Reinsurance

Reinsurance is an arrangement by which an insurance company transfers all or a portion of its risk under a contract (or contracts) of insurance to another company. The company transferring risk in a reinsurance arrangement is called the **ceding insurer**. The company taking over the risk in a reinsurance arrangement is the **assuming reinsurer**. In effect, the insurance company that issued the policies is seeking protection from another insurer, the assuming reinsurer. Typically, the reinsurer assumes responsibility for part of the losses under an insurance contract; however, in some instances, the reinsurer assumes full responsibility for the original insurance contract. As with insurance, reinsurance involves risk transfer, risk distribution, risk diversification across more insurance companies, and coverage against insurance risk. Risk diversification is the spreading of the risk to other insurers to reduce the exposure of the primary insurer, the one that deals with the final consumer.

Reinsurance Works

Reinsurance may be divided into three types: (1) treaty, (2) facultative, and (3) a combination of these two. Each of these types may be further classified as proportional or nonproportional. The original or primary insurer (the ceding company) may have a treaty with a reinsurer. Under a **treaty arrangement**, the original insurer is obligated to automatically reinsure any new underlying insurance contract that meets the terms of a prearranged treaty, and the reinsurer is obligated to accept certain responsibilities for the specified insurance. Thus, the reinsurance coverage is provided automatically for many policies. In a **facultative arrangement**, both the primary insurer and the reinsurer retain full decision-making powers with respect to each insurance contract. As each insurance contract is issued, the primary insurer decides whether or not to seek reinsurance, and the reinsurer retains the flexibility to accept or reject each application for reinsurance on a case-by-case basis. The combination approach may require the primary insurer to offer to reinsure specified contracts (like the treaty approach) while leaving the reinsurer free to decide whether to accept or reject reinsurance on each contract (like the facultative approach). Alternatively, the combination approach can give the option to the primary insurer and automatically require acceptance by the reinsurer on all contracts offered for reinsurance. In any event, a contract between the ceding company and the reinsurer spells out the agreement between the two parties.

When the reinsurance agreement calls for **proportional (pro rata) reinsurance**, the reinsurer assumes a prespecified percentage of both premiums and losses. Expenses are also shared in accord with this prespecified percentage. Because the ceding company has incurred operating expenses associated with the marketing, evaluation, and delivery of coverage, the reinsurer often pays a fee called a **ceding commission** to the original insurer. Such a commission may make reinsurance profitable to the ceding company, in addition to offering protection against catastrophe and improved predictability.

Nonproportional reinsurance obligates the reinsurer to pay losses when they exceed a designated threshold. **Excess-loss reinsurance**, for instance, requires the reinsurer to accept amounts of insurance that exceed the ceding insurer's retention limit. As an example, a small insurer might reinsure all property insurance above $25,000 per contract. The excess policy could be written per contract or per occurrence. Both proportional and nonproportional reinsurance may be either treaty or facultative. The excess-loss arrangement is depicted in Table 7.9 "An Example of Excess-Loss Reinsurance". A proportional agreement is shown in Table 7.10 "An Example of Proportional Reinsurance".

In addition to specifying the situations under which a reinsurer has financial responsibility, the reinsurance agreement places a limit on the amount of reinsurance the reinsurer must accept. For example, the SSS Reinsurance Company may limit its liability per contract to four times the ceding insurer's retention limit, which in this case would yield total coverage of $125,000 ($25,000 retention plus $100,000 in reinsurance on any one property). When the ceding company issues a policy for an amount that exceeds the sum of its retention limit and SSS's reinsurance limit, it would still need another reinsurer, perhaps TTT Reinsurance Company, to accept a second layer of reinsurance.

Table 7.9 An Example of Excess-Loss Reinsurance

Original Policy Limit of $200,000 Layered as Multiples of Primary Retention	
$75,000	Second reinsurer's coverage (equal to the remainder of the $200,000 contract)
100,000	First reinsurer's limit (four times the retention)
25,000	Original insurer's retention

Table 7.10 An Example of Proportional Reinsurance

	Total Exposure	**Premium**	**Expenses**	**Net Premium***	**Loss**
Reinsurer	70%	7,000	1,400	5,600	105,000
Ceding Insurer	30%	3,000	600	2,400	45,000
Total	100	10,00	2,000	8,000	150,000
*** Net premium = Premium–Expenses**					

Assume 30–70 split, premiums of $10,000, expense of $2,000, and a loss of $150,000. Ignore any ceding commission.

Benefits of Reinsurance

A ceding company (the primary insurer) uses reinsurance mainly to protect itself against losses in individual cases beyond a specified sum (i.e., its retention limit), but competition and the demands of its sales force may require issuance of policies of greater amounts. A company that issued policies no larger than its retention would severely limit its opportunities in the market. Many insureds do not want to place their insurance with several companies, preferring to have one policy with one company for each loss exposure. Furthermore, agents find it inconvenient to place multiple policies every time they insure a large risk.

In addition to its concern with individual cases, a primary insurer must protect itself from catastrophic losses of a particular type (such as a windstorm), in a particular area (such as a city or a block in a city), or during a specified period of operations (such as a calendar year). An **aggregate reinsurance** policy can be purchased for coverage against potentially catastrophic situations faced by the primary insurer. Sometimes they are considered excess policies, as described above, when the excess retention is per occurrence. An example of how an excess-per-occurrence policy works can be seen from the damage caused by Hurricane Andrew in 1992. Insurers who sell property insurance in hurricane-prone areas probably choose to reinsure their exposures not just on a property-by-property basis but also above some chosen level for any specific event. Andrew was considered one event and caused billions of dollars of damage in Florida alone. A Florida insurer may have set limits, perhaps $100 million, for its own exposure to a given hurricane. For its insurance in force above $100 million, the insurer can purchase excess or aggregate reinsurance.

Other benefits of reinsurance can be derived when a company offering a particular line of insurance for the first time wants to protect itself from excessive losses and also take advantage of the reinsurer's knowledge concerning the proper rates to be charged and underwriting practices to be followed. In other cases, a rapidly expanding company may have to shift some of its liabilities to a reinsurer to avoid impairing its capital. Reinsurance often also increases the amount of insurance the underlying insurer can sell. This is referred to as increasing capacity.

Reinsurance is significant to the buyer of insurance for a number of reasons. First, reinsurance increases the financial stability of insurers by spreading risk. This increases the likelihood that the original insurer will be able to pay its claims. Second, reinsurance facilitates placing large or unusual exposures with one company, thus reducing the time spent seeking insurance and eliminating the need for numerous policies to cover one exposure. This reduces transaction costs for both buyer and seller. Third, reinsurance helps small insurance companies stay in business, thus increasing competition in the industry. Without reinsurance, small companies would find it much more difficult to compete with larger ones.

Individual policyholders, however, rarely know about any reinsurance that may apply to their coverage. Even for those who are aware of the reinsurance, whether it is on a business or an individual contract, most insurance policies prohibit direct access from the original insured to the reinsurer. The prohibition exists because the reinsurance agreement is a separate contract from the primary (original) insurance contract, and thus the original insured is not a party to the reinsurance. Because reinsurance is part of the global insurance industry, globalization is also at center stage.