FINITE RISK INSURANCE AS A FORM OF
ALTERNATIVE RISK TRANSFER

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Abstract

The concept alternative risk transfer relates to the point where insurance, banking and/or the capital market converge in an attempt to efficiently provide enterprises with sufficient financial capacity for protection against a variety of risks. No single all-embracing definition of the concept exists, as these products are tailor-made to the needs of each client. Finite risk insurance represents a category of alternative risk transfer products. Key features and objectives of finite risk insurance receive due attention, after which the focus shifts to the variants and types of contracts concerned. Loss Portfolio Transfers, Adverse Development Coverage, Spread Loss Coverage and Finite Quota Share Reinsurance are identified as the main types of finite risk insurance. The linking of the financial needs of enterprises and insurers to particular finite risk insurance solutions are illustrated in the next two sections. The closing section of this research paper focuses on future prospects of finite risk insurance.

Keywords: Adverse development coverage, Alternative risk transfer, Finite quota share reinsurance, Finite risk insurance, Loss portfolio transfer, Spread loss coverage

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1. Introduction and Objectives of Research

The concept alternative risk transfer actually relates to the point where insurance, banking and/or the capital market converge in an attempt to efficiently provide enterprises with adequate financial capacity to protect themselves against various kinds of risks (Asaff, 2000; European Commission, 2000:36-39; Hofmann, 2006:11-13). These risks inter alia relate to intellectual property, as well as environmental, asbestos and product liabilities (Balmer, 2002:24-25; Chase, 2002:62-65). Because products of alternative risk transfer are tailor-made according to the needs of individual clients, there is no single all-embracing definition of the concept. The demand for alternative risk transfer products consequently is based on an extensive range of business needs. Alternative risk transfer products, nevertheless, can be classified according to the following categories (Allen, 2002:24-27; Gjertsen, 2002:10):

1. Securitisation, which, inter alia, involves catastrophe bonds;
2. Insuratisation, referring, amongst others, to credit default swaps, collateralised debt, residual value insurance and revenue guarantee products;
3. Finite risk insurance (and reinsurance); and
4. Captive insurance companies.

This research paper primarily focuses on the third category, namely finite risk insurance. The various financial instruments of finite risk insurance can, however, be equally applied to reinsurance, as will be pointed out in this paper. The objectives of the research paper are to:

1. Identify how finite risk insurance could be used to meet the financial needs of enterprises (that is non-insurers) and insurers; and to
2. Comment on the viability of finite risk insurance as a source of risk financing.

The paper is based on an elaborate literature study and includes the following, to meet the stated objectives:

1. A summary of the key features and objectives of finite risk insurance, followed by a shift in focus to the variants and types of related contracts.
2. A discussion and illustration of how the financial needs of enterprises and insurers can be linked to particular finite risk insurance solutions.

The ultimate aim of the paper is to answer the research question: Does finite risk insurance have a future in meeting the financial needs of enterprises and insurers?
2 Key Features and Objectives of Finite Risk Insurance


1. The transfer of risk from the enterprise to the insurer is limited to a finite (overall aggregate limit) amount.

2. The coverage usually comprises of underwriting risks, as well as one or more of timing, credit, interest rate or exchange rate risks. Risks that are usually non-insurable or hard-to-place can therefore also be covered by finite risk insurance. Coverage of these kinds of risks is important for a holistic approach to risk management. The coverage is usually provided in a broad sense, without a long list of exclusions, but less risk is generally transferred than with traditional insurance products.

3. The policy term is usually longer than one year as multi-year periods are used to obtain diversification benefits, as well as an insurance market equilibrium by focusing on the demand for and supply of coverage.

4. As a finite risk insurance arrangement is a unique customised solution for a particular enterprise, the effective costs to a large extent depend on the claim experience of the enterprise. The claim experience can partially determine the policy terms and conditions, for example the extent of the premium, the excess payable in the event of a claim and the limits of coverage.

5. A portion of the premiums that is not utilised to settle claims is usually paid back to the insured when the contract terminates. A profit-sharing relationship therefore exists between the enterprise and the insurer.

