

INTRODUCTION TO REINSURANCE (144-1)

EO 1. **REINSURANCE** lets a primary insurer (aka a **ceding insurer**) insure itself with a reinsurer.
A **primary insurer** issues insurance policies.
A **ceding insurer** buys reinsurance.
A **reinsurer** indemnifies other insurers for losses.

The ceding insurer pays a **reinsurance premium** to the reinsurer in exchange for transferring some of the ceding insurer's insurance risk.

Insurance risk is uncertainty about the adequacy of insurance premiums to pay insurance losses.
A risk in reinsurance refers to the subject of insurance (a building, a policy), **not** to the uncertainty of the occurrence of loss.

Retention is the amount of insurance risk the ceding insurer does **not** cede to the reinsurer, but rather retains.
Reinsurance agreements do not alter either the terms of the underlying insurance policies **or** the primary insurer's obligations to honor them.

*[**Retrocession** allows a reinsurer (aka a **retrocedent**) to insure its own risks with a reinsurer (aka a **retrocessionaire**).]*

THE SIX [eight] PRINCIPAL FUNCTIONS OF REINSURANCE: An insurer reinsures for the same reasons an insured insures--to substitute a small known loss (**the premium**) for possible catastrophic loss (**the loss exposure**).

Specifically, **an insurer reinsures to gain**

1. **large line capacity**--to write higher limits for single risks.
A **line** is the maximum amount of insurance or liability limit an insurer will accept on a single loss exposure.
Large line capacity is the insurer's ability to
 - a. write larger amounts of insurance **or**
 - b. provide higher liability limits than it's otherwise willing to provide.**The line is influenced by**
 - a. insurance regulations;
 - b. the size of potential losses the insurer can safely retain;
 - c. the characteristics of the loss exposure; **and**
 - d. the availability, amount, types, and cost of reinsurance.
2. **catastrophe protection**--to spread fundamental risk.
Examples of catastrophic risks include flood, hurricane, and war.
3. **stable loss experience**--to keep loss ratios within closer tolerances.
Volatile loss experience can
 - a. affect stock values of publicly-traded insurers,
 - b. degrade an insurer's financial rating,
 - c. destabilize the management of the underwriting and marketing departments,
 - d. undermine the sales force's confidence, **and/or**
 - e. lead to insolvency.**Reinsurance stabilizes loss experience by limiting the insurer's liability for**
 - a. a single loss exposure,
 - b. several exposures caused by one event, **and/or**
 - c. loss exposures that aggregate claims over time.

4. **surplus relief**--to offset policy acquisition costs with the ceding commission to overcome the effects of statutory accounting.
 The reinsurer pays a **ceding commission** to the ceding insurer to cover some or all of the ceding insurer's acquisition expenses.
 The ceding commission provides **surplus relief** by replenishing the ceding insurer's policyholders' surplus.
Policyholders' surplus is the insurer's net worth, as reported on statutory financial statements prescribed by state insurance regulators.
 Insurers experiencing excessive growth have trouble meeting policyholders' surplus requirements, because insurers must recognize acquisition expenses at the time each new policy is sold, *but* they can only recognize insurance premiums as they are earned over the life of the policy.
 Insurers selling many new policies therefore have high current expenses and low current revenues, driving down policyholders' surplus.
Net written premiums equal gross premiums charged to policyholders *minus* premiums paid to reinsurers *plus* reinsurance premiums assumed.
The capacity ratio equals the ratio of net written premiums to policyholders' surplus.
 An insurer's capacity ratio should *not* exceed 3 to 1.
5. **withdrawal from a territory or line of business**--to reinsure an entire class, line, territory, or book of business (aka **portfolio reinsurance**).
A novation is an agreement that substitutes one insurer or reinsurer for another.
 A primary insurer uses a novation to completely eliminate its liabilities under a group of policies it has issued.
 Primary insurers withdraw from markets that are unprofitable, undesirable, or no longer fit the insurer's strategic plan.
A primary insurer who wants to withdraw from a market can
 - a. stop selling new policies and continue all in-force policies until they expire,
 - b. cancel all policies and refund unearned premiums to insureds, *or, most gracefully,*
 - c. buy portfolio reinsurance.
6. **underwriting expertise**--when entering a new line of business. *Example:* A primary insurer entering the boiler and machinery market might reinsure that new line with a reinsurer that specializes in B+M coverage to get help underwriting and pricing its policies.
- [7. **premium capacity**--to write limits beyond its own financial capacity.]
- [8. **legal compliance**--to comply with laws requiring special reinsurance.]

