Reinsurance

An Introduction

Introduction to Reinsurance

1. What is Reinsurance
2. Basics of Reinsurance
3. Benefits of Reinsurance
4. Types of Reinsurance
5. Reinsurance Industry

What is Reinsurance ?

- **It’s still insurance !!**
- **BUT of a VERY different nature**
  - It is a contract between an insurer and another insurer OR (more usually) a “consortium” of other insurers.
  - The “other” insurers are known as Reinsurers.
  - These “Reinsurers” actually “insure” the “insurer”

What is Reinsurance ?

- **It's insurance !! BUT of a VERY different nature….**

  The contract of reinsurance is known as a reinsurance policy.

  – If the reinsurance policy pertains to a line of business assumed for a period, it is known as a reinsurance "treaty"

  – A reinsurance contract is typically a "back to back" arrangement with the direct policy/line of business

  – The insurer is thus not free to do what it likes !

  – Every reinsurance has a "cost"

What is Reinsurance ?

Put simply,

reinsurance is the mechanism of insurance of insurers

Basics of Reinsurance

Hamad insured his car with ABC Insurance.

Now, if you look at things from ABC's viewpoint, you will see that they could have several other policyholders like Hamad. What if something unforeseen happened, and a number of policyholders made a claim at the same time?

Would ABC be able to meet ALL these unexpected claims?

How could ABC protect itself against an eventuality like this?

Basics of Reinsurance

To safeguard its interests in situations such as these, ABC needs **reinsurance**.

In other words, insurance companies use reinsurance **to protect themselves against unanticipated "frequency" of losses**.

That's just one of the reasons for ABC requiring Reinsurance.

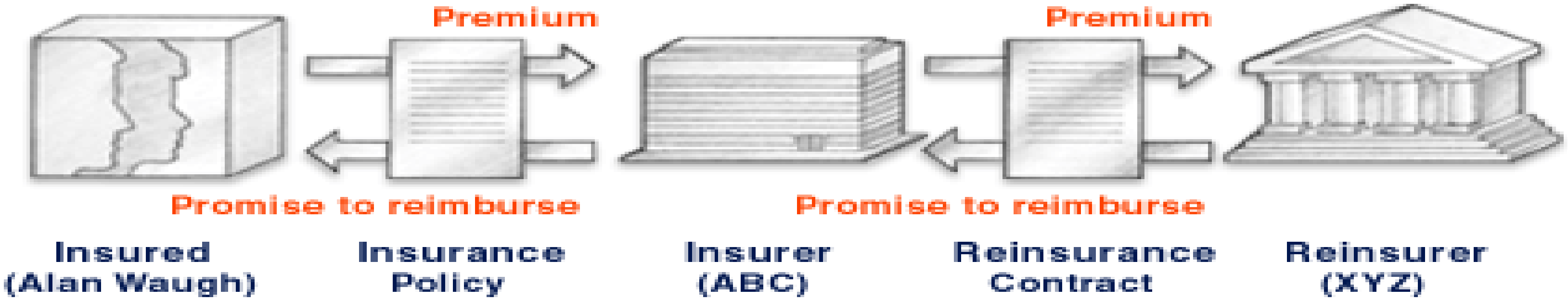
Basics of Reinsurance

Hamad returns with a BMW 7 series “art car” valued at USD.2,500,000.

Once again, to safeguard its interests in situations such as this singular high value, ABC needs **reinsurance.**

In other words, insurance companies use reinsurance **to protect themselves against a “singular large” exposure / loss**
That’s just another of the reasons for ABC requiring reinsurance.

Basics of Reinsurance

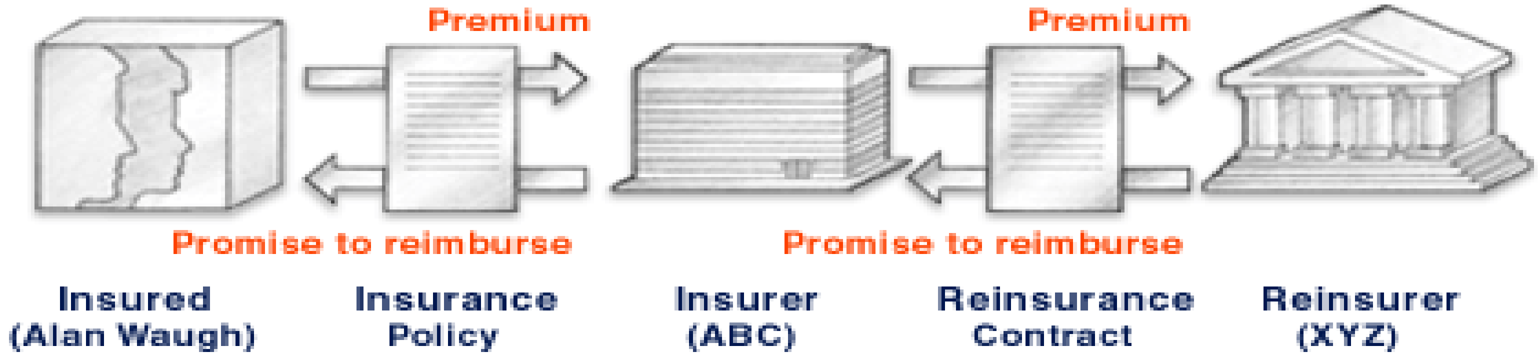


ABC thus purchases a Reinsurance policy from another insurer, XYZ, to protect itself from the losses it may incur on the policies it has issued to Hamad. For ABC, XYZ is a Reinsurer.

The reinsurance contract specifies:

- the <u>premium</u> ABC will have to pay to XYZ
- the <u>extent of protection</u> that XYZ gives to ABC.
- the <u>method</u> by which the <u>protection</u> to ABC will operate

Basics of Reinsurance



Just as Hamad would have submitted all information on his cars to ABC, XYZ too will require ABC to put up all <u>information</u> pertaining to

- <u>Hamad</u> and <u>his cars</u>
- <u>the scope of the covers</u> (*desired to be*) offered under the policies to Hamad

Using this data, XYZ determines the scope, extent and method of **re**insurance protection it can give to ABC as well as the price (reinsurance premium) required for the same.

