Shedding Light on Shadow Reinsurance

By Kerry Pechter *Fri, Oct 4, 2013*

New research from the London Business School and Federal Reserve Bank of Minneapolis adds detail to the use of "shadow reinsurance" by life insurers, a practice that frees up reserves but reduces transparency and may drive up risk.

How Captive Reinsurance Works					
Operating Company (in domicile with tighter capital regulation)					
		Step 1. OC sells insurance for $100 (statutory reserve of $100 and GAAP reserve of $90).		Step 2. OC cedes reinsurance.	
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Bonds $10	Equity $10	Bonds $10 Premium $100	Reserves $110 Equity $0	Bonds $10	Equity $10
Captive (in domicile with looser capital regulation)					
1. Captive created.				2. Captive assumes reinsurance. Establishes trust with $90 in bonds. Secures letter of credit up to $20.	
Assets	Liabilities			Assets	Liabilities
	Equity $0			Trust: Bonds $90 Letter of credit Cash $10	Reserve $90 Equity $10
Source: Koijen, Ralph S. J., and Yogo, Motohiro: "Shadow Insurance," Sept. 28, 2013. Unpublished draft.					

Since 2002, life insurers have ramped up their use of “shadow reinsurers” as a way to reduce their taxes or capital requirements, write researchers at the London Business School and the Federal Reserve Bank of Minneapolis in an unpublished paper.

Shadow reinsurers are defined in the paper as unauthorized affiliates of life insurers that are domiciled in places such as Bermuda, the Cayman Islands, South Carolina or Vermont, with looser capital requirements than the parent companies’ domiciles.

The savings from this practice may help reduce the cost and expand the supply of life insurance and annuities, but they may add risk to the life insurance industry, just as so-called shadow banks added to the systemic risk that crashed the global economy in 2008, according to authors Ralph S. J. Koijen and Motohiro Yogo.

Their study shows that the volume of shadow insurance grew from just $11 billion in 2002 to $364 billion in 2009, and has remained high:

> “We estimate that total liabilities ceded by U.S. life insurers to shadow reinsurers was $364 billion at its peak in 2009, or 2.98 times the equity of the ceding companies,” they said. “At the end of 2012, it remains large at $363 billion or 2.52 times equity. We find that shadow insurance adds a tremendous amount of financial risk for the companies involved, which is not reflected in their ratings. When we adjust measures of financial risk for shadow insurance, risk-based capital drops by 49 percentage points for the median company, which is equivalent to three rating notches. Hence, default probabilities are likely to be higher than what may be inferred from their reported ratings. Our adjustments for shadow insurance implies an increase in the expected asset shortfall of $19 billion for the life insurance industry, which is a cost to the state guaranty funds (and ultimately taxpayers).”

If shadow reinsurance were banned, the authors predict that prices for insurance products would go up. “We find that insurance prices would rise by 1.2 percent for the average operating company. For an empirically realistic value of 11 for the demand elasticity, the market would shrink by 13.1 percent. This corresponds to $10.6 billion annually when aggregated across all the operating companies that are involved in shadow insurance,” their paper said.

Regulators have become concerned about the transfer of liabilities from one holding company insurer to another in order to free up capital.

Last June, the New York State Department of Financial Services, published a report, “Shining a Light on Shadow Insurance: A Little-known Loophole that Puts Insurance Policyholders and Taxpayers at Greater Risk.” The report was the result of a year-long investigation in to the hidden use of shadow reinsurance and its ability to make insurance companies look healthier than they are. According to the report:

> “In a typical shadow insurance transaction, an insurance company creates a ‘captive’ insurance subsidiary, which is essentially a shell company owned by the insurer’s parent. The company then ‘reinsures’ a block of existing policy claims through the shell company — and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve and collateral requirements for the captive shell company are typically lower. Sometimes the parent company even effectively pays a commission to itself from the shell company when the transaction is complete.
>
> “This financial alchemy, however, does not actually transfer the risk for those insurance policies because, in many instances, the parent company is ultimately still on the hook for paying claims if the shell company’s weaker reserves are exhausted (‘a parental guarantee’).”

The National Association of Insurance Commissioners is also looking into the matter. According to the NAIC website, the group’s Financial Condition Committee has created a Captive and Special Purpose Vehicle Use SubGroup to:

> “Study insurers’ use of captives and special purpose vehicles to transfer insurance risk, other than self-insured risk, in relation to existing state laws and regulations, and establish appropriate regulatory requirements to address concerns identified in this study. The appropriate regulatory requirements may involve modifications to existing NAIC model laws and/or generation of a new NAIC model law.”

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