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Current Issues in Life Reinsurance
Are actuaries at risk ?

Andrew Linfoot
Director, Asia

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Agenda

- Current Issues
- Implications for Actuaries
- Strategies for Risk Reduction

Current Issues

- **Recent actions in the US by the New York Attorney General and the US Securities and Exchange Commission have made finite reinsurance a current topic of concern**
- **So far this year, 3 insurers have restated multiple years of past earnings (Marketwatch 21.7.05):**
  - Renaissance Re
  - AIG – USD3.9b reduction in earnings, 2.6b reduction in book value, USD50b drop in market value (Bloomberg 31.5.05)
  - ACE – negligible effect on earnings
  - One US CEO subsequently resigned and is facing a fraud lawsuit from the NY AG (LA Times 5.7.05)
- **Two major international reinsurers are being investigated for their role in these transactions:**
  - A former senior executive from 1 plead guilty to 2 criminal charges of conspiring to misstate financial statements involving one of the above transactions. (The Insurance Journal 7.6.05)
  - A new investigation into another reinsurer was announced (The Irish Times 21.7.05)
- **More than 20 other insurers subpoenaed (Marketwatch 21.7)**

Current Issues

- **The primary regulatory concern has been the use of finite reinsurance to distort the balance sheet of ceding insurers, for various purposes, including:**
  - Eliminating volatility in losses from period to period ("earnings smoothing")
  - Concealing the impairment of assets
  - Misleading users of financial statements by increasing apparent strength.
- **Finite Reinsurance is generally defined as a form of financial reinsurance that takes the time value of money into account—finite reinsurance typically involves:**
  - Risk transfer and risk financing are combined in one contract
  - The reinsurer's assumption of risk is limited
  - The reinsurance contract covers multiple years
  - Results can be shared with the ceding company

Current Issues

- **The transactions that have drawn regulatory attention were reported as reinsurance, even though there were arrangements in place, including side letters, ensuring that reinsurers would not take on underwriting risk**
  - Many of these transactions were used to support substantial understatements of earnings in a particular accounting period, even though losses would ultimately be recognised (thus "smoothing" reported earnings from period to period)
  - In some cases, finite reinsurance was used to bolster the assets of troubled insurers
  - Loss of reinsurance accounting has required insurers to restate earnings for the affected periods
- **Finite reinsurance should be reported as reinsurance on financial statements if, and only if, the agreement transfers significant risk of loss to the reinsurer**
- **Under US accounting rules for reports to both regulators and investors, there must be a transfer of significant underwriting and timing risks, and there must be a reasonable possibility of loss by the reinsurer**
  - Stated another way, the risk of loss must be more than "remote"
  - The form of the transaction is not controlling: there cannot be any other arrangements by which the reinsurer is protected from loss

Current Issues

- **It is useful to keep in mind that there are legitimate uses for finite reinsurance**
  - If the reinsurer takes on substantial underwriting risk, reinsurance accounting would generally be appropriate
- **It is also important to bear in mind that it isn't the transaction itself that is illegal, merely its misrepresentation in the financial accounts as reinsurance (if it doesn't qualify).**
- **The New York Insurance Department initiated a requirement that insurers to attest that they have not entered into agreements under which:**
  - There are written or oral side agreements that reduce the risk transferred to a reinsurer
  - The reporting insurer or reinsurer has maintained a file supporting the accounting treatment of the transaction
- **The draft EU Reinsurance Directive contains guidelines for finite reinsurance – see Annex for further detail.**

Current Issues - Life Reinsurance

- **Finite reinsurance has more commonly been used by non-life insurers**
- **In the life insurance business, coinsurance transactions are frequently used to realise the value of future profits, which can be used to increase the ceding insurer's surplus for regulatory accounting purposes**
  - In a "proper" surplus relief transaction, the reinsurer assumes a contractually agreed share of the risk that losses will exceed premiums and investment income—without limit
- **The reinsurer is entitled to retain the appropriate share of the profits, if any, that emerge from the reinsured business**
  - In such agreements it is permissible to share profits through such things as experience refunds, but losses should not be shared
- **Similar effects have also been achieved using risk premium transactions, although these will typically only share the mortality/morbidity risks.**

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Implications for Actuaries – Why should we care ?