6. Potential investment income earned on the premiums by the insurer during the insurance period is taken into account when the premiums are calculated. The time value of money therefore plays an important role.

One of the fundamental objectives in using finite risk insurance is for enterprises to achieve their planned financial results over more than one year (Barile, 2004:36; Fleckenstein, 2001). For example, an enterprise wants to smooth its loss experience over a multi-year period, in such a way that the amount of capital needed to adequately cover these risks can be reduced (Allen, 2002:27). The volatility of earnings can accordingly be reduced and the financial results of an enterprise become more predictable (Fleckenstein, 2000a; Fleckenstein, 2001; Kelly & Zeng, 1998:4; Zolkos, 2004:6). Smoothing earnings over time may, however, conceal the true financial position of an enterprise which is in financial trouble (“Giving finite”, 2003:49-52). An enterprise may also utilise finite risk insurance solutions to stabilise and improve its liquidity by transferring future liabilities to an insurer (Denney, 1998; Ralston, 2002). Finite risk insurance consequently is very popular when enterprises experience dramatic changes due to inadequacies in the insurance and capital markets (Peto, 1999).

Enterprises are able to pursue more effective employment of their capital base by utilising finite risk insurance rather than maintaining equity to cover risks (Peto, 1999; Zolkos, 2001:24-25). The possibility exists that, under particular circumstances, an enterprise can transfer a loss reserve from its balance sheet to an insurer. In this way the equity of a firm is increased approximately by the difference between the loss reserve (which represents a liability) and the premium paid (which is the present value of the discounted loss reserve) (Barile, 2004:36; European Commission, 2000:50; Ralston, 2002). The additional capital may be utilised to pursue merger and acquisition opportunities (Denney, 1998).

Finite risk insurance can be cheaper, because the premium paid over the multi-year period of the insurance contract can be closely correlated with the loss experience of an enterprise (Fleckenstein, 2000a; Peto, 1999). Finite risk insurance products are often chosen to obtain an optimal balance between the risk of an enterprise and the cost of insurance (Kelly & Zeng, 1998:4). When non-correlated risks are covered by one finite risk insurance contract, the combined cost of insurance should be less than the total of the individual premiums, had separate insurance contracts been established to cover the risks. A long-term partnership and/or relationship between an enterprise and an insurer should yield mutual trust and understanding that may culminate in more cost efficient insurance contracts (Asaff, 2000).

Finite risk insurance actually addresses the business needs of the enterprise by starting from a cognisance of what the enterprise wants, designing a financial product that fits the needs of the enterprise and determining the convergence of insurance, banking and/or capital markets that should be involved to create a more competitive market (Fleckenstein, 2000b; Mundy, 2000:32-33).

By obtaining finite risk insurance, an enterprise may reduce administrative tasks related to keeping records of claims and the settlement thereof (Ralston, 2002). The main disadvantage of finite risk insurance is that less protection is usually provided than when traditional insurance products are involved (Fleckenstein, 2000a).

Variants and Types of Finite Risk Contracts

Finite risk contracts can be arranged with two variants in mind, viz. retrospective and prospective contracts.
Retrospective contracts relate to losses already incurred but not yet settled, or to risks due to previous underwriting activities (Schanz, 1997:12). Retrospective contracts may involve the transfer of a loss portfolio from an insured to an insurer, or an insurer may merely provide future coverage for liabilities of previous years (European Commission, 2000:12; Gordon, 1992:145). The main types of retrospective finite risk insurance contracts are Loss Portfolio Transfers and Adverse Development Coverage (Fleckenstein, 2000b; Reitz, 2005:57-58).

Prospective contracts relate to business written in future underwriting years. The finite risk insurance contract can contain stipulations concerning the adjustment thereof, depending on the future volume of business (European Commission, 2000:50). Spread Loss Coverage and Finite Quota Share Reinsurance are the main types of prospective finite risk (re)insurance contracts.

The following sections contain detailed discussions of the four main types of finite risk insurance contracts mentioned above.

