Capital can be Hard to Find: Using Reinsurance to Finance Growth Initiatives

Life insurers are raising and managing capital in an ever-more challenging financial and business environment, with smaller insurers facing particular difficulties. In response, reinsurance – already a key risk management tool for insurers – has another capital offering up its sleeve: 'Financing reinsurance' is a straightforward and efficient reinsurance transaction that can release capital to insurers at the time it's most needed.

Life insurers are used to buying reinsurance: (1) to transfer risk to limit volatility in future income, results or capital needs; (2) to receive product development, underwriting or other services; and (3) to reduce current capital needs or improve returns on current capital. Within the third category, reinsurance structures can reduce the required capital through transfer of risk to the reinsurer (solvency or capital support solutions) and provide an alternative means of raising capital, a structure referred to as 'financing reinsurance'.

Financing reinsurance in a nutshell

A financing reinsurance contract is a traditional reinsurance quota share treaty that is additionally geared either to helping alleviate the cost of acquiring new policies (new business strain financing) or to the early realization of the value of in-force policies (value-of-inforce financing), enabling an insurer to finance growth initiatives at any time. The financing is essentially an upfront commission from the reinsurer based on the expected future earnings of the new or existing treaty portfolio (in which the reinsurer participates), which is then repaid over time on a contingent basis from actual earnings.

To alleviate new business strain

The reinsurer, recognizing the initial high financial burden of acquiring new business, supports the insurer in the establishment and/or expansion of the portfolio by providing an upfront commission[1] that is calculated on a policy-by-policy basis. The financing is of particular value to young, fast growing insurers as the initial stages of building up a portfolio incur particularly high costs, frequently exceeding the premium income in the first year and hence resulting in a technical loss[2]. In addition, because the volume of the financing depends on the volume of new business written, financing reinsurance is also often more cost effective than borrowing a fixed amount of capital (which may be insufficient or excessive).

Once the portfolio in question moves into positive cash flows, the reinsurer's pre-financing expenses are reimbursed from the portfolio's regular earnings.

To facilitate other growth initiatives

Of course, new capital-intensive opportunities (or additional capital requirements, such as from regulatory

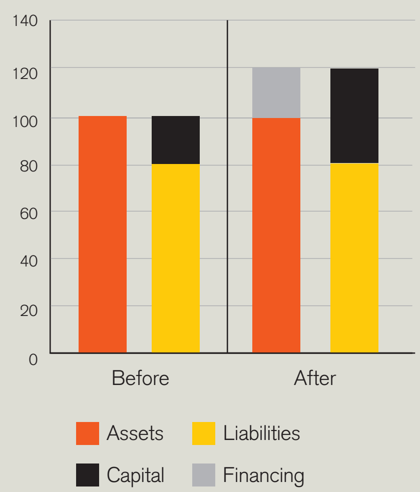

Figure 1: By using financing reinsurance, the life insurer's capital is increased by the value of the financing. In most jurisdictions this has no impact on balance sheet liabilities because the reimbursement of the financing is contingent on the performance of the associated quota share reinsurance business. Source: PartnerRe.

[1] As cash or non-cash options.
[2] Many statutory and some financial accounting systems do not allow insurers to fully capitalize their initial expenses. This initial loss does not reflect the true profitability of the policies.

change) for life insurers can and do arise at any time. For these, the same financing principles can also be built into quota share treaties on existing business, realizing the future profits of a portfolio at its present value for reinvestment into other business opportunities or needs. The reinsurer receives repayment of the financing from the regular earnings of the portfolio. This is referred to as value-of-in-force financing[3]. As financing re-payments are contingent on the development of the portfolio, the amortization period for the financing component is in both cases not fixed. Once fully amortized, the corresponding treaty continues as a traditional risk premium treaty including profit commission.