EO 2. **THE TWO MAJOR TYPES OF REINSURANCE:**

1. **TREATY REINSURANCE** underwrites an entire class or portfolio of risks.
 The reinsurer accepts *every* risk in the class or portfolio, which is why treaty reinsurance is sometimes called obligatory insurance.
 The contract is worded generally enough to include *all* risks in the class or portfolio.
 Treaty reinsurance reduces the risk of **adverse selection** because the ceding insurer can't cede only those loss exposures that are undesirable. Premium payments depend on the type of contract.
2. **FACULTATIVE REINSURANCE** has the reinsurer underwrite each risk individually.
 Each facultative contract is worded for application to a single risk, which is why faculty reinsurance is sometimes called non-obligatory insurance. **The facultative certificate of reinsurance** defines the terms of the facultative reinsurance coverage on a specific loss exposure.
Facultative reinsurance serves four functions: Facultative reinsurance
 - a. provides capacity above the limits of a treaty for a large risk.
 - b. reduces the exposure in a geographic area.
 - c. insures high-hazard loss exposures.
 - d. fills in gaps in treaties.

*[Hybrids of treaty and facultative reinsurance combine characteristics of both types of reinsurance. In a **facultative treaty**, the ceding insurer and the reinsurer agree on how all subsequent facultative submissions will be handled.*

*In a **facultative obligatory treaty**, the reinsurer must accept all loss exposures submitted by the ceding insurer.]*

EO 3. **THREE SOURCES OF REINSURANCE:**

1. **Professional reinsurer**--is an insurer whose primary business is reinsurance.
A direct writing reinsurer has employees who deal directly with primary insurers.
A reinsurance intermediary is a broker who negotiates reinsurance agreements between a primary insurer and one or more reinsurers in exchange for a brokerage commission from the reinsurer.
Before reinsuring a primary insurer, the reinsurer considers the primary insurer's financial strength, experience, reputation, *and* management competence.
The relationship between reinsurer and primary insurer is one of utmost good faith because each party relies on the other for full disclosure of all material facts about the risks.
2. **Reinsurance department of a primary insurer**--keeps its reinsurance operations separate from its primary insurance operations to keep client information confidential.
3. **Reinsurance pool, syndicate, or association**--is a group of insurers formed to share the group's loss exposures, usually through reinsurance.

[Reinsurance professional and trade associations include

1. **The Independent Reinsurance Underwriters Association (IRU)**--consists of reinsurers and intermediaries who publish the *Journal of Reinsurance*, conduct research, and sponsor educational activities.
2. **The Brokers and Reinsurance Markets Association (BRMA)**--consists of reinsurers and intermediaries primarily concerned with contract wording for treaty reinsurance as well as other operational issues for treaty reinsurance.
3. **The Reinsurance Association of America (RAA)**--is a trade association of reinsurers that conducts advocacy and educational activities.]

EO 4. The Key Words and Phrases *[and other newly-introduced word and phrases]* for each assignment are defined in a separate section in The Burnham System green book that accompanied this Burnham System tan book.

Please study them here, in context, rather than separately in the green book.

