# Capital-Motivated Reinsurance:
# A tool with many benefits

Capital-motivated reinsurance has grown into a reliable means of optimising insurer capital to suit a broad range of requirements. Using it to its best advantage, however, takes knowledge and expertise. **Mr Gaston Nossiter** of **RGA Asia Pacific** elaborates.

Over the past decade, capital-motivated reinsurance has emerged as a strategically powerful and fiscally sound portfolio optimisation tool for the capital management needs of today's life insurance companies.

With the ongoing global financial crisis continuing to make access to debt and equity capital both difficult and costly, insurers need a reliable, flexible, and cost-effective means of accessing high-quality capital, not only to meet risk mitigation and reserve funding needs, but also to maximise capital efficiency. Such capital efficiency enables achievement of financial return targets, solvency requirements, and market needs such as competitive pricing and product development.

## Capital management and risk reduction strategies

Capital-motivated reinsurance can fit this bill. By utilising familiar reinsurance structures, from yearly renewable term to coinsurance and modified coinsurance, insurers can avail themselves of a broad range of capital management and risk reduction strategies.

These strategies can range from de-risking a block of fixed annuity business, releasing the embedded value of an in-force block of business, or providing financing to ease the strain of either launching a new product or funding a merger or acquisition. Indeed, in Canada, more than two thirds of all mortality business is reinsured primarily to improve capital and financial returns.

Through capital-motivated reinsurance, insurers can manage their risk, improve their solvency margins, and increase the amount of capital available – all without the insurer needing to issue debt or equity.

## Capital-motivated reinsurance in Asia

For Asia, much as throughout the rest of the world, the global financial crisis that erupted in 2008 both severely contracted debt and equity capital's availability and sparked a rise in their costs.

This squeeze highlighted the need for insurers to access more capital sources, which over the past three years has generated a substantial increase in the use of capital-motivated reinsurance. At this point, insurers in nearly every Asian country have entered into capital-motivated reinsurance treaties.

In addition, appetite in Asia for mergers and acquisitions has been rising, especially in the region's emerging markets, stemming from sizable growth in mass affluent populations. This, too, is generating demand for capital-motivated reinsurance.

The ongoing and increasing volatility of the world's financial markets is translating into greater capital volatility, in Asia as well as worldwide. Capital requirements as a rule rise as financial markets shrink, and fall as financial markets grow. For insurers, this has generated capital motivated reinsurance's use to facilitate "just in time" capital – in other words, a capital facility that can be used when needed and withdrawn when not.

## Quota share treaty – the simplest example

In its simplest form, the "just in time" capital strategy begins when an insurer enters into a small quota-share reinsurance treaty. The reinsurer's pricing and quoting process means due diligence has already taken place for the full block of business. It is then a simple process for the reinsurer to validate the pricing on a periodic basis by monitoring the performance of the reinsured block.

When additional capital is required, the insurer can request an increase in the quota share which can be accomplished quickly and without the need to issue a new treaty. Conversely, if capital needs abate, the insurer can then reduce the reinsurer's quota share, also without a new treaty.

This strategy creates an efficient capital facility that can help mitigate an insurer's capital volatility, and does not need to be restricted to one purpose. It can be used as well to

generate capital as required, to fund insurer business initiatives such as mergers, acquisitions, or new product launches.

## Challenges

For insurers, using capital-motivated reinsurance as a tool to manage capital offers several advantages.

The capital-motivated reinsurance transaction is simpler and potentially less expensive than debt or equity issuance. No shareholder vote is necessary, and more often than not, there is no need to involve external third parties. Another benefit is that capital released via capital-motivated reinsurance is viewed, for regulatory accounting purposes, as the same or better than debt or equity capital. In addition, reinsurance is already familiar to insurers as a risk mitigation vehicle, so the learning curve will not be steep.

Challenges, however, still abound in Asia. First, every Asian jurisdiction has different rules regulating reinsurance, capital requirements, valuations, and the like. The definition of what constitutes a reinsurance contract varies from jurisdiction to jurisdiction. Second, how risk transfer is defined is quite clear in some Asian jurisdictions but less so in others. As the use of capital-motivated reinsurance increases in Asia, insurance regulators will need a stronger, deeper understanding of reinsurance's applications.

## Working with regulators

To ensure insurance companies manage risks and capital appropriately and with an eye toward maintaining solvency, Asian regulators are currently moving to introduce a range of asset and capital management frameworks such as risk-based capital requirements.

In some Asian countries, a regulator is not required to pre-approve a reinsurance transaction as long as the insurer's auditor and appointed actuary sign off that the transaction satisfies the definition of risk transfer under local regulatory and accounting standards. So for now, insurers and reinsurers should be sure to clearly describe and disclose all material information in full about covered and non-covered risks, so that regulators understand the nature of the reinsurance coverage provided.

Insurers and reinsurers should also be sure to take the time to explain all aspects of any proposed capital-motivated reinsurance transaction to regulators, as some of these treaties may involve structures not commonly seen in Asia.

Finally, both insurers and reinsurers should obtain affirmation from local regulators that the transaction has been approved or, at the very least, that non-disapproval has occurred.

## Conclusion

Asian countries and their insurance markets are growing and maturing fast. Reinsurers are in an excellent position to help insurers in this region with product development, pricing, risk management, and capital and returns optimisation.

Demand in Asia for capital-motivated reinsurance is expected to continue to grow as pressures on insurers increase to deliver both good returns on capital and competitively-priced products to consumers.

A key lesson from the financial crisis is that insurers, by adding capital-motivated reinsurance, obtain broader access to capital. When selecting a reinsurer with which to partner, be sure that reinsurer will be a genuine long-term partner, that will not only help with capital, but will also provide sensible, legitimate risk mitigation and other consultative help as well.

Companies with strong balance sheets and ready access to capital will be the winners as the globe emerges from the current financial crisis. Reinsurance will help the best of them get there.

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