CHAPTER SEVEN

RE-INSURANCE

Students' learning objectives of the Chapter

At the end of /after studying this chapter, students should be able to:

- Describe and explain the importance and contribution of reinsurance
- Define and explain the development of insurance from different viewpoints
- Identify and explain the categories in to which Reinsurance Agreements may be classified
- Discuss the Ways of Administering Re-Insurance contracts

Introduction

Re-insurance is a method created to divide the task of handling risk among several insurances Often this task is accomplished through cooperative arrangements called treaties that specify the way in which members of the group will share risks. Reinsurance is also accomplished by using the services of specific companies and agents organized for that purpose. Reinsurance may be considered as the shifting by a primary insurer, called the ceding company, of the part of the risk it assumes to another company called the re-insurer.

That portion of the risk kept by the ceding company is known as the line or retention and varies with the financial position of the insurer and the other portion of risk is passed on to another re insurer, the process is known as retrocession. An insurer transfers a part of his risk on a particular insurance by insuring it with another insurer or other insurers. Every insurer has a limit to the risk that he can bear. If at any time a profitable venture comes his way, he may insure it even if the risk involved is beyond his capacity, which is his retention limit. In such cases, in order to safe guard his interest he may reinsure the same risk for an amount in excess of his retention limit with other insurers, so that the loss due to risk is spread over many insurers.

- **Reinsurance** is a form of insurance purchased by insurance companies in order to mitigate risk means when an insurer transfers a part of his risk on a particular insurance by insuring it with another insurer or other insurers, it is called "Re-insurance".

Terms

Direct Insurer:

An insurance company which accepts the risk from the proposer and which is solely responsible to the policyholder for the obligations undertaken.

Reinsurer:

The insurance company which provides reinsurance cover to the ceding company.

Ceding company:

Insurance company that places reinsurance business of the original risk with a reinsuring company; or the original insurer; the insurer who obtains a guarantee (on fire policy).

Cession:

This is the amount reinsured with the reinsurance i.e., ceded to the reinsurer.

Retention:

This is the amount retained by the ceding company for its own account i.e., maximum it is prepared to lose on anyone loss. It is also known as '*net limit*' or '*net holding*' or '*net line*'. (the portion reinsured by reinsurer)

Surplus:

This refers to the difference between the sum insured under the policy issued by the ceding company.

Reinsurance Commission:

It refers to the amount paid by the reinsurer to the insurer (ceding office) as a contribution to the acquisition and administration costs. Usually, it is a fixed percentage of premium received by the reinsurer.

Retrocession:

The process by which a reinsurer passes on risks to another reinsurer.

Characteristics of Reinsurance

- ✓ Reinsurance is a contract between the two insurance companies.
- ✓ The original insurer agrees to transfer part of his risk to other insurance company on the same terms and conditions.
- ✓ Original insurer cannot insure the risk with a re-insurer, more than the sum assured, originally by the insured.

- ✓ The original insurer should intimate to the reinsurer about the alteration, if any, made in terms and conditions with the insured.

7.1 Importance and Contribution of Reinsurance

One may wonder why an insurer that has gone to all the expenses and difficulty of security business would voluntarily transfer some of it to third party. There are several reasons for this, the main one being that the primary insurer is often asked to assume liability for loss in excess of the amount that its financial capacity would permit. Instead of accepting only a portion of the risk and thus causing inconvenience and even ill will of its customer, the company accepts all the risk, knowing that it can pass on to the re-insurer the part that it does not care to bear. The policyholder is thus shared the necessity of negotiating with many companies and can place insurance with little delay. Using a single insurer with a single premium also simplifies insurance management procedures. The policy coverage is not only more uniform and easier to comprehend, but the added guaranty of re-insurer also makes it much safer.
From the viewpoint of the insurer, reinsurance not only distributes risk, but also has other uses and advantages. Stabilized profit and loss rations are an important advantage in the use of reinsurance. It is true that good business often must be shared with others, but in return some bad business is also shared. In the long run it is usually considered more desirable to have a somewhat lower but stable level of profits and underwriting losses than to have a higher but unstable level.

This is not to imply that reinsurance arrangements necessarily reduce average profit levels, but they do smooth out fluctuations that would normally occur. Furthermore, reinsurance does not always mean the loss of premium volume for one of the results of reinsurance is the procurement of a new business. As a member of group of ceding companies organized to share mutual risks, one ceding company must usually accept the business of their insurers.

Reinsurance is also used to allow for a reduction in the level of unearned premium reserve requirements. For new, small companies especially, one of the limiting factors in the rate growth is the legal requirement that the company set aside premiums received as unearned premium reserves for policyholders. Since no allowance is made in these requirements for expenses incurred, the insurer must pay for producers' commissions and for other expenses out of surplus. As the premiums are earned over the life of the policy these amounts are restored

to surplus. Finally, reinsurance may be used to retire from business or to terminate the underwriting on a given type of insurance. If a firm wish to liquidate its business, it could conceivably cancel all its policies that are subject to cancellation and return the unearned premiums to the policyholders. However, this would be quite unusual in actual practice because of the necessity of sacrificing the profit that would normally be earned on such business. It would probably be impossible to recover in full the amount of expense that had been incurred in putting the business on the books.