Obviously, ABC and XYZ need to agree first before ABC and Hamad enter into a binding contract

Basics of Reinsurance

Thus,

Reinsurance is a transaction in which one insurer ("reinsurer") agrees,

for a "premium",

to indemnify another insurer ("reinsured"), against

all or part

of the losses the latter might sustain under it's policies of insurance

Basics of Reinsurance

- In any reinsurance transaction, one insurer transfers part of the risk assumed under its contract of insurance to another insurer, called the reinsurer.

- The reinsurer promises to indemnify or reimburse the insurer for some or all of the losses it sustains under the specified policies, or groups of policies.

- This reimbursement is calculated according to a method / formula established in a reinsurance contract between the insurer and the reinsurer.

- In return, the insurer pays the reinsurer a premium

Basics of Reinsurance

The “premium” required by the Reinsurer would be ordinarily a “portion” of the premium received by the Insurer from the primary insured.

It is also possible that the Reinsurer may want:
• the whole of the premium or perhaps even more for reinsuring the part of the risk - this is because the premium available with the Insurer are not “risk commensurate”

Effectively, a Reinsurer has the ability, to an extent, to ensure observance / maintenance of “underwriting standards”.

Basics of Reinsurance

- Traditionally, there is no direct contractual relationship between the Reinsurer and the original Insured / Policyholder.

  A direct contractual relationship at times is established under pre-agreed situations - this qualifying agreement is known as a "cut-through clause"

- Reinsurance "reimburses" <u>after</u> financial expense is actually incurred by the insurance company in meeting it's obligations to the Policyholder(s).

  This principle holds though case laws have modified it under "pay as may be paid" in situations of insolvency of the direct insurer

- Reinsurance responds for loss sustained against those specific policies or line of business defined as being reinsured.

Basics of Reinsurance

Terms

- **Ceding company**
  - This means the reinsured which “cedes” whole or part of the risk taken on in it’s direct policy of insurance.

- **Cession**
  - This means the amount of the risk ceded under the reinsurance

Benefits of Reinsurance

Enhancement of "capacity"

Reduction of "risk"

Benefits of Reinsurance

Enhances capacity:

This is a two-fold benefit. Reinsurance can either improve large line capacity or premium capacity.

Reduces risk:

Reinsurance works towards risk reduction by increasing the spread of risk, stabilizing loss, providing catastrophe relief.

Benefits of Reinsurance

Ways in which reinsurance is a benefit to insurance companies.

- *Large line capacity*
- *Premium capacity*
- *Spread of risk*
- *Stabilization of loss experience*
- *Underwriting assistance*
- *Catastrophe relief*

The first two benefits work towards capacity enhancement.
The latter four deals with risk reduction.

Benefits- Capacity Expansion

An insurance company may be asked to write a variety of risks of different sizes. **But can it actually write all of them?**

The maximum amount of a single risk that can be taken on by the Insurer is referred to as the "capacity" of the insurer-

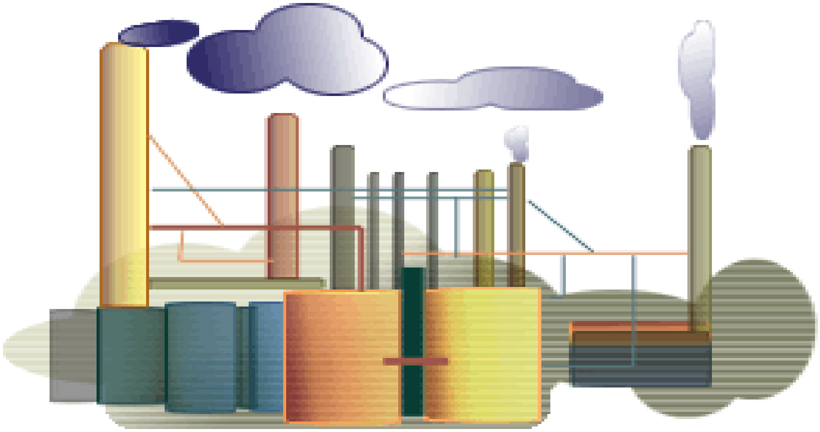
• referred as "net capacity" in relation to the ability to write a risk "net" for it's own account.

•referred as "gross capacity" in relation to the ability to write a risk using a reinsurance treaty and it's own account (ie.net capacity)

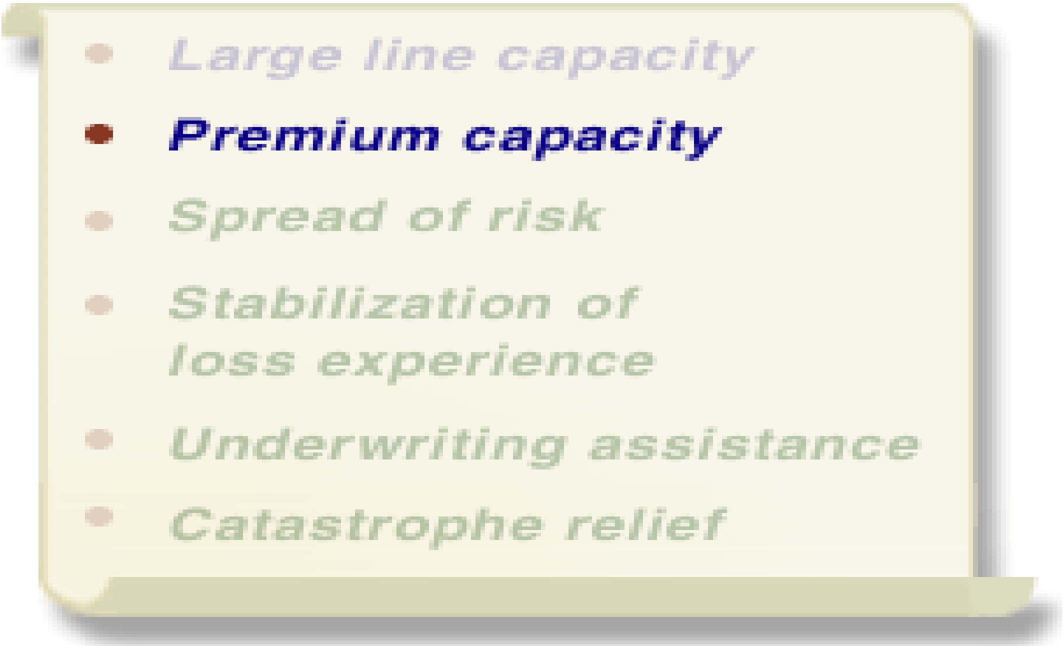
Benefits- Capacity Expansion

So by reinsuring the amount in excess net capacity, the insurer is actually able to accommodate a larger risk.