3.1 Loss Portfolio Transfer

A loss reserve may originate from any kind of latent financial liability that an enterprise may have due to the business activities of previous years (Monti & Barile, 1995:95). This type of finite risk insurance is typically used for workers’ compensation reserves, as well as for asbestos, environmental and product liabilities (Paar, 2002:11-15). A loss reserve is generally created by the enterprise to provide for the possible future settlement of latent liabilities. When a Loss Portfolio Transfer contract is concluded, an enterprise transfers its retrospective loss reserve to an insurer who undertakes to settle the liabilities in exchange for a premium paid by the enterprise (Baur, 1999:20; Peto, 1999). The loss reserve is actually removed from the balance sheet of the enterprise. The insurer’s liability, however, will often be subject to a specific limit (Diacon & Carter, 1992:236).

The lengthy and expensive run-off of activities of an enterprise is avoided by a Loss Portfolio Transfer arrangement. The premium paid by the enterprise approximately represents the net present value of the ceded loss reserves, as well as a loading by the insurer for the associated costs, profit and risk premium (Schanz, 1997:13). The key aspect of a Loss Portfolio Transfer arrangement is the timing risk, because the insurer will experience a substantial loss when claims have to be settled unexpectedly soon. The level of the interest rate used for the calculation of the net present value of the loss reserve consequently is of prime importance, together with the accuracy of the projection of the payment pattern (Schanz, 1997:13).

As a Loss Portfolio Transfer contract increases the equity of the enterprise by an amount almost equal to the difference between the loss reserve and the premium paid, the enterprise is in a better financial position to expand its operating activities (Gordon, 1992:144). For example, company mergers or takeovers become possible because the loss reserves no longer provide an obstacle to such a transaction (Baur, 1999:20; Fleckenstein, 2001; Paar, 2002:11-15; Sullivan, 2004:34-38).

A Loss Portfolio Transfer contract can be of vital importance to insurers, in particular (Schanz, 1997:15). When an insurer, for example, wants to withdraw from particular lines of underwriting business, strengthen its reserve structure or improve its balance sheet, a Loss Portfolio Transfer arrangement with a reinsurer is the proper route to take (Denney, 1998; Fleckenstein, 2001; Reitz, 2004:31). If an insurance company (for example a captive insurance company) wants to terminate its activities, a Loss Portfolio Transfer seems to provide a sensible option (Baur, 1999:20).

The numeric example presented in Table 1 explains the impact of the application of a Loss Portfolio Transfer on the financial statements of an insurer (Schand, 1997:14). The financial position without a Loss Portfolio Transfer contract is given, and the assumption is that a loss portfolio of R800 000 is transferred to a reinsurer with a corresponding premium of R500 000.

It should be emphasised that technical reserves of insurers are treated as debt to meet insurance liabilities (Diacon & Carter, 1992:206). It is clear from the illustration that the following comparative differences occur in the income statement when a Loss Portfolio Transfer contract is applied: The reinsurance premiums paid are R500 000 more; the provision for a change in the technical reserves is R800 000 less because the loss portfolio transferred to the reinsurer; and the premiums earned, as well as the underwriting profit, consequently are R300 000 more.

The comparative differences in the balance sheet when a Loss Portfolio Transfer takes place are that the equity increases by R300 000 due to the higher underwriting profit; that the technical reserves are R800 000 less as a result of the lower provision in the income statement; and that the total assets are R500 000 less due to the fact that more reinsurance premiums are paid. The ratio underwriting profit to total assets increases from 11,2 per cent to 12,7 per cent, while the ratio equity to total assets increases from 80 per cent to 82,9 per cent when the loss portfolio transfer occurs. The conclusion that is reached is that insurers are able to improve their profitability and solvency by utilising Loss Portfolio Transfer contracts.
3.2 Adverse Development Cover

This type of retrospective finite risk insurance (which is sometimes called “Retrospective Excess of Loss Cover”) offers a broader spectrum of cover than Loss Portfolio Transfer contracts (Baur, 1999:20). Adverse Development Coverage is generally constructed as an aggregate excess of loss policy where coverage is provided against losses in excess of the reserves that an enterprise has already provided (European Commission, 2000:50). It should be emphasised that no transfer of loss reserves to the insurer occurs when Adverse Development Coverage is arranged, while the opposite is true in the case of a Loss Portfolio Transfer.

