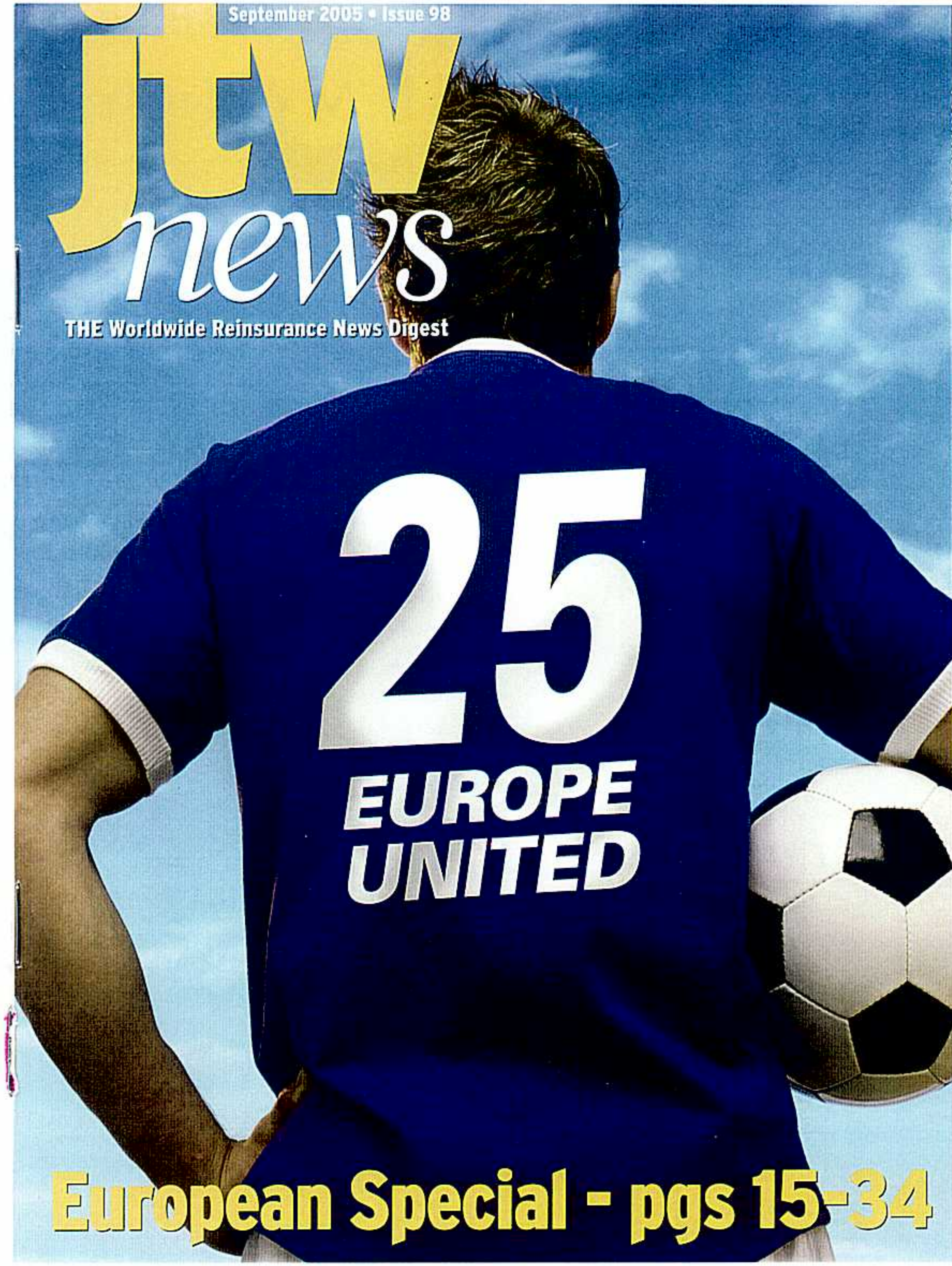

September 2005 • Issue 98
jtw news
THE Worldwide Reinsurance News Digest
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EUROPE UNITED
European Special - pgs 15-34

State of the ART

Thomas Renggli from PartnerRe shares his views on ART, finite in particular, highlighting the issues and steps necessary for programs to be a successfully applied, integral component of reinsurance risk transfer.

