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A PRACTICAL GUIDE TO FINITE RISK INSURANCE AND REINSURANCE

BY R. GEORGE MONTI AND ANDREW BARILE

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PREFACE

Driven by market demand, the finite risk field has expanded in recent years well beyond financial reinsurance, the subject of Executive Enterprises' prior reference work, *A Practical Guide to Financial Reinsurance*. In this volume, *A Practical Guide to Finite Risk Insurance and Reinsurance*, the sections of the prior work that dealt with financial reinsurance have been revised to reflect many important developments in the finite risk field in the last two years, especially changes in applicable accounting rules. To give the reader greater insight into the practical aspects of finite risk deals, we include six case studies of major, current-market financial reinsurance transactions. We are also pleased to include material regarding a new category of finite risk coverage that we refer to in this book as "financial insurance." In that section Pat Jordan, Senior Vice President of Willis Corroon, New York, provides several comprehensive case studies of current financial insurance transactions.

A word about terminology would be appropriate at this point. In this work, we use the term "finite risk" to describe the all-embracing category of financial covers in the insurance field. Its two subcategories are the well-known area of financial reinsurance, as explored in the original reference work, and the emerging financial cover area that we refer to in this volume as "financial insurance." While the differences between these subcategories are described at length in Chapter One, the reader can readily distinguish between the two concepts by noting that financial *in*surance usually involves a corporation (or its captive insurer) contracting directly with an assuming enterprise, while financial *re*insurance involves a ceding insurance enterprise—that is, an insurer or reinsurer—in an arrangement with an assuming *re*insurer.

The authors would like to thank the many insurance and reinsurance executives who provided valuable assistance and advice in the development of this book, especially Pat Jordan for his contributions on financial insurance and Gregory Leonard, president of Pegasus Advisors, Inc., of Simsbury, Connecticut, for his insights into the complexities of recent developments in the accounting rules applicable to financial reinsurance.

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SECTION ONE

INTRODUCTION TO FINITE RISK COVERS

In this Section, we introduce the general topic of finite risk and review in detail the basic acounting, tax, and regulatory requirements affecting all such covers.

In Chapter One, after defining finite risk and distinguishing its two principal subcategories, financial insurance and financial reinsurance, we identify characteristics common to both. We then analyze, in Chapter Two, the all-important accounting rules promulgated by FASB for finite risk transactions. We review thoroughly the rule controlling the proper determination of what constitutes a sufficient degree of "risk transfer" as to permit a contract to be proerly accounted for as reinsurance and FASB's recently adopted position regarding multiyear funded reinsurance contracts. We finish with an analysis of accounting for various finite risk agreements.

Because favorable tax treatment is a highly important element in the economic viability of finite risk arrangements, we review in Chapter Three the basic concepts used in computing tax benefits. These include gross income, taxable income, discounting of loss reserves, and reallocation. We also look at the federal courts' efforts to define "insurance" and "transfer of risk" in determining what is properly deductible as an insurance premium, the potential influence of FASB's various pronouncements on the courts' thinking, and the power of the Internal Revenue Service to recharacterize or adjust financial reinsurance deals to "properly reflect income" between related parties involving items affected by a reinsurance agreement.

In Chapter Four, we look at the more important drafting issues that arise in the context of insurance regulations, using, as a handy guide, the best-known example of regulation in the finite risk field, New York's Reg. 108 (Loss Portfolio Transfers).

Introduction to Finite Risk Covers

Chapters Five through Nine are devoted to the five basic forms of finite risk agreements. Although they are primarily geared to financial *re*insurance transactions (still the most frequently encountered type of finite risk transaction), their provisions are easily adapted to financial *in*surance deals as well.