Adverse Development Cover arrangements provide protection against a variety of risks including “incurred but not reported” (IBNR) risks, as well as “incurred but not enough reserves” (IBNER) risks (Schanz, 1997:16). This type of contract is often concluded on a stop loss basis, with the insurer only becoming liable when the accumulated losses during a particular insurance period exceed a stipulated amount (Baur, 1999:20). The insurer then has to settle all losses during the remainder of the period. Adverse Development Cover arrangements can also involve an excess of loss treaty (Baur, 1999:20). This coverage can be on a per risk basis or per event basis, and the insurer becomes liable when a particular loss exceeds a stipulated amount.

Adverse Development Coverage requires the application of the time value of money. The premium paid by the enterprise reflects the level of the associated risks and represents the net present value of the expected loss payments during the insurance period (Schanz, 1997:16). A risk premium for underwriting, timing and investment risks will be added to the basic premium (European Commission, 2000:50). The amount of risk that is protected by the insurer will, inter alia, be determined by:

(1) The class of business insured;
(2) The accuracy of the assessment of prospective liabilities;
(3) The excess point where the insurer will settle the losses on behalf of the enterprise; and

Adverse Development Coverage has specific advantages for enterprises (Baur, 1999:21). Protection provided by an insurer against losses in excess of the reserves of an enterprise should decrease the expected volatility of the firm’s financial results. The stability of financial results may improve the corporate value, stock market capitalisation and/or the credit rating of an enterprise, thus enabling the enterprise to consider mergers and take-over opportunities.

In addition to smoothed financial results over a multi-year period, insurers can benefit from Adverse Development Coverage by reinsuring themselves against losses in excess of the reserves that they have already provided. Insurers can also use Adverse Development Coverage to reinsure against the credit risk relating to their existing reinsurer(s) becoming insolvent (Schanz, 1997:17).

3.3 Spread Loss Cover

Spread Loss Coverage (also known as “Spread Loss Treaty”) represents one widely used type of the so-called “Prospective Excess of Loss Coverage”. This kind of prospective insurance solution is usually based on non-proportional reinsurance techniques (Baur, 1999:21). Spread Loss Cover arrangements have a number of characteristics, namely (Baur, 1999:21; European Commission, 2000:51; Lane, 2002:172-173; Monti & Barile, 1995:127; Schanz, 1997:21):

(1) A Spread Loss Cover contract is a multi-year policy. Should an enterprise terminate the arrangement before the stipulated date, a cancellation clause that includes a penalty may come into operation.
(2) Annual or single premiums paid by the enterprise (less loading for risk, expenses and profit by the insurer) are accumulated over

<table>
<thead>
<tr>
<th>Table 1. Illustration of the impact of a Loss Portfolio Transfer on the financial statements of an insurer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact on the income statement</td>
</tr>
<tr>
<td>With Loss Portfolio Transfer</td>
</tr>
<tr>
<td>Without Loss Portfolio Transfer</td>
</tr>
<tr>
<td>Gross premium income</td>
</tr>
<tr>
<td>– Reinsurance premiums paid</td>
</tr>
<tr>
<td>Net premium income</td>
</tr>
<tr>
<td>– Provision for a change in the technical reserves</td>
</tr>
<tr>
<td>Premiums earned</td>
</tr>
<tr>
<td>– Claims paid and operating expenses</td>
</tr>
<tr>
<td>Underwriting profit</td>
</tr>
<tr>
<td>Impact on the balance sheet</td>
</tr>
<tr>
<td>Without Loss Portfolio Transfer</td>
</tr>
<tr>
<td>Equity</td>
</tr>
<tr>
<td>Technical reserves</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
</tbody>
</table>
the entire insurance period in a financial statement known as an “experience account”. The extent of future premiums may be linked to claims paid by the insurer.

3. The insurer settles insured losses from the experience account. The insurer carries any associated credit and timing risks and may be seen as a short- to medium-term lender who provides a line of credit in the event of a loss. The risks covered may include those exposures that are normally uninsurable or only insurable at exceptionally high cost. The insurer may fix the amount of cover on an annual basis, including an aggregate limit on the amount of claims over the entire contract period.