By using reinsurance companies Net or Gross Capacity, Reinsurance gives them greater freedom to write risks of all sizes, by improving their large line capacity.



Benefits- Premium Capacity



Key Terms

- The Kenney ratio,
- Premium capacity, and
- Unearned premium reserve.

Benefits- Premium Capacity

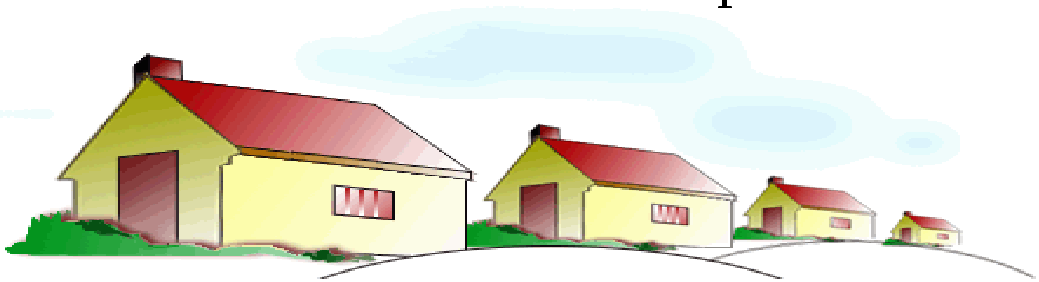
Premium capacity is the company's ability to write additional premium, while maintaining a healthy **Combined Ratio**

Benefits- Risk Reduction

- *Large line capacity*
- *Premium capacity*
- *Spread of risk*
- *Stabilization of loss experience*
- *Underwriting assistance*
- *Catastrophe relief*

Benefits- Risk Reduction

How does reinsurance extend the spread of risk?



The Law of Large Numbers says that the accuracy with which losses can be predicted increases with the number of exposures insured, especially when they are nearly homogenous in size and kind, and are independently exposed to loss.

Benefits- Risk Reduction

So, how does reinsurance increase the Spread of Risk?

It can do this in two ways.

- By increasing the size (Homogeneity) of the exposures.

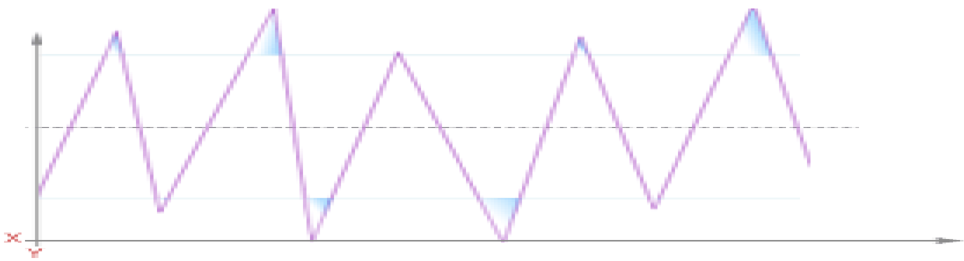
- By increasing the number of exposures and geographic spread.

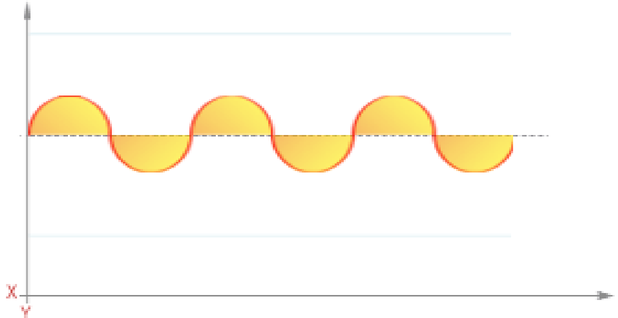
Benefits- Risk Reduction

How does reinsurance stabilize the loss experience?

A company decides the maximum amount of loss it would find acceptable for a single risk, or a single event in any year, and seeks reinsurance that will reimburse for losses greater than this amount.

By smoothing out the peaks and troughs of loss experience, reinsurance controls the accumulation of losses, as well as the company's exposure to loss on individual risks.





