Direct Your Learning

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Introduction to Reinsurance

Educational Objectives

After learning the content of this assignment, you should be able to:

- Describe reinsurance and its principal functions.
- Describe treaty reinsurance and facultative reinsurance.
- Describe the three sources of reinsurance.

Outline

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.

The second function of reinsurance is to protect against the financial consequences of a single catastrophic event that causes multiple losses in a concentrated area. For example, an insurer might purchase reinsurance that provides up to $50 million of coverage per hurricane when the total amount of loss from a single hurricane exceeds the amount the insurer can safely retain.

Stabilize Loss Experience

An insurer, like most other businesses, must have a steady flow of profits to attract capital investment and support growth. However, demographic, economic, social, and natural forces cause an insurer's loss experience to fluctuate widely, which creates variability in its financial results. Volatile loss experience can affect the stock value of a publicly traded insurer; alter an insurer's financial rating by independent rating agencies; cause abrupt changes in the approaches taken in managing the underwriting, claim, and marketing departments; or undermine the confidence of the sales force (especially independent brokers and agents who can place their customers with other insurers). In extreme cases, volatile loss experience can lead to insolvency.

Reinsurance can smooth the resulting peaks and valleys in an insurer's loss experience curve. In addition to aiding financial planning and supporting growth, this function of reinsurance encourages capital investment because investors are more likely to invest in companies whose financial results are stable.

Reinsurance can be arranged to stabilize the loss experience of a line of insurance (for example, commercial auto), a class of business (for example, truckers), or a primary insurer's entire book of business. In addition, a primary insurer can stabilize loss experience by obtaining reinsurance to accomplish any, or all, of these purposes:

- Limit its liability for a single loss exposure
- Limit its liability for several loss exposures affected by a common event
- Limit its liability for loss exposures that aggregate claims over time

The exhibit illustrates how reinsurance can stabilize a primary insurer's loss experience. See the exhibit "Stabilization of Annual Loss Experience for a Primary Insurer With a $20 Million Retention."

Provide Surplus Relief

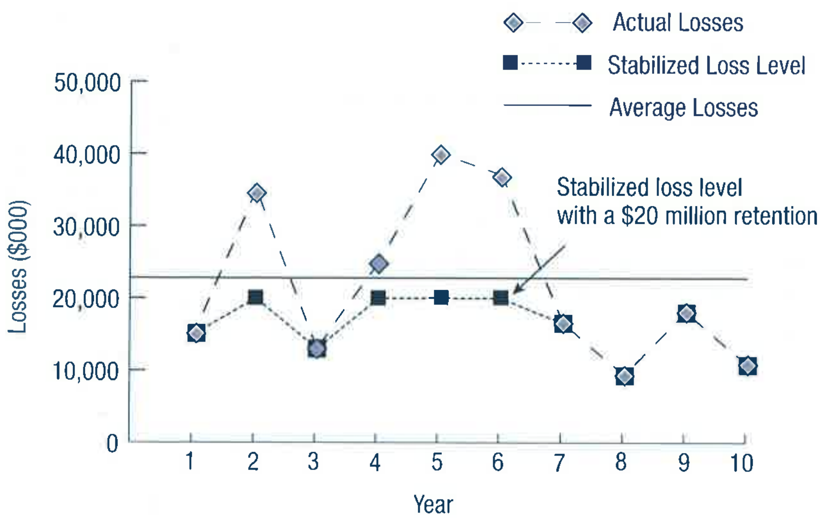
Insurers that are growing rapidly may have difficulty maintaining a desirable capacity ratio, because of how they must account for their expenses to acquire new policies. State insurance regulation mandates that, for accounting purposes, such expenses be recognized at the time a new policy is sold. However, premiums are recognized as revenue as they are earned over the policy's life. When an insurer immediately recognizes expenses while only gradually recognizing revenue, its policyholders' surplus will decrease as its capacity ratio increases.