4. Interest income earned on a positive balance of the experience account is credited to the account. The interest rate applied is usually fixed contractually.

5. When the experience account shows a negative balance, the enterprise should pay higher premiums or should settle the negative balance before the contract expires. As the insurer also accepts a part of the underwriting risks, the enterprise is usually not obliged to settle the negative balance of the experience account completely.

6. If the experience account has a positive balance when the arrangement comes to an end, the enterprise will usually receive a partial refund from the insurer.

Spread Loss Coverage provides various benefits to enterprises (Baur, 1999:22). Losses incurred are smoothed over the term of the arrangement and continuity is consequently emphasised as a prime goal of an enterprise. The experience account provides an enterprise with an off-balance sheet and a flexible financial instrument. It is important to stress that traditional uninsurable exposures may also be covered by means of a Spread Loss Cover arrangement. Premiums paid by an enterprise may be tax deductible, since the insurer covers underwriting risks as well.

Insurers can likewise benefit from the application of Spread Loss Cover solutions (Schanz, 1997:22). The underwriting results of an insurer are smoothed over the multi-year period as the timing risk of claims is transferred to a reinsurer. Likewise, the variability of the underwriting capacity of an insurer over the medium-term may be reduced by the protection provided by a reinsurer. Furthermore, an insurer can stabilise its reinsurance costs because it is protected by means of a single contract that disregards market cycles over a multi-year period. Table 2 presents a numeric example to illustrate the way in which an experience account for Spread Loss Coverage can be handled (Schanz, 1997:21). The illustration is based on the following assumptions:

1. The normal annual payments by the enterprise equal R1 000 000. However, if the experience account has a negative closing balance, the annual payment of the following year will increase to R1 400 000 until the closing balance is positive again.

2. Annual losses paid by the insurer are as shown in Table 2.

3. Annual interest receivable on a positive closing balance will be allocated at a rate of 10 per cent per annum.

4. Annual interest payable on a negative closing balance will be calculated at an interest rate of 20 per cent per annum.

5. After the contract period of four years has expired, any positive or negative balances will be either refunded to, or settled by, the two parties according to the following ratio: Enterprise: 40 per cent of closing balance, and Insurer: 60 per cent of closing balance.

3.4 Finite Quota Share Reinsurance

Finite Quota Share Reinsurance (which is the same as “Financial Quota Share Reinsurance”) is part of the prospective variants of finite risk insurance contracts that cover current and/or future underwriting years (Baur, 1999:21). These arrangements operate in a similar manner as the traditional quota share reinsurance (European Commission, 2000:51). A proportion of the premiums of every policy is ceded to a reinsurer, together with the same proportion of associated risk, and the reinsurer is liable for the same proportion of every claim (Diacon & Carter, 1992:224; Gordon, 1992:144).

The ceding enterprise will, in return, receive a commission based on a sliding scale from the reinsurer. The purpose of reinsurance commissions is to help ceding enterprises to cover the costs incurred (Diacon & Carter, 1992:291). This kind of commission links the loss experience of the ceded risks to the amount of commission paid by the reinsurer (European Commission, 2000:52). The commission rate will generally increase (within particular fixed limits) when there is a reduction in the loss ratio (Carter, 1979:91).

An interesting variation of this type of finite risk insurance is the so-called Anti-cyclical Quota Share Reinsurance (Schanz, 1997:19). The basic principle of this kind of arrangement is that the reinsurance commission paid by the reinsurer to the insurer increases when the loss ratio increases, consequently helping the insurer when assistance is of utmost importance. This kind of arrangement is just the opposite of the sliding-scale commission that is usually applied in the financial sector. Anti-cyclical Quota Share Reinsurance can be linked to the problem of moral hazard where the insurer will benefit from an increase of the loss ratio. The reinsurer can mitigate the situation by limiting his liability or by applying multi-year contracts.
Table 2. Illustration of an experience account used for a Spread Loss Cover contract