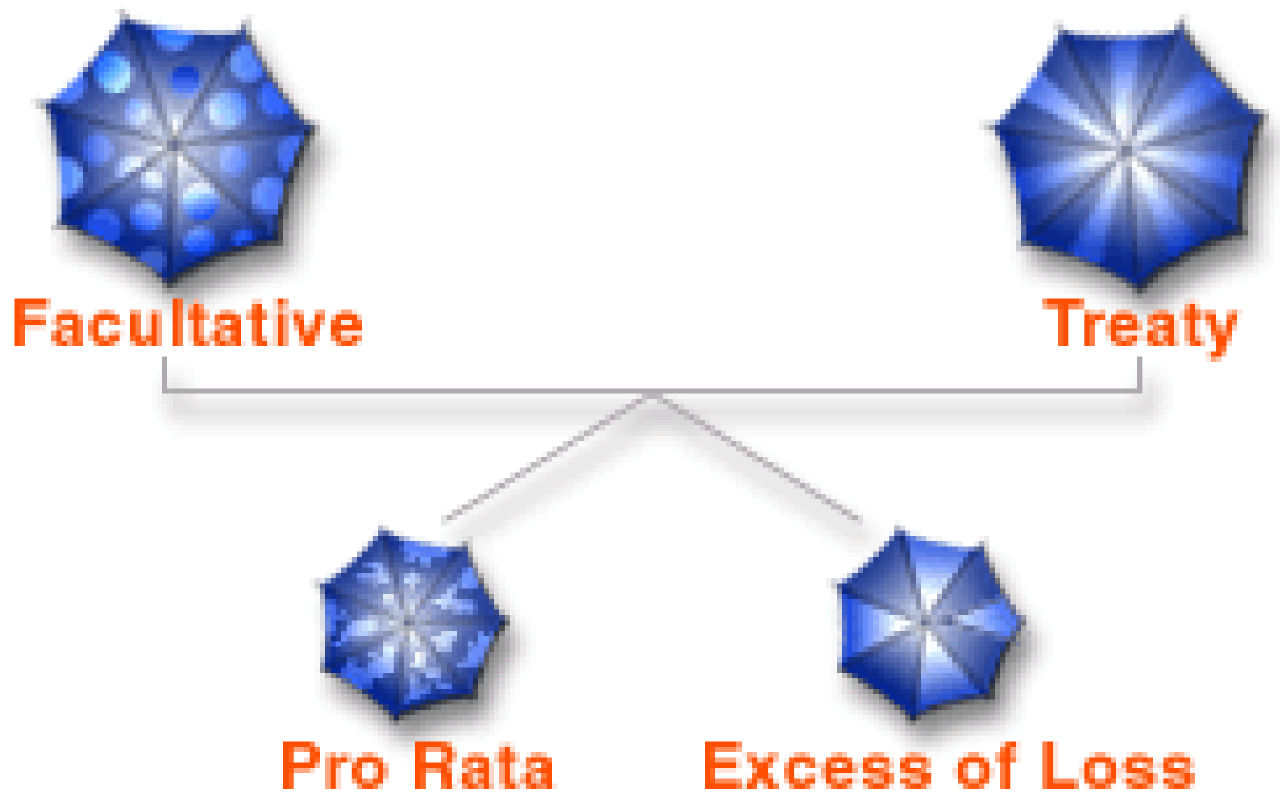
Benefits- Risk Reduction

But what if something completely unexpected happens?

Assume an earthquake. A large number of risks get affected by one single event.

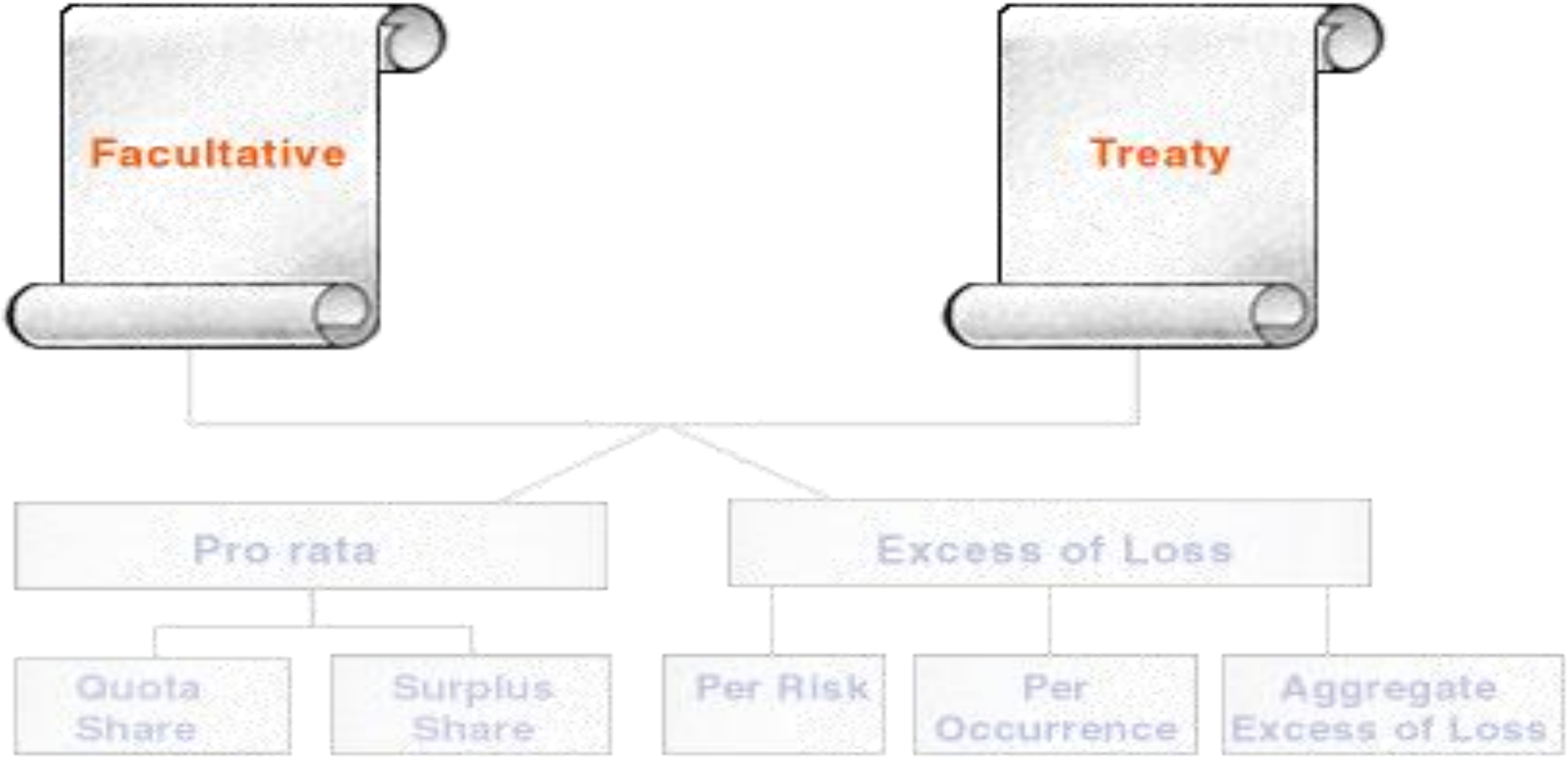
This is a situation where reinsurance can offer **catastrophe relief.** It does this by providing a separate reinsurance mechanism that acts as a safety valve through which a catastrophic loss is shared with one or more Reinsurers.

Types of Reinsurance



Types of reinsurance

There are two different methods of placing reinsurance: Facultative and Treaty.



