Basic Reinsurance Concepts

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OVERVIEW

- What is Reinsurance
- Insurance/Reinsurance Similarities
- Parties to the Reinsurance Agreement
- Why Insurers Buy Reinsurance
- Types of Reinsurance Agreements
- How Reinsurance Works

Reinsurance: A Definition

- Insurance for Insurance Companies
  - An insurance company (primary/ceding company) shares portions of its premium and liability with another insurance company (reinsurer)
- Reinsurance is a transaction solely between two or more insurance companies
  - Underlying policyholders have no interest in, or privity to, the reinsurance contract
  - Subject matter of a reinsurance contract is the risk the reinsured undertook in its original policies
  - Reinsurer "reimburses" the ceding (primary) company for the reinsurer's portion of paid claims in exchange for a portion of the ceding company's premium

Insurance/Reinsurance Similarities

Both Insurance and Reinsurance:

- Protect against uncertain, future events
- Involve a transfer of risk
- Require a payment of premium
- Pay for certain types of expenses
- Require underwriting skills (selecting, analyzing, and pricing risks)

Insurance/Reinsurance Differences

Insurance	Reinsurance
• Buyers have varying knowledge levels	• Buyers assumed to be knowledgeable
• Provides Defense and Indemnification	• Provides Indemnification only
• Pays on behalf of	• Reimbursement contract
• Primarily domestic	• International/global
• Highly regulated	• Unregulated

How Reinsurance Works

- Shifts risks from one insurer to another
- Allows “sharing” of risks to reduce burden on a carrier
- Frees up capacity for a primary insurer
- Allows coverage of large risks or books of business
- Often a “subscription” market

Why Buy Reinsurance?

- Catastrophic loss relief
- Stabilize loss experience and reduce uncertainty
- Capacity to write larger (or additional) risks
- Ability to better meet member needs
- Premium capacity
- Regulatory compliance

Choosing to Reinsure

Risk factors should impact the decision process

- Size of potential loss
- Unpredictable frequencies
- Length of time for claim payments
- Volatility of loss outcomes

Two Main Types of Reinsurance

- **"TREATY" Reinsurance** -- a transaction encompassing a block of the ceding company's book of business. The reinsurer must accept all business included within the terms of the reinsurance contract

- **"FACULTATIVE" Reinsurance** -- transaction on an individual risk basis. Ceding company has the option to offer an individual risk to the reinsurer and the reinsurer retains the right to accept or reject each risk

Characteristics of Reinsurance Contract Types

FACULTATIVE	TREATY
• Individual risk review	• No individual risk scrutiny
• Right to accept or reject each risk	• Obligatory acceptance of covered business
• Profit expected in the short and long-term	• Long-term relationship – make money over time
• Certificate written to confirm each deal	• One contract covers all subject risks
• Can reinsure a risk that might be expected	• Less costly than “per risk” reinsurance
• Protects treaty from adverse underwriting results	

Forms of Reinsurance

- Pro Rata Reinsurance (Proportional)
  - Sharing concept – ceding company and reinsurer share premiums and losses in pre-determined, specified percentage
- Excess of Loss Reinsurance (Non-Proportional)
  - For a portion of the premium, reinsurers cover losses above a specified amount (retention) by the ceding company, up to a pre-determined limit

Quota Share Reinsurance

40% Quota Share			
	Gross	Ceded	Net
Policy Limit	$500,000	$200,000	$300,000
Premium	$12,500	$5,000	$7,500
Loss	$275,000	$110,000	$165,000

Excess of Loss Reinsurance

- Portion of premium paid (ceded) to reinsurer has no relationship to portion of loss paid
- Example: Carrier might pay 3.17% of written premium for Workers' Compensation for $5M in coverage above a $1M retention
  - Written Premium: $59,713,641
  - Premium paid: $1,892,922
  - Loss occurrence results in $3,340,000 loss
  - Payment to ceding company of $2,240,000

Excess of Loss - Clash Cover

- Designed to prevent the payment by the ceding company of two retentions (involving different lines of business) related to a single occurrence (loss)

Excess of Loss – Clash Cover

- Lineman crosses over center line in company vehicle, resulting in head-on collision
- Both drivers sustain serious injury
- Retention for both WC and Auto are $500,000
- WC payments = $700,000; Auto = $1.1M
- Without clash cover, ceding company recovers $800,000
- With clash cover, ceding company pays only one retention and recovers $1.3M

Evaluating Reinsurance Programs

Buy Less Reinsurance?	Buy More Reinsurance?
• Company has excess capital	• Regulatory and rating agency pressure
• Keep larger share of historically profitable business	• Let reinsurers share the coming unprofitable results
• Eliminate unnecessary expenses and transaction costs	• It's cheap (surplus capital)
• Keep net premiums up	• Predictions of future CAT's
	• Support higher limits being sold

Reinsurance Program Considerations

Compared to Federated, no other company has exactly the same:

- Volume and mix of business
- Profitability history and outlook
- Exposure to large claims, mass torts, CATs
- Capital amount and structure
- View on safety and loss prevention
- Stakeholder expectations
- Risk appetite/aversion
- Loss reserve adequacy
- Investment strategy and performance
- Corporate structure

Evaluation of Reinsurers

- Financial standing and capabilities
  - Commercial ratings & performance tests
  - Size, leverage, liquidity of balance sheets
- Commitment to line of business
- Degree of input (interference)
  - Underwriting and claims
- Claim payment reputation
- Organizational structure and management philosophy

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