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>0</td>
<td>220 000</td>
<td>-216 000</td>
<td>-379 200</td>
</tr>
<tr>
<td>+ Annual payment by enterprise</td>
<td>1 000 000</td>
<td>1 000 000</td>
<td>1 400 000</td>
<td>1 400 000</td>
</tr>
<tr>
<td>- Losses paid by insurer</td>
<td>-800 000</td>
<td>-1 400 000</td>
<td>-1 500 000</td>
<td>-700 000</td>
</tr>
<tr>
<td>Balance before interest receivable or payable</td>
<td>200 000</td>
<td>-180 000</td>
<td>-316 000</td>
<td>320 800</td>
</tr>
<tr>
<td>+ Interest receivable (10% per annum)</td>
<td>20 000</td>
<td>0</td>
<td>0</td>
<td>32 080</td>
</tr>
<tr>
<td>- Interest payable (20% per annum)</td>
<td>0</td>
<td>-36 000</td>
<td>-63 200</td>
<td>0</td>
</tr>
<tr>
<td>Closing balance</td>
<td>220 000</td>
<td>-216 000</td>
<td>-379 200</td>
<td>352 880</td>
</tr>
<tr>
<td>- Payment to enterprise (40% of closing balance)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Payment to insurer (60% of closing balance)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Final balance of experience account</td>
<td>0</td>
<td>220 000</td>
<td>-379 200</td>
<td>-379 200</td>
</tr>
</tbody>
</table>

As Finite Quota Share Reinsurance is a type of finite risk insurance, the liability of the reinsurer will be limited to a specific amount that may be a maximum loss ratio or a proportion of the ceded premiums. Profit sharing between the ceding enterprise and the reinsurer (which is approached without making use of the services of an insurer as intermediary) may also be included as a stipulation of the particular arrangement (European Commission, 2000:52). The financial results of an enterprise may also be smoothened over multi-year periods.

Benefits provided by Finite Quota Share Reinsurance contracts to insurers are as follows (European Commission, 2000:51; Fleckenstein, 2001; Hochberg & Konstelni, 2001:58-61; Schanz, 1997:18):

1. As the solvency margin of an insurer is calculated by dividing the shareholders’ equity by the net premium income (and the last-mentioned item equals the gross premium income less reinsurance premiums paid), an insurer’s solvency can be improved by applying reinsurance. This is especially important when an insurer experiences a strong growth in underwriting business.

2. Reinsurance will smooth the financial results of an insurer over multi-year periods.

3. As a portion of the risks is ceded to a reinsurer, reinsurance will in fact increase the underwriting capacity of a particular insurer.

4. The reinsurance commission received may be applied by the insurer to improve the ability to fund new business acquisitions.

5. An insurer can stabilise its reinsurance costs over a multi-year period by applying a single contract that does not take market cycles into account.

4 Linking Financial Needs of Enterprises to Particular Finite Risk Insurance Solutions

The information obtained in the preceding section should be applied in order to link the financial needs of enterprises to particular finite risk insurance solutions. The results are presented in the following figure.

According to Figure 1, enterprises that need to increase their equity can arrange a Loss Portfolio Transfer to obtain the necessary result. Furthermore, enterprises that require protection against financial liabilities of previous years to improve their financial position to enable mergers and take-overs, can utilise Loss Portfolio Transfer arrangements or Adverse Development Coverage to cover the retrospective liabilities. The last-mentioned finite risk solution can also be applied to obtain protection against losses in excess of the reserves that a particular enterprise has already provided. Three alternatives, namely Adverse Development Coverage, Spread Loss Coverage and Finite Quota Share Reinsurance, may be considered when an enterprise needs to smooth the financial results over multi-year periods.
5 Linking Financial Needs of Insurers to Particular Finite Risk Insurance Solutions

The information obtained in Section 3 leads to the results presented in Figure 2. The financial needs of insurers are linked to particular finite risk insurance solutions in this figure.

Loss Portfolio Transfer contracts are able to satisfy two specific financial needs of insurers, namely to increase the equity of the insurer or to provide protection when an insurer withdraws from some or all lines of underwriting business. Should insurers want to obtain protection against losses in excess of the reserves already provided, or want to obtain protection against the credit risk of a specific reinsurer becoming insolvent, they can conclude an Adverse Development Cover contract. Three finite risk solutions are available when an insurer needs to smoothen its financial results over multi-year periods, namely Adverse Development Coverage, Spread Loss Cover or Finite Quota Share Reinsurance.