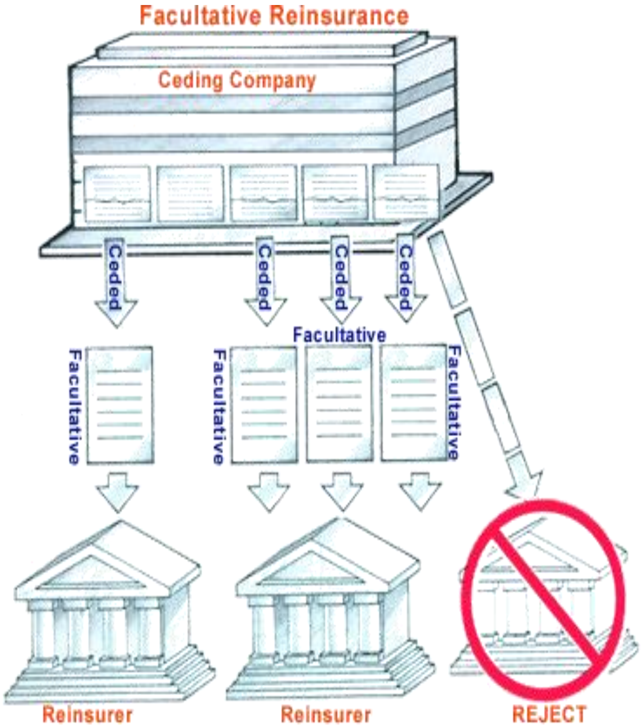
Types of reinsurance – Treaty Reinsurance

Treaty reinsurance covers a book or class of business.

Under treaty reinsurance, the ceding company and the reinsurer enter into a formal agreement, called a treaty.

It stipulates that for a **certain group, or class of business,** the ceding company will purchase reinsurance, which the reinsurer will provide the pre-agreed extent of protection.

Facultative Reinsurance



The other type of reinsurance is Facultative reinsurance.

It covers a single policy, and is underwritten much as a primary insurer underwrites the original risk.

There is no obligation on the part of the Reinsurer to accept the risk.

There is also no obligation on the part of the Reinsurer to accept midterm amendments

Facultative refers to the reinsurer's “faculty "or ability) to accept or reject each presented risk.

Features of Facultative Reinsurance

- It covers individual risks rather than groups of risks.

- It is optional. The ceding company may choose to cede, or not to cede, a particular risk. The reinsurer may choose to accept or reject any risk that is offered.

- The terms of each individual facultative reinsurance agreement are negotiable between the two parties as to amounts of insurance or loss ceded, premiums, and commissions.

Disadvantages of Facultative Reinsurance

- It involves extensive paperwork, as each risk is handled separately, from underwriting the risk to settling losses under the contract.
- This means that the costs involved are also higher for both the ceding company and the reinsurer.

- There may be delays in obtaining facultative reinsurance as a lot of time is spent in underwriting each risk and negotiating each contract

- **Most importantly,** technically a risk <u>cannot</u> be booked on the direct side until the required reinsurance gets arranged

Characteristics of Treaty Reinsurance

- While the treaty is in force neither party has an option regarding reinsurance about any individual policy falling under that particular class of business.

- The terms of the treaty cover all the policies, and, accordingly, each and every policy coming within it's ambit must be reinsured.

- The treaty specifies the terms and conditions of how much reinsurance is to be provided for each risk.

Advantages of Treaty Reinsurance

- The ceding company can write a policy even if the policy amount is greater than the company's retention. In this way, it can expand premium capacity.

- Since treaty reinsurance is automatic, it ensures that no individual risk fitting within the agreed descriptions is overlooked.

- Usually , the Reinsurer is settled/ billed quarterly for its earnings/ obligations, without specific listing of the components. This makes it easier for the ceding company and also inexpensive to operate.

Disadvantages of Treaty Reinsurance

Over a period of time, it is possible that the ceding company could fail to live up to its commitment of risks written.

Sometimes, it may specifically exclude certain classes or types of risks (e.g., fire or earthquake).

Since billing is usually quarterly, and not on a per-risk ceded basis, treaty reinsurance can prove unprofitable to the reinsurer in the short term.

It could even be unaffordable to the ceding company in the long run, as the payments could go on for a long period, with no claim arising whatsoever.

Treaty Reinsurance

ADVANTAGES

- Ceding company can write a policy without delay even if policy amount is greater than company's retention.
- Since treaty reinsurance is automatic, it ensures that no individual risk is overlooked.
- Often, the reinsurer is billed quarterly for its obligations without breakdown into individual losses, making it relatively easy and inexpensive to operate.
- Treaty reinsurance helps to stabilize losses, provide surplus relief, and protect from catastrophic events.
- Reinsurer is guaranteed a steady flow of business.

DISADVANTAGES

- The ceding company could fail to observe good faith.
- Sometimes, it may specifically exclude certain classes or types of risks.
- Treaty reinsurance can prove unprofitable to the reinsurer in the short term, or unaffordable to the ceding company in the long run.
- The reinsurer forfeits the right to underwrite individual risks.

Treaty v/s Facultative

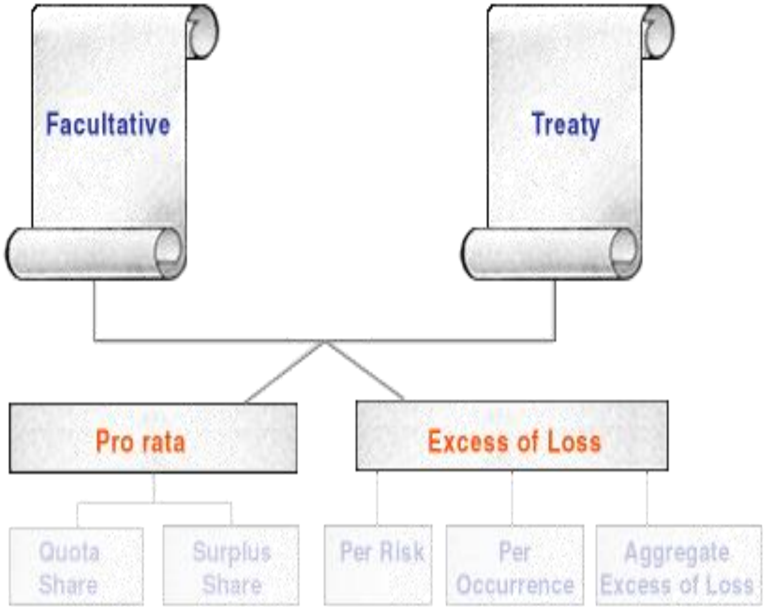
- Facultative reinsurance covers a single risk, while treaty covers a group of risks.

- Acceptance of policies under a treaty is automatic and obligatory, while in facultative reinsurance each policy is separately negotiated.

