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Financial Reinsurance – do’s and don'ts

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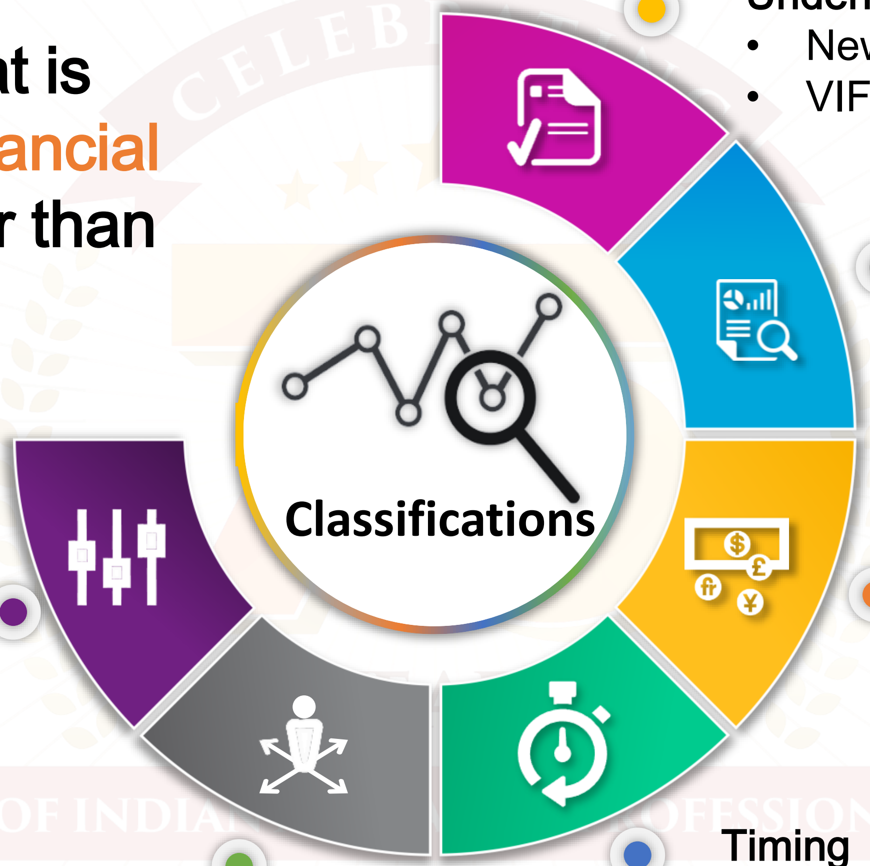
Agenda

- When to use Fin Re (and when not to)
- Market overview
- Alternatives to financial reinsurance
- Optimising the cost of capital

Fin Re - Quick overview

Reinsurance that is motivated by financial objectives rather than the risk transfer



Underlying business type
- New business financing/surplus relief
- VIF monetisation

Aimed at asset or liability
Increase of assets or reduction of liabilities

By liquidity/asset recognition requirements
Cash or non-cash financing

Timing
Immediate, differed, structured financing

Optional/contingent
- Insurer has option to draw subject to constraints
- Contingent on trigger events

Hybrid forms

When financial reinsurance helps

Create additional free assets/convert an intangible VIF asset into cash to:

- Finance new business strain or to write higher volumes for same strain
- Finance capital expenditure, planned expansion or a business acquisition

Improve profit recognition and / or profitability measures for new or in-force business:

- Some accounting bases can give distorted view of profitability
- improve the IRR on which new business is written

Improve quality of capital:

- Lock-in a proportion of an intangible VIF asset reducing volatility
- May send right signals to the market about focus on balance sheet quality
- Does not weigh on debt leverage

When financial reinsurance does not work

1. Purpose is to mis-represent the company's financial position
2. To facilitate a dividend which leaves the life fund too weak
3. Reinsurance can require payment from sources other than emerging surplus
4. No legitimate purpose - (e.g. risk transfer or access economic reserves)
5. Life business involving transfer of investment risk (except some markets/variations)