*Unasked EO. This assignment included a reading on **The Terrorism Risk Insurance Act (TRIA)**, which was also included in ARE 143.*

*However, no educational objective (**EO**) in this assignment dealt with the TRIA.*

I have included a summary of that reading here, but, at least in theory, there should be no exam question on The Terrorism Risk Insurance Act on your ARE 144 exam, since no question belongs on the exam which does not relate to a specific educational objective.

THE TERRORISM RISK INSURANCE ACT (TRIA) OF 2002 created a temporary Federal program that provides compensation for insured losses resulting from acts of terrorism.

*In December 2005, Congress approved the **Terrorism Risk Insurance Extension Act of 2005**, which extended TRIA until December 31, 2007. [Congress has extended the TRIA until 12/31/2014.]*

Federal government help is needed in providing insurance for the terrorism risk because

1. commercial insurance customers want and need coverage against the terrorism exposure,
2. terrorism presents a catastrophic exposure to our industry (beyond our ability to absorb the potential loss), **and**
3. the lack of credible statistical data to project terrorism loss frequency and severity prevents our industry from properly pricing the exposure.

THE THREE QUALIFYING CRITERIA FOR AN ACT TO BE CERTIFIED AS TERRORISM:

The act of terrorism must

1. be violent or dangerous to human life, property, and/or infrastructure,
2. result in damage in the US (or to specified air carriers, vessels, or missions outside the US), **and**
3. be committed as part of an effort to coerce the US population or the US government.

Further, the act of terrorism must **not** be committed as part of a war declared by Congress **and** the aggregate insured losses must exceed \$50 million through 2006 and \$100 million in 2007.

COVERED INSURERS UNDER THE TERRORISM RISK INSURANCE ACT OF 2002 (TRIA):

1. all licensed or admitted insurers;
2. eligible surplus lines insurers;
3. insurers approved to offer P-C insurance for maritime, aviation, or energy exposures;
4. state residual market insurers; **and**
5. captives and self-insured entities approved by the Secretary of the Treasury.

The types of insurance covered by the Terrorism Risk Insurance Act of 2002 (TRIA) include commercial lines coverages, including workers' compensation and bonds. **The 2005 extension added** commercial auto, burglary, and theft insurance; surety insurance; professional liability insurance; **and** farm owners insurance.

The types of insurance not covered by the Terrorism Risk Insurance Act of 2002 include personal lines, crop, livestock, mortgage, medical malpractice, flood, life, **and** health insurance.

Insurer deductibles under the Terrorism Risk Insurance Act of 2002:

1. **Transition period (11/26/02-12/31/02)**--1% of direct earned premiums for calendar year 2001.
2. **Program Year 1 (all of 2003)**--7% of direct earned premiums for calendar year 2002.
3. **Program Year 2 (all of 2004)**--10% of direct earned premiums for calendar year 2003
4. **Program Year 3 (all of 2005)**--15% of direct earned premiums for calendar year 2004.
5. **Program Year 4 (all of 2006)**--17.5% of direct earned premiums for calendar year 2005.
6. **Program Year 5 (all of 2007)**--20% of direct earned premiums for calendar year 2006.

Loss sharing under the Terrorism Risk Insurance Act of 2002: For aggregate losses over \$5 million,

1. **First \$5 million**--is paid by insurers.
2. **Losses over \$5 million up to \$100 billion**--Insurers pay the above deductibles **plus** 10% of losses and the federal government pays the remaining 90% of losses above the deductibles through 2006. **In 2007, the excess loss above the deductibles is paid 15% by insurers and 85% by the federal government.**
3. **Losses over \$100 billion**--are not payable (although individual insurers must pay at least their deductibles).

The federal government recovers its costs under the Terrorism Risk Act of 2002 by charging

1. **insurers**--based on a formula that varies by program year **and**
2. **insureds**--policy surcharges of 3%.

Insurers are compensated for coverage for acts of terrorism under the Terrorism Risk Act of 2002 by charging premiums for terrorism exposures not reimbursed by the federal government.