- In a treaty reinsurance, both the insurer and the reinsurer have no choice beyond pre-agreed individual risks ceded within groups of policies, while in facultative there is always a choice for both the ceding company and the reinsurer.

Types of reinsurance

Pro Rata and Excess Loss

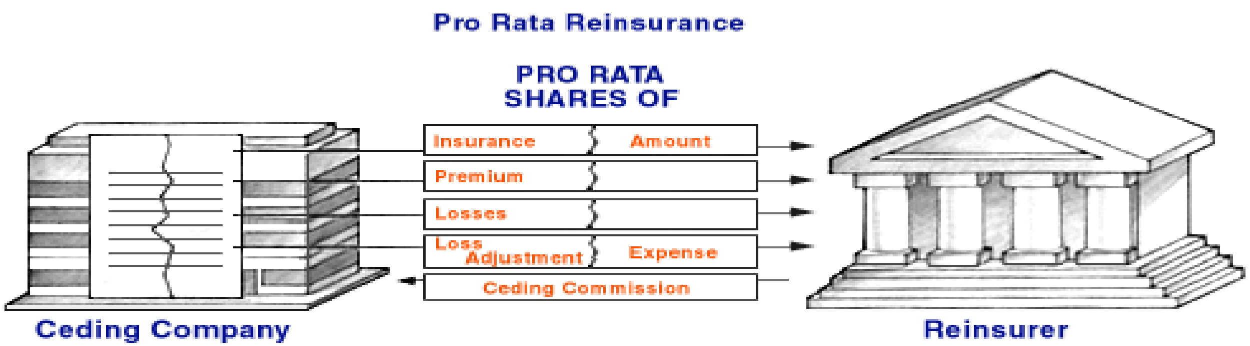


Facultative and treaty, can be implemented in two forms

- proportional and
- non-proportional

Types of reinsurance

Pro Rata and Excess of Loss



Pro rata reinsurance:

Also called proportional reinsurance.

Under this type of reinsurance, the insurance amount, premium, and losses under the policy are shared between the ceding company and the reinsurer in a pre-agreed proportion

Types of reinsurance

Features of Pro Rata Reinsurance

- Losses are shared between ceding company and reinsurer in the same proportion as the risk and it's premiums

- Typically, the reinsurer also pays a corresponding amount in loss adjustment expenses.

- For its expenses in underwriting and servicing the policy of insurance, the original insurer retains/ receives a ceding commission. *This ceding commission may also be seen as the acquisition costs of business of the Reinsurer.*

Types of reinsurance

Excess of loss reinsurance:

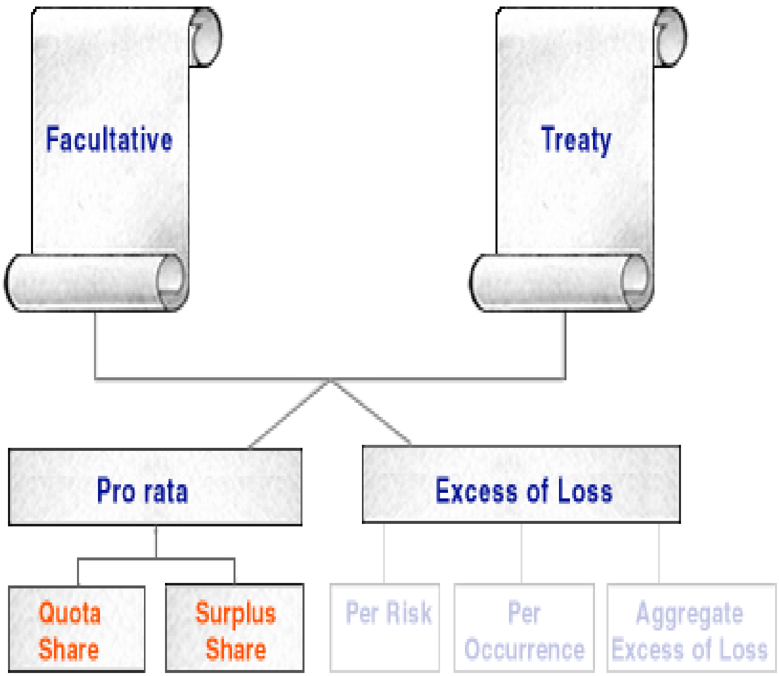
Also known as non-proportional reinsurance.

Unlike "proportional reinsurance", the "risk", the "premiums" and any "losses" do not get shared in any related proportion.

The reinsurer agrees to indemnify the ceding company for losses that exceed a specified retention in exchange for a premium that does not bear a proportional relationship to the losses shared.

The primary insurer pays for all losses within the retention and cedes all those in excess up to the limit of reinsurance expressed in the contract.

Pro Rata reinsurance



There are two main sub categories of pro rata reinsurance:

- **Quota share**

- **Surplus share**

The major difference between the two is in how the ceding company's retention is stated.

Pro Rata reinsurance

Quota share reinsurance

In quota share reinsurance, the ceding company cedes a fixed percentage of each policy written in a defined class of business or individual policy, as the case may be. The ceding company retains the remainder.

Example –

Arbitt cedes 40% of each policy in a class of homeowner's policies to the reinsurer, Feldun, and retains the remaining 60%.

This means, the reinsurer would receive 40% of the premium and reimburse the ceding company for 40% of the losses.

Likewise, the ceding company would keep 60% of the premium and pay 60% of the losses.

Features of quota share reinsurance

- The reinsurer participates in each policy that is a part of the defined class of business.

