Introduction to Reinsurance

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REINSURANCE AND ITS FUNCTIONS

A single insurer that sells a $100 million commercial property policy and a $100 million commercial umbrella liability policy to the owners of a high-rise office building may appear to be jeopardizing its financial stability. Insurers who provide billions of dollars of property insurance in wind-prone Florida and earthquake-prone California may seem similarly imperiled. However, such transactions are possible when the insurers use reinsurance as a tool to expand their capacity.

No insurer intentionally places itself in a situation in which a catastrophic event could destroy its net worth. Additionally, insurance regulators attempt to prevent insurers from being left in such a position. Reinsurance is one way insurers protect themselves from the financial consequences of insuring others. This section introduces basic reinsurance terms and concepts, including the principal functions of reinsurance.

Basic Terms and Concepts

Reinsurance, commonly referred to as "insurance for insurers," is the transfer from one insurer (the **primary insurer**) to another (the **reinsurer**) of some or all of the financial consequences of certain loss exposures covered by the primary insurer's policies. The loss exposures transferred, or ceded, by the primary insurer could be associated with a single subject of insurance (such as a building), a single policy, or a group of policies.

An insurer that transfers liability for loss exposures by ceding them to a reinsurer can be referred to as the reinsured, the ceding company, the cedent, the direct insurer, or the primary insurer. Although all these terms are acceptable, "primary insurer" will be used to denote the party that cedes loss exposures to a reinsurer.

Reinsurance is transacted through a **reinsurance agreement**, which specifies the terms under which the reinsurance is provided. For example, it may state that the reinsurer must pay a percentage of all the primary insurer's losses for loss exposures subject to the agreement, or must reimburse the primary insurer for losses that exceed a specified amount. Additionally, the reinsurance agreement identifies the policy, group of policies, or other categories of insurance that are included in the reinsurance agreement.

Reinsurance

The transfer of insurance risk from one insurer to another through a contractual agreement under which one insurer (the reinsurer) agrees, in return for a reinsurance premium, to indemnify another insurer (the primary insurer) for some or all of the financial consequences of certain loss exposures covered by the primary's insurance policies.

Primary insurer

In reinsurance, the insurer that transfers or cedes all or part of the insurance risk it has assumed to another insurer in a contractual arrangement.

Reinsurer

The insurer that assumes some or all of the potential costs of insured loss exposures of the primary insurer in a reinsurance contractual agreement.

Reinsurance agreement

Contract between the primary insurer and reinsurer that stipulates the form of reinsurance and the type of accounts to be reinsured.

Insurance risk
Uncertainty about the adequacy of insurance premiums to pay losses.

Retention
The amount retained by the primary insurer in the reinsurance transaction.

The reinsurer typically does not assume all of the primary insurer's **insurance risk**. The reinsurance agreement usually requires the primary insurer to retain part of its original liability. This **retention** can be expressed as a percentage of the original amount of insurance or as a dollar amount of loss. The reinsurance agreement does not alter the terms of the underlying (original) insurance policies or the primary insurer's obligations to honor them. See the exhibit "Risk."

Risk

Although "risk" is often defined as uncertainty about the occurrence of a loss, risk has several other meanings that are useful in understanding reinsurance practices. In reinsurance, the term risk often refers to the subject of insurance, such as a building, a policy, a group of policies, or a class of business. Reinsurance practitioners use the term risk in this way and include it in common reinsurance clauses.

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Reinsurance premium
The consideration paid by the primary insurer to the reinsurer for assuming some or all of the primary insurer's insurance risk.

Ceding commission
An amount paid by the reinsurer to the primary insurer to cover part or all of the primary insurer's policy acquisition expenses.

Retrocession
A reinsurance agreement whereby one reinsurer (the retrocedent) transfers all or part of the reinsurance risk it has assumed or will assume to another reinsurer (the retrocessionaire).

Retrocedent
The reinsurer that transfers or cedes all or part of the insurance risk it has assumed to another reinsurer.

Retrocessionaire
The reinsurer that assumes all or part of the reinsurance risk accepted by another reinsurer.

The primary insurer pays a **reinsurance premium** for the protection provided, just as any insured pays a premium for insurance coverage, but, because the primary insurer incurs the expenses of issuing the underlying policy, the reinsurer might pay a **ceding commission** to the primary insurer. These expenses consist primarily of commissions paid to producers, premium taxes, and underwriting expenses (such as policy processing and servicing costs, and risk control reports).

Reinsurers may transfer part of the liability they have accepted in reinsurance agreements to other reinsurers. Such an agreement is called a **retrocession**. Under a retrocession, one reinsurer, the **retrocedent**, transfers all or part of the reinsurance risk that it has assumed or will assume to another reinsurer, the **retrocessionaire**. Retrocession is very similar to reinsurance except for the parties involved in the agreement. The discussions of reinsurance in the context of a primary insurer-reinsurer relationship also apply to retrocessions.[1]

Reinsurance Functions

Reinsurance helps an insurer achieve several practical business goals, such as insuring large exposures, protecting policyholders' surplus from adverse loss experience, and financing the insurer's growth. The reinsurance that an insurer obtains depends mainly on the constraints or problems the insurer must address to reach its goals. Although several of its uses overlap, reinsurance is a valuable tool that can perform six principal functions for primary insurers:

- Increase large-line capacity
- Provide catastrophe protection
- Stabilize loss experience

- Provide surplus relief
- Facilitate withdrawal from a market segment
- Provide underwriting guidance

Depending on its goals, a primary insurer may use several different reinsurance agreements for these principal functions.

Increase Large-Line Capacity

The first function of reinsurance is to increase **large-line capacity**, which allows a primary insurer to assume more significant risks than its financial condition and regulations would otherwise permit. For example, an application for $100 million of property insurance on a single commercial warehouse could exceed the maximum amount of insurance that an underwriter is willing to accept on a single account. This maximum amount, or **line**, is subject to these influences:

Large-line capacity
An insurer's ability to provide larger amounts of insurance for property loss exposures, or higher limits of liability for liability loss exposures, than it is otherwise willing to provide.

Line
The maximum amount of insurance or limit of liability that an insurer will accept on a single loss exposure.

- The maximum amount of insurance or limit of liability allowed by insurance regulations. Insurance regulations prohibit an insurer from retaining (after reinsurance, usually stated as net of reinsurance) more than 10 percent of its policyholders' surplus (net worth) on any one loss exposure.
- The size of a potential loss or losses that can safely be retained without impairing the insurer's earnings or policyholders' surplus.
- The specific characteristics of a particular loss exposure. For example, the line may vary depending on property attributes such as construction, occupancy, loss prevention features, and loss reduction features.
- The amount, types, and cost of available reinsurance.

Reinsurers provide primary insurers with large-line capacity by accepting liability for loss exposures that the primary insurer is unwilling or unable to retain. This function of reinsurance allows insurers with limited large-line capacity to participate more fully in the insurance marketplace. For example, a primary insurer may want to compete for homeowners policies in markets in which the value of the homes exceeds the amount the primary insurer can safely retain. Reinsurance allows the primary insurer to increase its market share while limiting the financial consequences of potential losses.

Provide Catastrophe Protection

Without reinsurance, catastrophes could greatly reduce insurer earnings or even threaten insurer solvency when a large number of its insured loss exposures are concentrated in an area that experiences a catastrophe. Potential catastrophic perils include fire, windstorm (hurricane, tornado, and other wind damage), and earthquakes. Additionally, significant property and liability losses can be caused by man-made catastrophes, such as industrial explosions, airplane crashes, or product recalls.