Stabilization of Annual Loss Experience for a Primary Insurer With a $20 Million Retention

(1) Time Period (Year)	(2) Actual Losses ($000)	(3) Amount Reinsured ($000)	(4) Stabilized Loss Level ($000)
1	15,000	—	15,000
2	35,000	15,000	20,000
3	13,000	—	13,000
4	25,000	5,000	20,000
5	40,000	20,000	20,000
6	37,000	17,000	20,000
7	16,500	—	16,500
8	9,250	—	9,250
9	18,000	—	18,000
10	10,750	—	10,750
Total	$219,500	$57,000	$162,500

The total actual losses are $219.5 million, or an average of $21.95 million each time period. If a reinsurance agreement were in place to cap losses to $20 million, the primary insurer's loss experience would be limited to the amounts shown in the stabilized loss level column. The broken line that fluctuates dramatically in the graph below represents actual losses, the dotted line represents stabilized losses, and the horizontal line represents average losses.

Graph of Hypothetical Loss Data



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Surplus relief

A replenishment of policyholders' surplus provided by the ceding commission paid to the primary insurer by the reinsurer.

Policyholders' surplus

Under statutory accounting principles (SAP), an insurer's total admitted assets minus its total liabilities.

Many insurers use reinsurance to provide **surplus relief**, which satisfies insurance regulatory constraints on excess growth. State insurance regulators monitor several financial ratios as part of their solvency surveillance efforts, but the relationship of written premiums to **policyholders' surplus** is generally a key financial ratio and one considered to be out of bounds if it exceeds 3 to 1 or 300 percent. Policyholders' surplus (also called "surplus to policyholders" or simply "surplus") is an insurer's net worth as reported on the financial statement prescribed by state insurance regulators. It represents the financial resource the primary insurer can draw on to pay unexpected losses.

Some reinsurance agreements facilitate premium growth by allowing the primary insurer to deduct a ceding commission on loss exposures ceded to the reinsurer. The ceding commission is an amount paid by the reinsurer to the primary insurer to cover part or all of a primary insurer's policy acquisition expenses. The ceding commission immediately offsets the primary insurer's policy acquisition expenses for the reinsured policies and often includes a profit provision, or an additional commission, if the reinsurance ceded is profitable.

Because the ceding commission replenishes the primary insurer's policyholders' surplus, the surplus relief facilitates the primary insurer's premium growth and the increase in policyholders' surplus lowers its capacity ratio.

Facilitate Withdrawal From a Market Segment

Reinsurance can also facilitate withdrawal from a market segment, which may be a particular class of business, geographic area, or type of insurance. A primary insurer may want to withdraw from a market segment that is unprofitable, undesirable, or incompatible with its strategic plan. When withdrawing from a market segment, the primary insurer has these options:

- Stop writing new insurance policies and continue in-force insurance until all policies expire (often referred to as "run-off")
- Cancel all policies (if insurance regulations permit) and refund the unearned premiums to insureds
- Withdraw from the market segment by purchasing portfolio reinsurance

To withdraw from a market segment, an insurer can stop writing new business or, to the extent permitted by applicable cancellation laws, cancel all policies in effect and return the unearned premiums to its insureds. However, these approaches can be unwieldy and expensive and could create ill will among insureds, producers, and state insurance regulators. They also create uncertainty about the insurer's outstanding claims, which must be settled, and about new claims, which might continue to be filed even after the insurer ceases operations.

Portfolio reinsurance

Reinsurance that transfers to the reinsurer liability for an entire type of insurance, territory, or book of business after the primary insurer has issued the policies.

Another approach available to the primary insurer is to transfer the liability for all outstanding policies to a reinsurer by purchasing **portfolio reinsurance**. Portfolio reinsurance can facilitate withdrawal from a market segment and prevent the formation of ill will due to policy cancellation. It is an exception to the general rule that reinsurers do not accept all of the liability for specified loss exposures of an insurer.