Alternative Risk Transfer (ART) offers cedants a variety of additional risk transfer solutions with which to protect their balance sheets. These solutions are designed to protect a cedant's portfolio in situations where traditional reinsurance cannot, thereby complementing, but not replacing, traditional reinsurance. Structured (or finite) reinsurance solutions form a large sub-category of ART, comprising programs with one or more of the following defining features: ultimate capped liability of the reinsurer, some form of experience-account built up by reinsurance premiums, some form of expiry profit commission in the case of favourable loss development, the anticipation of some form of investment return on the experience-account and multi-year and/or multi-line structures.

Recent bad press, however, has brought doubts as to the validity of some ART instruments, which has been associated with the high profile failure of certain organisations. It is held by some that finite programs might tempt management to delay difficult management choices or to distort the optics of financial statements by smoothing results over time. There is certainly a general feeling of scepticism for these covers amongst the rating agencies. Despite this, demand for structured reinsurance is strong and reinsurers continue to formulate and offer cedants these protections. There is clearly a positive side to this story.

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New methods, old values

Traditional reinsurance is bought to increase capital availability and to reduce volatility in results. Finite transactions do the same but in a more focused manner; these transactions typically absorb reinsurance capital more efficiently than traditional reinsurance (achieved through the lower aggregate limit and the other above-mentioned features). Reasons for purchasing finite are manifold, but in addition to transferring risk, buyers typically focus on the more efficient use of the cedant's solvency, rating and economic capital. The key issues here, however, as with traditional annual reinsurance, are transparency and flexibility. With these, the benefits to the client from these solutions can be achieved and optimised.

In terms of transparency, the risk transfer element of all structured solutions should be properly and clearly conveyed by the cedent to the appropriate interested parties, which may include senior management, auditors and/or regulators. As it stands today, in all the main financial markets reinsurance accounting rules require a sufficient level of risk transfer to the reinsurer. It is critical therefore that the reinsurer has the expertise to organise solutions, which both fit with the required needs of the clients and which include adequate risk transfer according to the particular structure of the solution. Programs that do not fulfil the necessary criteria are not forbidden per se, but are then considered to be banking products (such as deposits or loans), having their own specific, accounting rules.

Non-traditional reinsurance solutions do not differ significantly from one provider to another. However, the approach of the providers is very different. At PartnerRe the traditional and non-traditional reinsurance specialists work in close co-operation and ART products are seen as an additional tool to protect the clients' portfolio. Our client partners, underwriters and actuaries have an in-depth knowledge of the client's portfolio and can blend traditional risk coverage into a non-traditional solution as needed. This knowledge sharing and close co-operation enables us to offer coverage even for quite small transactions relating to a specific problem as well as for larger transactions across several business lines.

We also insist on transparency, stipulating that for non-traditional contracts the cedent warrants that all necessary approvals are obtained. We also believe in the importance of structural flexibility. Our specialists work in close cooperation with our traditional reinsurance client partners, underwriters and actuaries, sharing knowledge to ensure that each client's portfolio is protected by an optimal combination of traditional and non-traditional solutions, to the overall benefit of the client. As long as finite reinsurance continues to provide legitimate client benefit, demand will continue, and finite as an important ART category will remain an integral component of insurance and reinsurance risk.

How can an ART solution help?

Let's take equalisation reserves as an example: new accounting and solvency guidelines will sooner or later make equalisation reserves a costly alternative in terms of capital requirements. Insurers with high premium volumes in volatile lines, such as liability, credit, marine and cat, will be most affected, as will life insurers who will no longer be able to include expected profits in solvency calculations. One solution is a multi-year contract, in which reinsurance premiums provide a similar benefit to equalisation reserves, whilst actual risk transfer is made of unexpectedly sudden or high losses. By using less reinsurance capital, all non-traditional reinsurance can reduce risk financing costs. Further, as an advantage over increased self-retention, reduction in the volatility of results is also achieved – since the majority of these solutions involve a degree of risk transfer.