# Finite reinsurance: a risky business?

**David Raim** and **Joy Langford** of Chadbourne & Parke LLP explain the workings of finite reinsurance and highlight recent worldwide regulations which affect its usage.

Finite risk reinsurance has increasingly taken front stage over the past few years. In the United States, both federal and state authorities – most notably the Securities and Exchange Commission (SEC) and the New York attorney general's office – are conducting investigations into the use of finite risk reinsurance. A number of additional investigations are underway in Europe and Australia. These investigations have resulted in civil and criminal actions against several companies due to the alleged use of finite risk reinsurance to improperly mask adverse financial results.

## What exactly is finite risk reinsurance?

There is no generally accepted definition of finite risk reinsurance. Broadly speaking, it is a form of reinsurance that carefully controls and limits the amount and type of risk transferred to the reinsurer, hence the use of the word "finite". It can be distinguished from other non-finite or "traditional" types of reinsurance based on the extent to which there are limitations on the risk that the amount of losses will exceed ceded premiums. This risk is generally referred to as "underwriting risk". While traditional reinsurance may limit the amount of underwriting risk transferred to the reinsurer, finite risk reinsurance does so to a greater extent. Instead, finite risk reinsurance focuses primarily on financial risks, such as timing risk (the risk that losses will need to be paid sooner than expected), investment risk (the risk that the reinsurer will earn less investment income than expected on the reinsurance premium) and credit risk (the risk that the cedent will not make the required premium payments). Sometimes, the principal risk assumed by the finite risk reinsurer is that losses will develop more quickly than expected and the reinsurer will lose the benefit of anticipated investment income on the reinsurance premium.

## Various aspects of finite risk

Finite risk reinsurance contracts are typically treaties that are manuscripted to meet the particular needs of a cedent. They may be quota share or excess of loss treaties and may cover prospective losses or retroactive losses that have already occurred, but where the amount and timing of the loss is not yet known. There are some key features, however, that are present in many finite risk reinsurance contracts. Most contracts cap underwriting risk, include an explicit recognition of the time value of money, contain a profit sharing mechanism and/or span several years. Each of these aspects of finite risk reinsurance contracts are discussed in turn below.

Firstly, finite risk reinsurance contracts cap the amount of underwriting risk assumed by the reinsurer. In the case of quota share contracts, this is often achieved through the use of a loss ratio cap which limits the reinsurer's losses to a percentage of the insurer's written premium. Excess of loss contracts typically reflect a set dollar amount that places a ceiling on losses.

Secondly, the time value of money is often recognised in finite risk reinsurance through the use of experience account provisions. An experience account is funded by a relatively large reinsurance premium, minus some fees, which then accumulates investment income over time. The parties intend for a significant percentage of loss payments to be funded by the experience account, thereby limiting the risk that the reinsurer will need to pay losses out of its own pocket.

Thirdly, finite reinsurance contracts often contain a commutation clause that allows for profit sharing between the cedent and reinsurer. Such commutation clauses typically allow the cedent to terminate the contract if the experience account balance is positive. The reinsurer is released from any future obligation to pay losses and, in exchange, the cedent receives all or part of the positive balance in the experience account.

Lastly, finite risk reinsurance contracts generally span several years. This allows an individual cedent to mitigate volatility by recognising a loss gradually, rather than all at once.

## Accounting for finite risk reinsurance

In the United States, a finite risk reinsurance contract, like any other reinsurance contract, may only be accounted for as

reinsurance if it (1) transfers significant underwriting and timing risk and (2) creates a reasonable possibility of a significant loss. Over the years, the accounting profession has developed a numerical rule of thumb requiring at least a ten percent probability of a ten percent loss to assist in applying this subjective standard. This rule has been criticised by some in recent months. While other countries have their own accounting rules, most generally track the basic principles underlying those in place in the United States.

## Regulatory investigations and proposals

Regulators have responded to the investigations into the use of finite risk reinsurance and ensuing civil and criminal proceedings by proposing new regulations. The regulations appear to be designed to generate greater transparency and disclosure regarding the use of finite risk reinsurance. The following is a brief summary of the regulatory developments to date in Australia, Bermuda, the European Union, Ireland, the United Kingdom and the United States:

### Australia

The Australian Prudential Regulation Authority (APRA), the regulator of the Australian financial services industry, initially turned its attention to finite risk reinsurance when it concluded that the alleged misuse of finite risk reinsurance contributed to the 2001 collapse of the HIH Insurance Group – Australia's largest corporate failure to date. In May 2005, APRA proposed strict requirements for the approval and documentation of "limited risk transfer arrangements". (See http://www.apra.gov.au/policy.) Companies would have to seek the approval of APRA prior to entering into such arrangements. APRA has proposed that the new regulatory requirements take effect in January 2006.

### Bermuda

Regulators at the Bermuda Monetary Authority (BMA) have announced that they intend to tighten laws on how certain finite risk reinsurance arrangements are reported.

### European Union

The European Union (EU) is planning to create a single reinsurance market through the adoption of a proposed reinsurance directive. The directive contains provisions requiring the disclosure of finite risk reinsurance contracts to regulators. Moreover, it permits the country where the reinsurer is domiciled, referred to as the company's "home state," to promulgate additional requirements for finite risk reinsurance. (See http://www2.europarl.eu.int/oeil/ file.jsp?id=243432.).

The Irish Financial Services Regulatory Authority (IFSRA) has asked each reinsurance group in Dublin's International Financial Services Centre (IFSC) to verify that there are no "issues" with finite risk reinsurance contracts they have written.

### United Kingdom

The Financial Services Authority (FSA) requested that insurers provide information on their use of finite risk reinsurance and certify by the end of April 2005 that they have not entered into finite risk reinsurance contracts which might "obscure the firm's financial position or could put the firm at risk of breaching any regulatory requirement." (See http://www.fsa.gov.uk/pages /about/media/pdf/ engineering_letter.pdf.) The FSA has also announced that it intends to review current regulations to determine whether to require companies to provide additional disclosures.

### United States

The Securities and Exchange Commission (SEC) and the New York attorney general, as well as a number of state insurance departments, have subpoenaed many companies as part of an investigation into finite risk reinsurance. These investigations have prompted the Financial Accounting Standards Board (FASB), National Association of Insurance Commissioners (NAIC) and New York Insurance Department, among others, to propose new rules to govern the use of finite risk reinsurance.

The FASB is also currently considering modifying the risk transfer criteria for finite risk reinsurance contracts.

The NAIC announced on May 11th 2005 that it is taking steps to amend the disclosure requirements for companies that use finite risk reinsurance. (See http://www.naic.org/pressroom/releases/rel05/Finite_Re_Update.pdf.) These requirements would compel companies to report any agreement that has the effect of altering policyholders' surplus by more than three percent, or represents more than three percent of premium or losses. The NAIC is also considering requiring CEOs and CFOs to attest to the propriety of the accounting treatment of finite risk reinsurance agreements and the absence of side agreements that modify apparent risk transfer.

In addition, in March 2005 the New York Insurance Department issued a circular letter requiring that the CEO of a company attest that there are no side agreements to a reinsurance contract that could limit its downside risk and that the company has an underwriting file documenting the economic intent of the transaction as well as a risk transfer analysis "evidencing the proper accounting treatment." (See Circular Letter No. 8 (March 2005) at http://www.ins.state.ny.us/cl05_08.htm.) It has additionally proposed changes to the statutory accounting rules that would require finite reinsurance contracts to be bifurcated to separately reflect their financing and risk transfer components.