AMERICAN ACADEMY of ACTUARIES

Report on Risk-Based Capital Impact of Reinsurance Cessions to Unauthorized Reinsurers

Presented by the American Academy of Actuaries' Life Capital Adequacy Subcommittee to the National Association of Insurance Commissioners' Life Risk-Based Capital Working Group

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Risk Based Capital Impact of Reinsurance Cessions to Unauthorized Reinsurers

Background

At the September 9, 2002 meeting of the NAIC's Life Risk Based Capital Working Group Larry Gorski, the working group's chair, asked the American Academy of Actuaries' Life Capital Adequacy Subcommittee (LCAS) to develop a mechanism to address "disappearing" RBC as a result of modco and funds withheld reinsurance with unauthorized reinsurers. Mr. Gorski stated that the working group is concerned that there is no requirement that the assuming company establish an RBC amount mirroring the RBC credit given to the ceding company.

Observations

The LCAS undertook a brief discussion of this matter at its October 31, 2002 meeting, and although it is not ready to make a formal recommendation on this matter, it can offer the following observations:

1. The fundamental issue that should be addressed is the recoverability of the reinsurance. The RBC formula should recognize the risk of default of reinsurance recoverables in the event that the risks ceded under a reinsurance arrangement materialize.
2. Many of the issues surrounding the recoverability of reinsurance are common to the entire insurance industry not just life insurance. As such, any proposed change that is not logically restricted to just the life insurance, should be passed by the health and property & casualty working groups before being presented as an Academy proposal.
3. It is important to distinguish between the mirror imaging of the components of RBC (e.g., C-1, C-2, etc.) and the mirror imaging of the change in total RBC after covariance reduction. Mirror imaging of the components is part of the current RBC formula for reinsurance transactions between authorized companies, but the covariance adjustment means that the net impact of the reinsurance transaction will differ between the ceding and assuming company. This is appropriate because the real benefit of covariance will differ just as the formula indicates.
4. The issue is not restricted to reinsurance transactions for which there is an explicit credit in the RBC formula. Even straight coinsurance or YRT reinsurance will result in a reduction in the cedent's RBC requirements as the assets and/or liabilities are removed from the various exposure bases.
5. A requirement that the assuming company establish its RBC requirements so as to mirror the cedent's credit is of limited use in enhancing the probability of recovery in the absence of a comprehensive system of solvency regulation applied to the reinsurer. Furthermore, even if the unauthorized reinsurer is subject to a comprehensive system of solvency regulation (as is the case for domestic unauthorized reinsurers as well as many foreign unauthorized reinsurers), ultimate recoverability will be affected by the overall financial health of the assuming company not just its RBC treatment of a single contract.

6. The credit risk associated with reinsurance recoverables is not dissimilar from the credit risk of other asset classes and as such could be subject to C1 treatment. The C1 requirement for reinsurance would recognize the probability of default differentiating by the security quality of the reinsurer and of the credit enhancement structure surrounding the reinsurance. As long as the C1 requirement appropriately reflects the risk, cedents could be allowed greater freedom in choosing the quality of the reinsurer or type of structure that best suits their needs.

At present, the LCAS is leaning toward a system that would introduce additional C1 requirements for the non-recoverability of risks transferred under reinsurance contracts to unauthorized reinsurers. The requirements would cover all cessions not just modco or funds withheld arrangements.