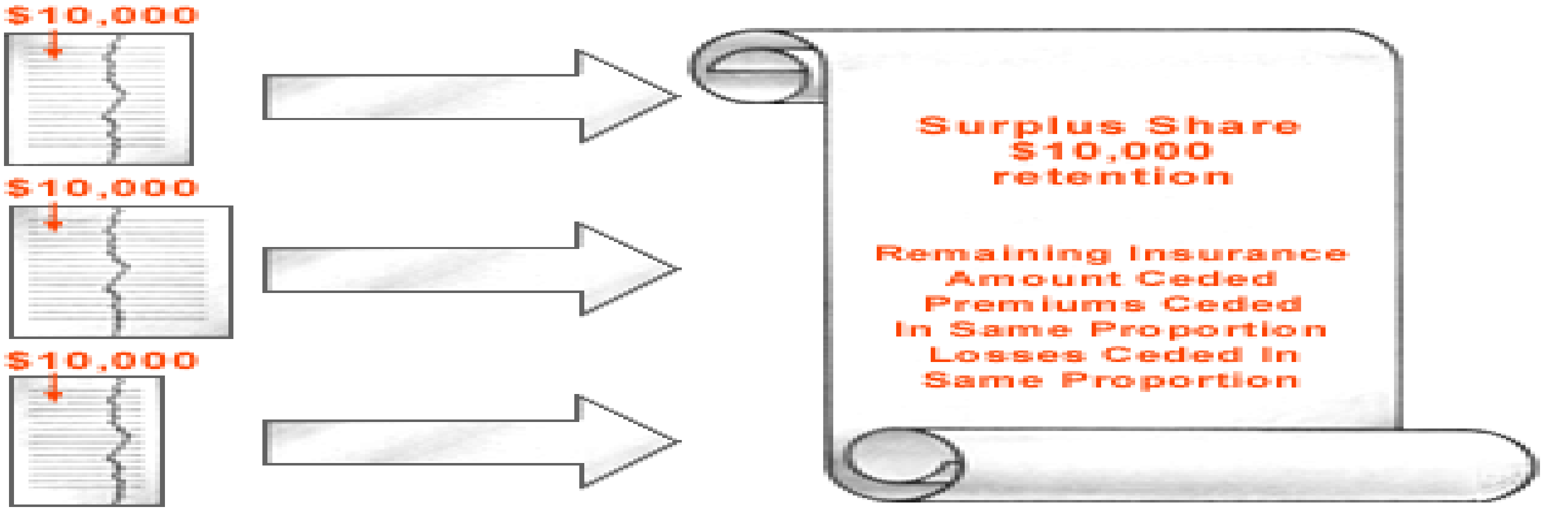
- Quota share treaties also provide for the reinsurer to pay the ceding company a commission.

- A quota share treaty usually states a reinsurance limit, which represents the maximum amount of reinsurance the reinsurer would be willing to provide.

Pro Rata Reinsurance

Surplus share reinsurance.

In **surplus share reinsurance,** the ceding company sets a unique retention amount for each type of risk to be reinsured. The retention is stated as a dollar figure rather than as a percentage. These retentions are known as **lines**.



Quota share v/s Surplus Share

Quota share	Surplus share
• The retention is a percentage of the insurance amount, regardless of the size of the risk.	• The retention is a fixed dollar amount for each type of risk. The reinsurer's percentage liability increases with the size of the risk.
• Insurance amounts, premiums, and losses are shared.	• Insurance amounts, premiums and losses are shared.
• The reinsurer participates in all risks to which the agreement applies.	• Risks which are smaller than the applicable retention are wholly retained by the ceding company.
• More effective in providing surplus relief.	• More effective in providing large line capacity, increasing the size homogeneity of risks, stabilizing loss experience and increasing premium capacity.
• Easier to administer, costs are much lower.	• Administrative costs are higher, since it is more complex.
• The ceding company ends up ceding a portion of each risk, sometimes even profitable business.	• The ceding company does not have to automatically cede a portion of each risk.

- Scope of the reinsurance market
- Organizations selling reinsurance
- Distribution systems
- Organizations buying reinsurance

The Reinsurance Market

Reinsurance is an international business, with buyers (ceding companies) and sellers (reinsurers) operating beyond national boundaries.

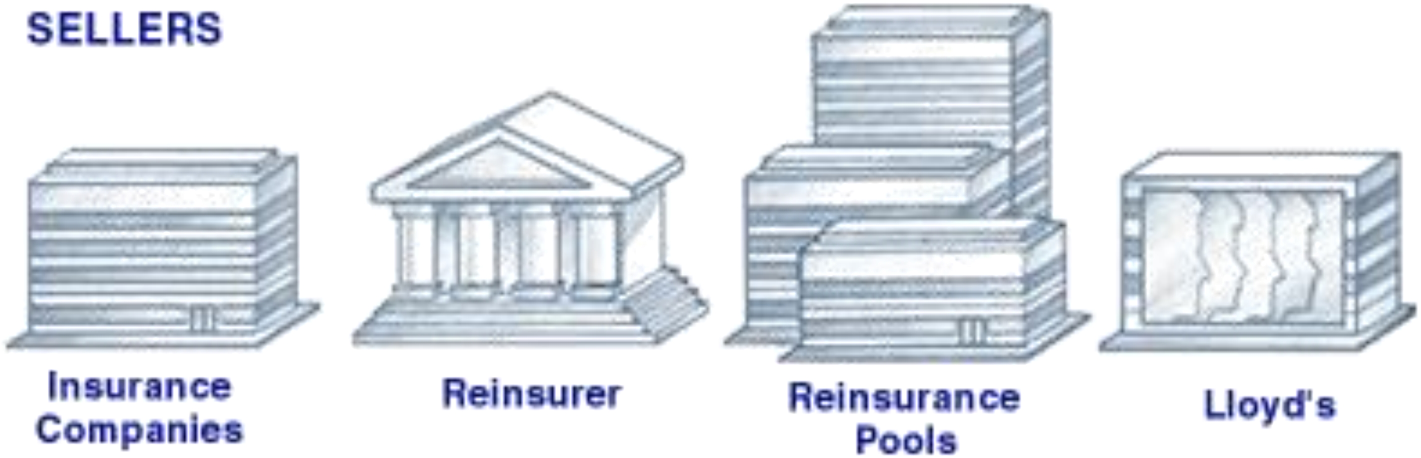
The United States represents the largest market for reinsurance.

England, Germany, Switzerland, Scandinavia, and Japan also have a major presence in the world reinsurance market.

Organizations that sell insurance

The following are the organizations that sell (accept) reinsurance.

1. Primary insurance companies
2. Professional reinsurance companies
3. Reinsurance Pools
4. Lloyd’s of London



Organizations that sell insurance

Professional reinsurance companies

- Their only business is reinsurance.
- They may specialize in a line of business
- Together they write the largest share of world's reinsurance premiums traded.

Organizations that sell insurance

Lloyd's of London

- It is a unique marketplace made up of thousands of individuals or underwriting members, who are in turn organized into groups or syndicates.

- Each syndicate is managed by a managing underwriter, who develops the book for insurance or reinsurance from accredited Lloyd's brokers.