Through reinsurance, however, the liabilities for existing insurance can be transferred and the policyholders' coverage's remain undisturbed, if and insurer desires to retire its life insurance business and to cease underwriting this line, it may do so through reinsurance. Since the life insurance policy is non-cancelable, the policyholder has the right to continue protection. If it were not for reinsurance, the insurer would find it difficult, if not impossible, to achieve its objective of relieving itself from the obligation of seeing that the insurer's coverage is continued.

7.2 Types of Reinsurance Agreements

Organizations for reinsurance are found in many forms. It ranges from individual contractual arrangements with re-insurers to pools where by a number of primary insurers agree to accept certain types of insurance on some pre-arranged basis.

1. **Facultative reinsurance**: - The simplest type of reinsurance is an informal facultative agreement, or specific reinsurance on an optional basis. Under this arrangement a primary insurer, in considering the acceptance of a certain risk, shops around for reinsurance on it, attempting to negotiable coverage, specifically on this particular contract.

The reinsurance agreement does not affect the insured in any way. Informal facultative reinsurance is usually satisfactory when reinsurance is of unusual nature for when it is negotiated only occasionally. Such an arrangement becomes cumbersome and unsatisfactory, however, if reinsurance agreements must be negotiated regularly.

Occasionally, an insurer will have an agreement whereby the re-insurer is bound to take certain types of risks if offered by the ceding company, but the decision of whether or not to reinsure remains with the ceding company. Such an arrangement is called a formal facultative contract or obligatory facultative treaty. It is used where the ceding company is often bound on certain types of risks by its agents before it has an opportunity to examine the applications. If the

exposure is such that reinsurance is not needed or desired, the ceding company may retain the entire liability.

In other cases, it will submit the business to the re-insurer, who is bound to take it. Such reinsurance agreements are often unsatisfactory for the re-insurer because of the tendency for the ceding company to keep better business for itself and pass on the more questionable lines to the re insurer.

2. **Treaty reinsurance:** - To protect all parties concerned from the tendency described above, to speed up transaction, and to eliminate the expense and uncertainties of individual negotiations, reinsurance may be provided where the ceding company is required to cede some certain amounts of business and the re-insurer is required to accept them. Such an agreement is described as automatic. The amount that the ceding company keeps for its own account is known as retention and the amount ceded to others is known as cession.

Two basic types of treaties have been recognized:

A. **Prorate treaties (Proportional)** is a type of reinsurance in which the primary insurer and reinsurer proportionally share the amounts of insurance, policy premiums, and losses (including loss adjustment expenses). Under such treaties which premiums and losses are shared in some proportion, and are usually identified as one of two types: **Quota share and surplus** share. Here loss adjustment expenses are expenses incurred by an insurer to settle claims

   i) Quota-Share Treaty: Under a quota-share treaty, the ceding insurer and reinsurer agree *to share premiums and losses based on some proportion*. The ceding insurer's retention limit is stated as a percentage rather than as a dollar or birr amount.

- For example, Awash Insurance Company and Ethiopian Reinsurance Company may enter into a quota-share treaty by which premiums & losses are shred 50% & 50%. Thus, if a Birr. 10,000 loss occurs, AIC pays Birr. 10,000 to the insured but is reimbursed by EIC for Br.5,000.

  Premiums are also shared based on the same agreed percentages. However, the reinsurer pays a ceding commission to the primary insurer to help compensate for the expenses incurred in writing the business.

- Thus, in the example given above, ERIC receive 50% of premium less a ceding commission that is paid to AIC.

  ii) Surplus - Share Treaty: Under a surplus-share treaty, the ***reinsurer agrees to accept insurance in excess of the ceding insurer's retention limit***, up to some

maximum amount. If the amount of insurance on a given policy exceeds the retention limit, the excess insurance is ceded to the reinsurer up to some maximum limit.

The primary insurer & reinsurer then share premiums and losses based on the fraction of total insurance retained by each party.

For example, assume that NICE has a retention limit of Br.200,000 (called a line) for a single policy, and that four lines or Br.800,000 are ceded to reinsurer, NIC. Thus, NICE's total underwriting capacity is Br.1,000,000 or any single exposure. Assume that a Br.500,000 property insurance policy is issued NICE takes the first Br.200,000 of insurance ($2/5^{th}$) and NIC takes the remaining Br.300,000 ($3/5^{th}$).

Under surplus-share treaty, premiums are also shared based on the fraction of total insurance retained by each party. However, the reinsurer pays a ceding commission to the primary insurer to help compensate for the acquisition expenses.