In portfolio reinsurance, the reinsurer accepts all of the liability for certain loss exposures covered under the primary insurer's policies, but the primary insurer must continue to fulfill its obligations to its insureds. For example, the primary insurer may decide to use portfolio reinsurance to withdraw from the errors and omissions insurance market. In this situation, the reinsurer typically agrees to indemnify the primary insurer for all losses incurred as of, and following, the date of the portfolio reinsurance agreement. However, the primary insurer continues to pay claims to (or on behalf of) its insureds who are covered by the underlying insurance.

Portfolio reinsurance can be expensive, particularly if the portfolio has been unprofitable and is expected to incur additional losses for the reinsurer. In many states, portfolio reinsurance must be approved by the state insurance department.

Sometimes a primary insurer wants to completely eliminate the liabilities it has assumed under the insurance policies it has issued. This can be accomplished through a **novation.** A novation is not considered portfolio reinsurance because the substitute insurer assumes the direct obligations to insureds covered by the underlying insurance. Usually, the approval of state insurance regulators or the insured is required to effect a novation.

Novation
An agreement under which one insurer or reinsurer is substituted for another.

Provide Underwriting Guidance

Reinsurance may also provide underwriting guidance. Reinsurers work with a wide variety of insurers in the domestic and global markets under many different circumstances. Consequently, reinsurers accumulate a great deal of underwriting expertise. A reinsurer's understanding of insurance operations and the insurance industry can assist other insurers, particularly inexperienced primary insurers entering new markets and offering new products. For example, one medium-size insurer reinsured 95 percent of its umbrella liability coverage over a period of years and relied heavily on the reinsurer for technical assistance in underwriting and pricing its policies. Without such technical assistance, certain primary insurers would find it difficult to generate underwriting profits from coverages with which they have limited expertise.

Reinsurers that provide underwriting assistance to primary insurers must respect the confidentiality of their clients' proprietary information. Reinsurers often learn about the primary insurer's marketing and underwriting strategies but should not reveal insurer-specific information to other parties.

REINSURANCE TRANSACTIONS

No single reinsurance agreement performs all the reinsurance functions. Instead, reinsurers have developed various types of reinsurance, each of which is effective in helping insurers meet one or more goals. A primary insurer often combines several reinsurance agreements to meet its particular needs. Each reinsurance agreement is tailored to the specific needs of the primary insurer and the reinsurer.

There are two types of reinsurance transactions: treaty and facultative.

Treaty reinsurance

A reinsurance agreement that covers an entire class or portfolio of loss exposures and provides that the primary insurer's individual loss exposures that fall within the treaty are automatically reinsured.

Facultative reinsurance

Reinsurance of individual loss exposures in which the primary insurer chooses which loss exposures to submit to the reinsurer, and the reinsurer can accept or reject any loss exposures submitted.

Treaty reinsurance uses one agreement for an entire class or portfolio of loss exposures and is also referred to as obligatory reinsurance. The reinsurance agreement is typically called the treaty.

Facultative reinsurance uses a separate reinsurance agreement for each loss exposure it wants to reinsure and is also referred to as nonobligatory reinsurance.

Treaty Reinsurance

In treaty reinsurance, the reinsurer agrees in advance to reinsure all the loss exposures that fall within the treaty. Although some treaties allow the reinsurer limited discretion in reinsuring individual loss exposures, most treaties require that all loss exposures within the treaty's terms must be reinsured.

Primary insurers usually use treaty reinsurance as the foundation of their reinsurance programs. Treaty reinsurance provides primary insurers with the certainty needed to formulate underwriting policy and develop underwriting guidelines. Primary insurers work with reinsurance intermediaries (or with reinsurers directly) to develop comprehensive reinsurance programs that address the primary insurers' varied needs. The reinsurance programs that satisfy those needs often include several reinsurance agreements and the participation of several reinsurers.

Treaty reinsurance agreements are tailored to fit the primary insurer's individual requirements. The price and terms of each reinsurance treaty are individually negotiated.

Treaty reinsurance agreements are usually designed to address a primary insurer's need to reinsure many loss exposures over a period of time. Although the reinsurance agreement's term may be for only one year, the relationship between the primary insurer and the reinsurer often spans many years. A primary insurer's management usually finds that a long-term relationship with a reinsurer enables the primary insurer to be able to consistently fulfill its producers' requests to place insurance with them.