Organizations that sell insurance

Reinsurance Pools

These consist of individual primary insurers that have been banded together to increase their large-line or premium capacity, or to provide coverage for risks which are uninsurable by conventional means.

Organizations that sell insurance

Features of a Reinsurance POOL

- Pools can be organized in different ways, depending on their purpose, the types of business being reinsured, and the type of reinsurance being used.

- Members of the Pool may reinsure only each other, only non-members, or some combination.

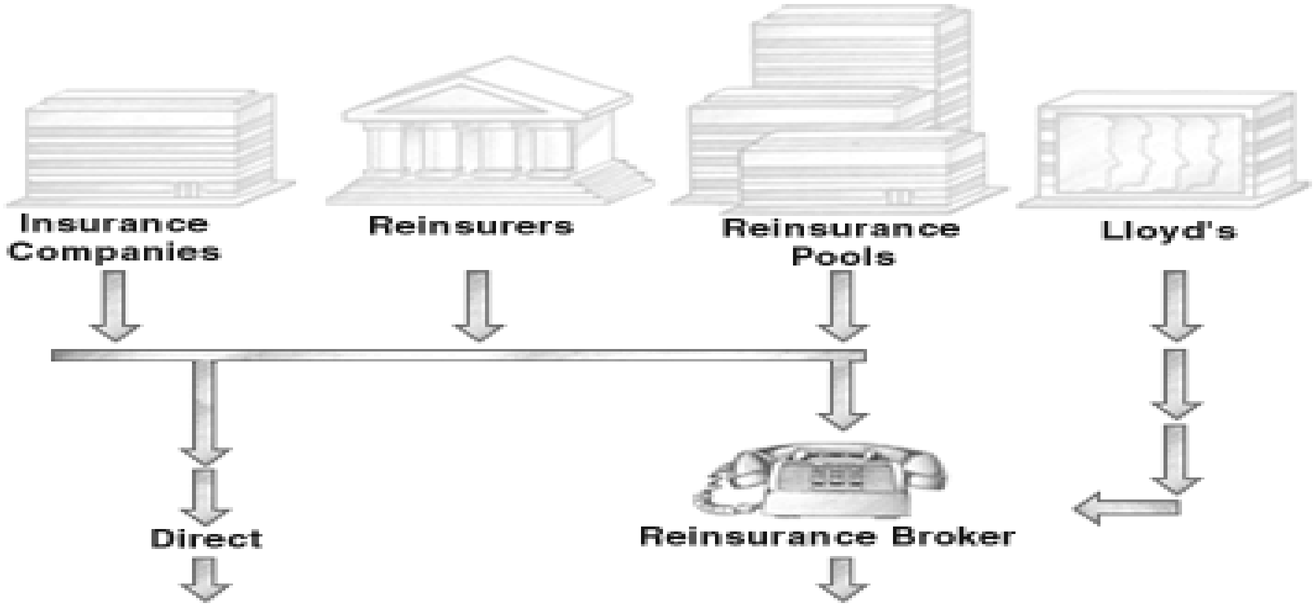
- Each member may assume a percentage of each loss that must be paid by the Pool.

- Pools are usually managed by a separate company which provides underwriting, loss handling, and administration for a fee.

Distribution Systems

Reinsurance may be distributed in two ways:

- Directly or
- through a Broker.



Distribution systems

Features that characterize a Reinsurance intermediary:

- The intermediary may place a ceding company's business with any reinsurer, seeking out the best available terms for the ceding company from the options in the marketplace.

- The intermediary is generally considered an agent of the ceding company, other than for premiums and losses, but usually is compensated through commissions paid by the reinsurer (called "Brokerage").

Advantages of Direct writing and Brokerage

Direct writing	Brokerage market
• The ceding company has a close, personal relationship with reinsurer.	• Brokers have access to appropriate and multiple resources through their knowledge of marketplace.
• Payment of large losses may be handled more quickly.	• Brokers have in-depth information about policy forms,capacity, financial conditions, etc. and can advise clients of suitability.
• Ceding company places business with fewer reinsurers, which simplifies the accounting process.	• Brokers maintain their own staff of reinsurance personnel so ceding company can do with less staff.

Reinsurance - in summary

When seen from the viewpoint of insured risks, there are broadly 2 types of reinsurance

- **Facultative (per "risk") reinsurance**

  The insurer writes a risk and passes on the whole of it or a portion of it to the Reinsurer

- **Treaty (per "portfolio") reinsurance**

  The insurer gets into an agreement to reinsure a whole book of business that the insurer proposes to develop during a period of (usually) 1 year. A "book" means the whole portfolio of risks underwritten in a line of business.

Reinsurance - in summary

When seen from the viewpoint of the "method" of reinsuring insured risks, there are broadly 2 types of reinsurance

- **Proportional reinsurance**

  The insurer writes a risk and passes on the whole of it or a portion of it to the Reinsurer. The same proportion of original premium is passed on to the Reinsurer who is then committed to share in the same proportion, all claims affecting the risk

- **Non Proportional reinsurance**

  The insurer writes a risk and passes on a part of it to the Reinsurer. The portion of original premium is also passed on to the Reinsurer who is then committed to share on all claims affecting the risk up to a predetermined total sum

Reinsurance - in summary

Why does an Insurer need Reinsurance ?

- Well, an Insurer need not always reinsure !

- The requirement to reinsure goes deep into corporate financial ability and attitude to “risk taking” - risk taking in financial terms means exposing the capital and free reserves of the Insurer.

Continue….

Reinsurance - in summary

Why does an Insurer need Reinsurance ?

- More generally, any of the following could result in a desire/ requirement to reinsure a specific risk or class :
  - the subject at hand is not “known” to the Insurer
  - a subject has a total exposure larger than the capital/capacity of the insurer
  - a subject is evaluated as “too risky”
  - a subject that does not gel / fit with the current book of the Insurer
  - the terms available are not “risk commensurate” !!

Reinsurance - in summary

Why does an Insurer need a Reinsurance <u>Treaty</u> ?

- An Insurer cannot always go “begging” for each risk it wants to write !
- An Insurer may want to be more predictable about it’s ability to handle types and sizes of risks
- An Insurer may want to have a more stable status on profits projections besides revenue projections
- An Insurer may want to receive “underwriting technology” infusion to move ahead in a competitive market with newer products or lines of business