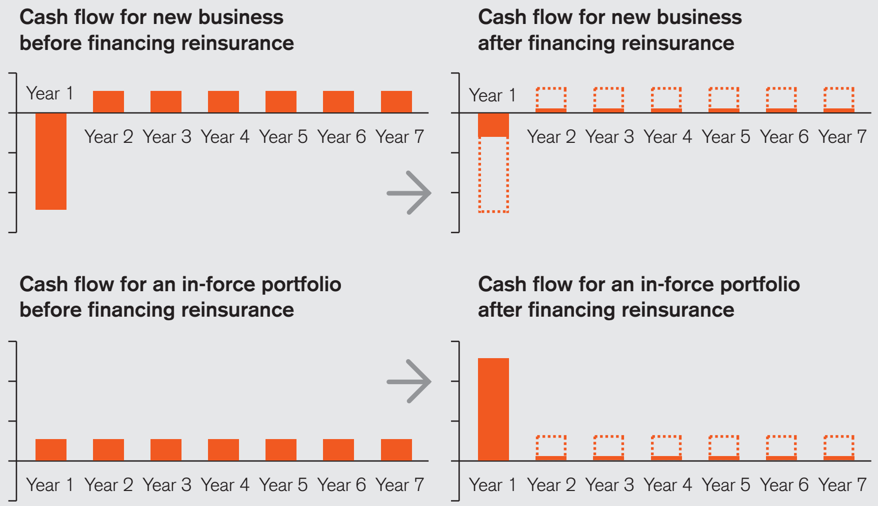

Figure 2: Insurer cash flow before and after financing reinsurance applied to: (a) new business and (b) an in-force portfolio. Financing reinsurance alleviates the initial high costs involved in acquiring new business via an upfront commission that is repaid on a contingent basis over time from future earnings. The same principle can also be used on existing business, realizing future earnings from an existing portfolio at a time when surplus capital is required for other reasons, such as for growth initiatives or to meet new regulatory requirements. Source: PartnerRe.

An effective capital management tool for insurers

A financing reinsurance solution must be optimally tailored to the company in question: the size of the transaction, the amount of risk transfer, the cost of the resulting capital, the timing of the capital benefit and the underlying business are all company specific and depend on exactly what a life insurance company is trying to achieve. The available capacity will be limited at the group scheme and/or individual company levels: the other capital management options being utilized will therefore also have an impact on the best form of the financing.

A well-structured financing reinsurance program can offer the following advantages:

- Flexibility of duration, size and structure: Capital 'when it's needed'
- Minimal transaction costs and short transaction times
- A single, transparent contract
- Risk protection beyond capital investment and therefore reduced risk-based capital requirements
- Aligned interests: continuity via a stable, long-term business partnership
- Additional services from the reinsurer, such as medical underwriting, claims management and product development.

In all these respects, financing reinsurance compares particularly well to other available means of accessing capital from public sources, including share issuance and subordinated debt.

Contractual aspects

In all instances, a financing reinsurance solution is part of a traditional reinsurance risk transfer, quota share treaty, with aligned interests between the insurer and reinsurer. Wording is added to the associated treaty contract to define the details of the commission and pay-back arrangement.

Each reinsurance financing solution is fully tailored to the insurer's needs, product and market, and is developed in conjunction with underwriters and auditors, and with full transparency to the insurer's board, external auditors and regulators.

When negotiating and structuring the contract, the reinsurer will require additional details over those requested for a treaty without financing, essentially to add clarity in respect of cash flow models and sensitivities, business planning and operational processes.

Of course, the future is uncertain and many factors could negatively impact the expected future profitability of a portfolio. To mitigate these risks and to ensure that party interests remain aligned throughout the contract, a number of additional contractual measures are usually included. For example, the contract will contain strict termination clauses (such as transfer of rights and obligations in the case of insurer insolvency), lapse claw-back conditions (for changes in policy-holder behavior) and wording relating to IT and administrative processes. Access to business plans and close contact with the insurance company's executives will also be required throughout the amortization period.

[3] For value-of-inforce financing, the commission does not vary with the portfolio premium volume, as it does for new business financing reinsurance contracts, but is calculated as a fixed value on the existing book of business.

Cash flow detail

In standard financing reinsurance structures, the cash flow is dominated by upfront commission payments and the corresponding amortizing components:

- For new business strain financing, the reinsurance commission follows the commission payments of the written policies. Usually, the scope includes all new business financing that is written within a certain period, e.g. one year.
- For value-in-force transactions, the reinsurance commission is paid to the insurer as a lump sum at inception of the treaty.
- The reinsurance premiums consist of the treaty's risk premium and amortizing components of the financing.
- For lapsed policies, claw-back commissions should be agreed.
- There may be additional fund fees based on the saving part (if any) of the ceded policies. The saving part itself is normally not reinsured (reinsurance on risk premium basis).
- The term of the amortization period is generally not fixed, but moves according to the amortization of the outstanding financed amount.

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Successfully applying financing reinsurance necessitates in-depth technical and market knowledge, a multi-disciplinary team including accounting, financing, tax, actuarial, legal, underwriting, reserving experts and consultation with auditors and regulators. Life insurers will therefore benefit most from a secure, experienced partner who can bring all these areas of expertise to the table to help them achieve their exact objectives.

PartnerRe has a dedicated multi-disciplinary team of life experts working in global life markets developing financing reinsurance solutions for its clients. Please contact us if you have questions or would like to discuss this potential capital source to finance growth initiatives within your company: www.partnerre.com.

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