Most, but not all, treaty reinsurance agreements *require* the primary insurer to cede all eligible loss exposures to the reinsurer. Primary insurers usually make treaty reinsurance agreements so their underwriters do not have to exercise discretion in using reinsurance. If treaty reinsurance agreements permitted primary insurers to choose which loss exposures they ceded to the reinsurer, the reinsurer would be exposed to **adverse selection**.

Adverse selection
The decision to reinsure those loss exposures that have an increased probability of loss because the retention of those loss exposures is undesirable.

Because treaty reinsurers are obligated to accept ceded loss exposures once the reinsurance agreement is in place, reinsurers usually want to know about the integrity and experience of the primary insurer's management and the degree to which the primary insurer's published underwriting guidelines represent its actual underwriting practices.

Facultative Reinsurance

In facultative reinsurance, the primary insurer negotiates a separate reinsurance agreement for each loss exposure that it wants to reinsure. The primary insurer is not obligated to purchase reinsurance, and the reinsurer is not obligated to reinsure loss exposures submitted to it. A facultative reinsurance agreement is written for a specified time period and cannot be canceled by either party unless contractual obligations, such as payment of premiums, are not met.

The reinsurer issues a **facultative certificate of reinsurance** (or facultative certificate) that is attached to the primary insurer's copy of the policy being reinsured.

Facultative certificate of reinsurance
An agreement that defines the terms of the facultative reinsurance coverage on a specific loss exposure.

Facultative reinsurance serves four functions:

- Facultative reinsurance can provide large-line capacity for loss exposures that exceed the limits of treaty reinsurance agreements.
- Facultative reinsurance can reduce the primary insurer's exposure in a given geographic area. For example, a marine underwriter may be considering underwriting numerous shiploads of cargo that are stored in the same warehouse and that belong to different insureds. The underwriter could use facultative reinsurance for some of those loss exposures, thereby reducing the primary insurer's overall exposure to loss.
- Facultative reinsurance can insure a loss exposure with atypical hazard characteristics and thereby maintain the favorable loss experience of the primary insurer's treaty reinsurance and any associated profit-sharing arrangements. Maintaining favorable treaty loss experience is important because the reinsurer has underwritten and priced the treaty with certain expectations. A loss exposure that is inconsistent with the primary insurer's typical portfolio of insurance policies may cause excessive losses and lead to the treaty's termination or a price increase. The treaty reinsurer is usually willing for the primary insurer to remove high-hazard loss exposures from the treaty by using facultative reinsurance. These facultative placements of atypical loss exposures also benefit the treaty reinsurer. For example, an insured under a commercial property policy may request coverage for an expensive fine arts collection that the primary insurer and its treaty reinsurer would not ordinarily want to cover. Facultative

reinsurance of the fine arts collection would eliminate the underwriting concern by removing this loss exposure from the treaty. Often, the treaty reinsurer's own facultative reinsurance department provides this reinsurance. The facultative reinsurer knows that adverse selection occurs in facultative reinsurance. Consequently, the loss exposures submitted for reinsurance are likely to have an increased probability of loss. Therefore, facultative reinsurance is usually priced to reflect the likelihood of adverse selection.

- Facultative reinsurance can insure particular classes of loss exposures that are excluded under treaty reinsurance.

Primary insurers purchase facultative reinsurance mainly to reinsure loss exposures that they do not typically insure or on exposures with high levels of underwriting risk. Consequently, primary insurers use facultative reinsurance for fewer of their loss exposures than they use treaty insurance. Primary insurers that find they are increasingly using facultative reinsurance may want to review the adequacy of their treaty reinsurance.

The expense of placing facultative reinsurance can be high for both the primary insurer and the reinsurer. In negotiating facultative reinsurance, the primary insurer must provide extensive information about each loss exposure. Consequently, administrative costs are relatively high because the primary insurer must devote a significant amount of time to complete each cession and to notify the reinsurer of any endorsement, loss notice, or policy cancellation. Likewise, the reinsurer must underwrite and price each facultative submission. See the exhibit "Hybrids of Treaty and Facultative Reinsurance."

