host supervisor about any action that will affect an insurer in the host supervisor's jurisdiction
- Disclosure
 - Insurers should disclose relevant information timely
 - Aiming at facilitating the understanding of exposed risks





International Association of Insurance Supervisors (IAIS)

A source for questions und answers



www.iaisweb.org



Thank you very much for your attention



April 2006
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