B. **Excess of loss treaties (Non-proportional),** under such treaties losses are paid by the re-insurer in excess of some predetermined deductible or retention. In excess of loss treaties there is no directly proportional relationship between the original premium and the amount of lose assumed by the reinsurer. There are many varieties of prorate treaties, but perhaps the two most common are the surplus treaty and the quota share treaty. An excess-of-loss treaty is designed largely for catastrophic protection. *Losses in excess of the retention limit are paid by the reinsure up to some maximum limit*. The excess-of-loss treaty can be written to cover a) a single exposure, or b) a single occurrence, such as a catastrophic loss from a tornado, or c) excess losses when the primary insurer's cumulative losses exceed a certain amount during some stated time period, such as a year.

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Under an excess line, or first surplus treaty, the ceding company decides what its net retention will be for each class of business. The re-insurer does not participate unless the policy amount exceeds this net retention. The larger the net retention the more the other members of the treaty will be willing to accept.

Thus, if the ceding company will retain Birr 10,000 on each dwelling fire exposure, the agreement may call for cession of up to “five lines” or 50,000 for reinsurance. The primary insurer could then take a fire risk of Birr 60,000. On the other hand, if the primary company is willing to retain only

Birr 5,000 on a residential fire exposure, it may have only four lines acceptable for reinsurance, and could not take more than 25,000 of fire insurance on a single residence.

First surplus treaties call for the sharing of losses and premiums up to a stated limit in proportion to the liabilities assumed. Sometimes a second surplus, or even a third surplus, treaty is arranged to take over business that is beyond the limits set by the first surplus treaty. The surplus treaty is probably the most common type of reinsurance in use today.

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Under quota share treaties, each insurer takes a proportionate share of all losses and premiums of a line of business. An illustration of the quota share treaty is the reinsurance pool or exchange. Pools are usually formed to provide reinsurance in given classes of business, such as cotton, lumber, or oil, where hazards are of a special nature and where the mutual use of engineering or inspection facilities provides an economy for participating members. Each member of the pool agrees to place all described businesses into the pool, but it shares some agreed proportion like 10% or 16.67 percent of the total premiums and losses. Quota share treaties are especially suitable for new small firms whose underwriting capacity is limited, and who would be unable to get started without such an arrangement because of the unearned premium reserve requirements.

It is not uncommon for a primary insurer to find that while it is willing to accept up to Birr 10,000 on each exposure insured in a given class, it is unable to stand an accumulation of losses that exceeds Birr 50,000. To impose a limit on such losses, the excess of loss treaty has been developed where the re-insurer agrees to be liable for all losses exceeding a certain amount on a given class of business during a specific period.

Such a contract is simple to administer because the re-insurers are liable only after the ceding company has actually suffered the agreed amount of loss. Since the probability of large losses is small, premiums for reinsurance are likewise also small.

A variation of the excess of loss type of reinsurance is the spread of loss treaty under which the primary insurer decides what loss ratio it is prepared to stand on a given kind of insurance, and agrees with a re-insurer to bear any loss that would raise the loss ration above the agreed level over a period of, say five years. Thus, the ceding company has spread its loss over a reasonable time period and, in effect, has guaranteed an underwriting margin through reinsurance. In this way an unusually high loss ratio in a poor underwriting year is averaged in with other years.

7.3 Ways of Administering Re-Insurance

Most re-insurance is administered by professional re-insurers who specialized in re-insuring the portfolios of other insurers. However, the re-insurer may be another insurer whose major business interest also is dealing with the public. Some insurers of this type have re-insurance department or subsidiaries that aggressively seek business from other insurers but most of them are re-insurer only because many reinsurance agreements obligate the ceding insurer to re-insure some of the liability assumed by the re-insurer under this direct business. The other way is a polo that may or may not include the ceding insurer. Re-insurance arrangement may distribute the insurance and the loss in many different ways.

Some of the distribution methods are:

- Under a quota share split, the insurance and the loss are shared according to some percentage. For example, if a Birr 100,000 policy is written and the agreed split is 50-50, then the re-insurer assumes half of the liability and the remaining half loss will be assumed by the insurer.
- Under a surplus share agreement, the re-insurer accepts that amount of the insurance in each of a stated amount and the loss is prorated according to the amount of the insurance assumed. For example, if a Birr 100,000 is the stated amount, the re-insurance's liability under a Birr 200,000 policy amount would be (200,000 – 100,000).
- Under an excess loss arrangement, the re-insurer agrees to pay that portion of the loss incurred under an individual contract in excess of some specified amount such as 100,000 Birr.
- Catastrophe re-insurance – like excess loss, but in this insurance the losses are those incurred by the insurer as a result of a single event under all contracts covered under the agreement. For example, the re-insurer might be obligated to pay that portion in excess of bin" 100,000 of the losses incurred.