A Spread Loss Cover arrangement or Finite Quota Share Reinsurance can be utilised by an insurer to stabilise the cost of reinsurance over a multi-year period by concluding a single contract that does not take market cycles into account. Should an insurer need the improvement of solvency and the increase of its underwriting capacity, the insurer should opt for Finite Quota Share Reinsurance. When an insurer requires additional funds for new business acquisitions, the reinsurance commission received in the event of Finite Quota Share reinsurance may satisfy this financial need.

6 Future Prospects of Finite Risk Insurance


(1) The key issue of finite risk insurance is that enough risk should be transferred in order to qualify as an insurance or reinsurance policy for tax purposes. According to Fleckenstein, the probability of a significant loss should at least be 10 to 15 per cent (2000a). The extent of the difference between the policy limit and the premium paid may also indicate the amount of risk that is transferred to the insurer by the enterprise (Reitz, 2005:57-58). If the premium is significantly lower than the policy limit, it may indicate that a considerable degree of risk is transferred and the premium may be tax deductible. On the other hand, if the difference between the premium and the policy limit is small, the authorities may decide that little risk is transferred, that it is mere a reserve for a known loss, and the premium may not be tax deductible.
Figure 2. Finite risk insurance solutions to suit the financial needs of insurers

(2) Governmental regulations may restrict finite risk solutions, although it seems as if regulations may be less restrictive in future. Finite risk insurance is being written to include more underwriting risk to satisfy regulatory and accounting changes after the collapse of the Enron Corporation in 2001 (Brigham & Daves, 2004:14-16). Economic costs of restrictive regulations should be mitigated.

(3) The effect that development and needs of the business environment has on the financial industry at large, will play a vital role. Special attention should be paid to the convergence of insurance, banking and/or the capital markets in order to provide the business environment with adequate financial capacity to protect itself against various kinds of risk (Megna, 2005; Priebe, 2005; Spiller, 2006; Zaffino, 2005). The convergence of the three markets should benefit the whole financial industry as the capacity of the insurance market is dwarfed by the enormous capital markets. Insurers and reinsurers can actually commoditize finite risk insurance contracts to the capital markets through Special Purpose Vehicles. The capacity to cover traditionally uninsurable or hard-to-place risks that are non-correlated with other types of risks may
become more important, although traditional insurance and reinsurance are likely to remain viable.

(5) The pressure on finite risk insurers to reduce the cost of insurance will be increased. It seems as if there is a growing tendency among companies to increase the proportion of the risks that they retain. Finite risk solutions should not only be tailor-made to suit the needs of enterprises, but should also keep the cost of insurance as low as possible.

(6) Providers of finite risk insurance solutions should:

(a) have an excellent knowledge of underwriting activities, including the professional knowledge common to actuaries, lawyers, and financial experts,
(b) have sound financial positions in the financial industry,
(c) be willing to accept a larger portion of risk transfer,
(d) be creative, flexible and innovative in providing new ideas and ways to achieve the corporate goals of enterprises,
(e) develop long-term relationships with enterprises, and
(f) have ability as well as accessibility to enable them to combine financial products from insurance, banking and/or the capital markets.

7 Closing Remarks

The attitude of the market that suggests that more complex products of alternative risk transfer are better, should be replaced by a more relaxed approach, with the application of the financial products being simplified. The transparency of the transactions should be voluntarily enhanced by the providers of finite risk insurance (“‘Work to’, 2004:8). The flexible terms and conditions that are available for finite risk insurance could be combined in numerous ways in order to provide different finite risk insurance solutions to various enterprises (Kelly & Zeng, 1998:16). Seen against the financial needs of enterprises and insurers, it seems that the future of finite risk insurance solutions is actually unlimited (Denney, 1998).

The answer to the research question stated in the introduction of this paper is therefore that finite risk insurance has a future in meeting the financial needs of enterprises and insurers.

References