Current state of play

Regulatory


UK

- Under Solvency II transferred risk is not limited to underwriting risk
- Proof of significant risk transfer is usually required under local regulations
- Multiple financial instruments available as an alternative to Fin Re


Japan

- Financial reinsurance limited to coinsurance and modified coinsurance
- Reinsurance commission should be in cash
- Reinsurer cannot terminate
- At least quarterly settlements


United States

- Have to transfer at least one of the following risks: mortality, morbidity, lapse, credit quality, reinvestment and disintermediation
- If treaty doesn't transfer all of the significant risks inherent to business, insurer is not allowed to reduce liabilities/establish asset
- Financial reinsurance doesn't qualify as reinsurance under GAAP


South Korea

- IFRS 17 to be implemented
- Capital injections would be required for a lot of companies to maintain solvency position


Singapore

- Have to transfer at least one of the following risks: mortality, morbidity, lapse, credit quality, reinvestment and disintermediation
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Sri Lanka

- no specific regulations allowing or disallowing
- decisions on case by case basis

Current state of play

Transaction types

UK

- Based on Solvency II capital relief
- Mass Lapse
- Extreme mortality
- New business financing
- Longevity swaps

Japan

- Coinsurance, modified coinsurance
- Release of long term VIF
- Release of prudent regulatory reserves
- Protection from lapse/low interest rate risk

United States

- Enhancing regulatory solvency position
    - Both cash/non-cash
- Conditional loans
- Longevity risk transfers