- **As reported in the Royal Gazette of 25 July 2005,**
  'Auditors, actuaries, consultants and investment banks will be among the growing number of companies named in finite risk lawsuits…'
  - The article reports on a speech made at a recent conference by David Bradford, EVP of Advisen Ltd, an advisory firm, and goes on to indicate the broadening scope of firms and professionals becoming involved
- **In recent months, he New York AG's investigations have progressed from the securities industry, to insurance brokers and now to general insurers/reinsurers.**
- **General insurance actuaries should already be concerned - in last 12 months (www.apra.gov.au):**
  - An actuary 'self-disqualified' in relation to Zurich Life (Australia) investigation into misleading reporting of financial reinsurance transactions
  - 6 reinsurance executives were disqualified (from acting as a director or senior manager of a general insurer/reinsurer) for their role in constructing a reinsurance deal for FAI *for a purpose they knew to be misleading.* None were actuaries, but…
  - Not directly related to reinsurance transactions, 2 actuaries disqualified in relation to HIH collapse.

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Implications for Actuaries – Why should we care ?

- Perhaps attention will turn to life reinsurance transactions ?
- Maybe a large life insurer will become insolvent, and the regulator will wonder where the actuaries were ? eg The Equitable
- As regulators, ratings agencies, consumer groups and other take a closer interest in how we execute our professional responsibilities, we will need to be able to reassure these stakeholders that we can do so effectively.
- Presumably the actuaries who have already had action taken against them did not set out to be deceptive. Probably caught in a very difficult position and didn't have sufficient experience to choose the correct path.

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Strategies for Risk Reduction – What should we do ?

- In Relation to Reinsurance Transactions:
  - If transactions are booked as reinsurance, they must comply with minimum risk transfer requirements. If not, they may still be valid, but should not be reported as reinsurance.
  - If you don't understand something, ask questions, and keep asking until you are satisfied with the answer.
  - You should involve other professionals in their area of expertise, eg accountant, auditor, legal advisor etc.
- Most (life) financial reinsurance arrangements do contain risk transfer, and I believe most in Asia are not designed to mask a company's financial picture, but to strengthen the insurer's balance sheet by transferring risk to the reinsurer, in exchange for a premium.

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Strategies for Risk Reduction – What should we do ?

- **Role of the individual**
  - We must be strong and principled.
  - Sometimes we have to deliver 'no' for an answer.
  - Compromise is an integral part of business, but integrity must never be compromised.
  - If in doubt – ask questions: colleagues, peers, other actuaries
  - If something doesn't 'feel right', there's a good chance it isn't.
  - A lot of our work is numerical and routine, but we are distinguished from mathematicians and bookkeepers by our use of judgement.
  - Maintain your professional network – former colleagues, classmates, customers, suppliers etc.
  - Encourage good corporate governance in your firm
- **"Front page test"**

Strategies for Risk Reduction – What should we do ?

- **Role of the profession**
  - To provide a high quality education path for actuaries
  - Provide a formal and informal support network
  - To encourage lifelong learning for members by encouraging CPD
  - To develop guidance notes and practice standards to deal with contentious topics

  - By acting as a well organised profession rather than an individual, our methods and results are less likely to be challenged or disputed.

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- **Potential Discussion Topics:**
  - Has anyone felt pressured into signing an actuarial statement they didn't agree with ?
  - Has anyone *refused* to sign an actuarial statement ?
  - Can/should local professional bodies support their members more ?

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Annex

- **The draft EU Reinsurance Directive defines "finite reinsurance" as follows:**
  - reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract, for a limited but significant amount, together with at least one of the two following features: (i) explicit and material consideration of the time value of money; or (ii) contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer.

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Annex

- **Fitch's definition:**
  - "Finite risk reinsurance is a form of reinsurance that explicitly considers the time value of money in addition to the expected amount of the loss payments in nominal dollars. The insurance risk assumed by a finite risk reinsurer is contractually limited so that the reinsurer's range of possible losses is relatively narrow. The primary emphasis is on risk financing rather than risk transfer, although finite risk transactions contain elements of both.
  - Furthermore, it is common for the contracts to include a retrospective or dynamic pricing mechanism in which the ceding company is either refunded portions of its premium if experience is good, or is required to make supplemental premium payments if experience is poor. Typically, the margin earned by the reinsurer selling the contract is modest, and true economic revenues earned by the reinsurer are represented by a fee payment as opposed to premium ceded."

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