Article Title: ARCHIVE | Criteria | Insurance | General: Adjusting For Finite Reinsurance Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled, "Assumptions For Quantitative Metrics Used In Rating Insurers Globally," published on April 14, 2011.) Finite reinsurance, in the extreme, is a form of financial leverage that is sold as reinsurance. It acts as a low-cost loan that rises above regulatory radar, as opposed to performing the traditional function of risk transfer, and takes the form of earnings or capital. Federal and state legal authorities are currently investigating companies that use finite reinsurance, which is sometimes referred to as financial reinsurance or financial engineering, to enhance the perception of earnings, capital, or both. At its inception in the 1980s, finite reinsurance products were traditional insurance products that, in exchange for limiting the potential liability of the reinsurer, allowed the ceding company to share in the profitability of the reinsurance contract. Although the degree of risk transfer is mitigated compared with a traditional full risk transferring insurance product, Standard & Poor's Ratings Services recognizes these contracts as an appropriate form of risk transfer as long as the accounting for these contracts reflects economic reality. In recent years, finite reinsurance products have, in the most extreme cases, evolved as an accounting mechanism to increase earnings and capitalization even though the economics of the transaction indicate otherwise. Standard & Poor's takes issue when a company uses finite reinsurance contracts as an accounting mechanism to bolster earnings and capitalization when the economics of these transactions indicate that appropriate risk transfer and loss absorption has not taken place. Specifically, Standard & Poor's has noted that some transactions lessen the impact of losses currently with the expectation that in subsequent years, full or substantially full reimbursement will be made under the guise of increased premium levels, additional commissions, higher interest rate levels for funds withheld, or a combination thereof. In such instances, Standard & Poor's has adjusted its view of an insurer's earnings and capital to reflect economic reality In a traditional reinsurance transaction, an insurer cedes a share of premiums in return for moving some of the risk off its balance sheet and onto that of a reinsurer. To qualify for accounting treatment as a risk-transfer insurance contract, a reinsurer is expected to incur at least a 10% probability of a 10% loss on the policy. When taken to the extreme to minimally satisfy the definition of risk transfer, this is equivalent to an expected 1% loss on the policy. Standard & Poor's has identified and disclosed the impact of finite reinsurance transactions for which the accounting is not rooted in economic reality in the rating analysis of interactively rated credits. In these cases, we focused on the resulting impact on its interpretation of capital and earnings. Recently, in an effort to identify a greater number of these difficult to detect transactions for which the accounting for the contract does not reflect economic reality, Standard & Poor's codified procedures for identifying finite reinsurance in interactively rated insurance insurers and, when appropriate, adjusting the accounting for it. These procedures involved are not new. "We always looked for finite reinsurance, but now we have established codified procedures by which we do so," said Thomas S. Upton, property/casualty ratings team leader at Standard & Poor's. Adjusting for finite reinsurance is a two-step process. First, Standard & Poor's requests that all interactively rated insurance and reinsurance companies provide a copy and summary of the top five external reinsurance contracts underlying the funds held balances with the accounting entries at inception through the most recent financial statement. In addition, Standard & Poor's requests that they disclose reinsurance contracts meeting any of following attributes: The external reinsurance agreement is retroactive. The external reinsurance agreement receives different accounting treatment under different methods of accounting, such as statutory, GAAP, or internal accounting. The external reinsurance agreement has been questioned, or is being questioned, by auditors or regulatory bodies regarding the classification (prospective or retrospective), or accounting treatment. The company views the external reinsurance agreement as one made for financial engineering purposes—that is, to delay the recognition of losses or smooth them over a period of time. The reinsurance agreement is supplemented by a side letter or verbal agreement that alters the carrier's risk exposure. The company believes there is more than a 50% chance that the external reinsurance agreement will be commuted. The external reinsurance agreement makes material use of deficit accounts or experience refund accounts. The external reinsurance agreement is accompanied by a retrocession of a portion of the risk to the original cedent or affiliate. The external reinsurance agreement remains in effect for more than one year. In the second step, Standard & Poor's compares the economic impact of each contract with its accounting treatment.

In cases where the economics of the transaction are not appropriately reflected in the accounting, Standard & Poor's adjusts the accounting, and thus capital and earnings, to reflect the underlying economic reality. In general, the resulting adjustment to capital and earnings is usually downward in the first years of the contract and then upward during the latter periods of the contract, thus unwinding the income and capital smoothing benefit introduced by the regulatory prescribed accounting treatment of these contracts. Standard & Poor's then determines the impact on the creditworthiness of the insurance company in question. In some cases, the impact on ratings can be negative. The commutation clause—or, in some cases, the profit-sharing clause—is a common tool used to structure a finite reinsurance transaction. Many financial reinsurance agreements have commutation clauses that afford the ceding carrier the option of canceling the reinsurance contracts and receiving a substantially full refund of the premium. When this clause exists, Standard & Poor's uses a present-value approach to determine the economic trigger point of the commutation provision and compare actual contract developments to the commutation triggering point. If Standard & Poor's believes that current circumstances will ultimately lead to a commutation, then it regards this contract as currently offering no economic benefit. Thus any booked benefit of the agreement is reversed. If Standard & Poor's concludes that current developments would not lead to a commutation, then the economic benefit of the transaction is compared to the accounting of the contract. In its analysis of quota share contracts, Standard & Poor's focuses on whether the interplay of specific clauses result in a contract whose economic behavior is not consistent with quota share accounting treatment. These clauses are common features of many quota share contracts for which the accounting is reflective of the underlying economics of the agreements, but they are also tools used in the structuring of finite quota share transactions for which the economics sharply diverge from the accounting treatment. Such clauses include but are not limited to: Sub limits on exposures for certain classes of business. Aggregate loss ratio caps. Deductibles requiring the ceding company to pay a certain level of first losses incurred on the business subject to the quota share agreement. Loss corridors reducing the assuming company's risk exposure for a range of specific loss ratios. Experience account, commutation, or profit-sharing clauses. Standard & Poor's applies the historical performance of the book of business to the contract terms to ascertain the economic impact of the agreement. In the absence of full disclosure, finite reinsurance can be difficult to detect, even when adjustments are made for the above triggers. Thus Standard & Poor's examines contracts for other signs of finite reinsurance as well. "If we see a reinsurance contract where the accounting does not match economic reality, we will adjust the accounting and resultant impact on earnings and capitalization. We will factor these adjustments into our ratings consideration," said Standard & Poor's credit analyst Steve Ader. "If the accounting matches economic reality, then we have no issue." By Michael Shari