South Korea

- Regulator reviewing possibility of coinsurance

Singapore

- Enhancing regulatory solvency position
- Relief of capital for extreme risks

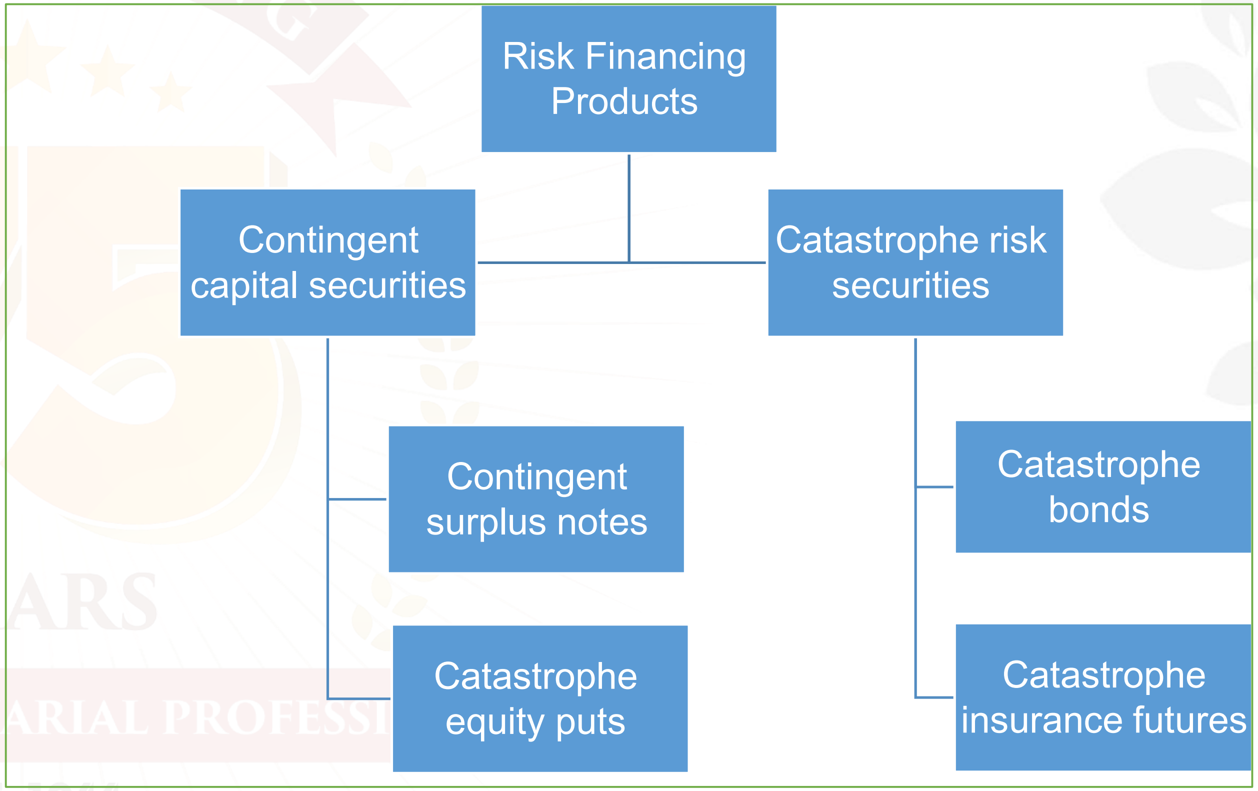
Sri Lanka

- No transactions as yet, expect first one in 2020

Alternatives to Financial Reinsurance

- Subordinated Debt
- Securitization
- Cumulative preference shares
- Contingent dept
- Derivative and dynamic hedging strategies

Risk Financing Products



Benefits of Subordinated debt

Subordinated dept

- Capital is transferred directly to the insurer’s balance sheet
- Enables insurer to write additional business
- Enhances the return on equity
- Does not amortise over its term, the full amount is eligible as regulatory capital until maturity
- No dilution of control for shareholders and no voting rights are conferred to the note holder
- Long term nature can facilitate financial planning by offering long term cost of capital certainty
- The proceeds of the loan can be invested to earn a return with tax deductible interest payments

Subordinated Debt and Reinsurance

	Sub Debt	Reinsurance
Duration	Fixed (+10 years)	Flexible (usually annually negotiated)
Risk mitigation	No	Yes
Communication	Is public	Is private
Counterparty risk	No	Yes
Work required	Achievable within shorter period	Complex process requiring many parties to participate
Difficulties	Price dependent on historical company performance	New issuance /required return can be unavailable because of downgrades/poor market performance

$$\text{Solvency Ratio} = \frac{\text{Eligible Capital}}{\text{Capital Required}}$$

Subordinated Debt and Reinsurance

Cost considerations

Reinsurance

- Risk free rate
- Liquidity considerations (cash vs non-cash)
- Currency risk
- Cost of transaction (if new)

Value of the initial consideration also matters: on VIF monetization transactions it is usually 65 - 75% of the VIF

Subordinated dept

Cost is driven by:

- the annualised issued cost loading
- spread over the swap rate (risk-free rate)

Capital increase will be decreased by:

- issuing process
- coupon (typically based on yield to first call day)

Subordinated Debt and Reinsurance

Optimising cost of capital

Reinsurance

$$Target\ Solvency\ ratio = \frac{Own\ funds - Cost\ of\ Reinsurance}{Existing\ Capital - Capital\ Relief}$$

Subordinated dept

$$Target\ Solvency\ ratio = \frac{Own\ funds + Dept\ amount\ (1 - Cost\ of\ Capital)}{Existing\ Capital}$$

For reinsurance to be cost effective:

$$Cost\ of\ Reinsurance \leq Cost\ of\ Debt\ Capital * Dept\ amount$$

For reinsurance to be a more cost-efficient solution, the cost of capital for sub dept should be:

$$Cost\ of\ Capital \geq \frac{Cost\ of\ Reinsurance}{Target\ Solvency\ Ratio * Existing\ Capital - Own\ Funds + Cost\ of\ Reinsurance}$$

Blended approach

Target

- free up/raise capital in the most cost-effective manner

- Reduce the possible risk of increased costs resulting from multiple deals through deal coordination, selective marketing and broker placement expertise

Considerations

- Combination of reinsurance and debt issuance
- Small transactions instead of large ones
    - easier to evaluate/implement
    - easier to manage/trace raised capital
    - less regulatory scrutiny comparing to large transactions

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Thank You