Hybrids of Treaty and Facultative Reinsurance

Reinsurers sometimes use hybrid agreements that have elements of both treaty and facultative reinsurance. The hybrid agreements usually describe how individual facultative reinsurance placements will be handled. For example, the agreement may specify the basic underwriting parameters of the loss exposures that will be ceded to the reinsurer as well as premium and loss allocation formulas. Although hybrid agreements may be used infrequently, they demonstrate the flexibility of the reinsurance market to satisfy the mutual needs of primary insurers and reinsurers. The two hybrid agreements briefly described next illustrate common reinsurance agreement variations.

- In a *facultative treaty*, the primary insurer and the reinsurer agree on how subsequent individual facultative submissions will be handled. A facultative treaty could be used when a class of business has insufficient loss exposures to justify treaty reinsurance but has a sufficient number of loss exposures to determine the details of future individual placements.
- In a *facultative obligatory treaty*, although the primary insurer has the option of ceding loss exposures, the reinsurer is obligated to accept all loss exposures submitted to it. Facultative obligatory treaties are also called *semi-obligatory treaties*.

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REINSURANCE SOURCES

The reinsurance market is international in scope, with many participants. In the United States, licensed insurers can market reinsurance unless prohibited by statute or charter. Few such prohibitions exist, and many primary insurers sell some reinsurance. If an insurer is too small to provide reinsurance on its own, it can participate in various reinsurance pools and syndicates.

Reinsurance can be purchased from three sources:

- Professional reinsurers
- Reinsurance departments of primary insurers
- Reinsurance pools, syndicates, and associations

Additionally, the reinsurance business has several professional and trade associations that serve member companies and provide information to interested parties.

Professional Reinsurers

The first source of reinsurance is **professional reinsurers**, which interact with other insurers either directly or through intermediaries as primary insurers do.

A reinsurer whose employees deal directly with primary insurers is called a **direct writing reinsurer**. However, most direct writing reinsurers in the U.S. also solicit reinsurance business through reinsurance intermediaries.

Reinsurance intermediaries generally represent a primary insurer and work with that insurer to develop a reinsurance program that is then placed with a reinsurer or reinsurers. The reinsurance intermediary receives a brokerage commission—almost always from the reinsurer or reinsurers—for performing other necessary services in addition to placing the reinsurance, such as disbursing reinsurance premiums among participating reinsurers and collecting loss amounts owed to the insurer.

Although the variety of professional reinsurers leads to differences in how those reinsurers are used and what they can offer, some broad generalizations may be made about professional reinsurers:

- Primary insurers dealing with direct writing reinsurers often use fewer reinsurers in their reinsurance program.
- Reinsurance intermediaries often use more than one reinsurer to develop a reinsurance program for a primary insurer.
- Reinsurance intermediaries can often help secure high coverage limits and catastrophe coverage.
- Reinsurance intermediaries usually have access to various reinsurance solutions from both domestic and international markets.
- Reinsurance intermediaries can usually obtain reinsurance under favorable terms and at a competitive price because they can determine prevailing market conditions and work repeatedly in this market with many primary insurers.

Professional reinsurer

An insurer whose primary business purpose is serving other insurers' reinsurance needs.

Direct writing reinsurer

A professional reinsurer whose employees deal directly with primary insurers.

Reinsurance intermediary

An intermediary that works with primary insurers to develop reinsurance programs and that negotiates contracts of reinsurance between the primary insurer and reinsurer, receiving commission for placement and other services rendered.

Professional reinsurers evaluate the primary insurer before entering into a reinsurance agreement because the treaty reinsurer underwrites the primary insurer as well as the loss exposures being ceded. In evaluating the primary insurer, the reinsurer gathers information about the primary insurer's financial strength by analyzing the primary insurer's financial statements or by using information developed by a financial rating service. Other information about the primary insurer may be obtained from state insurance department bulletins and the trade press.

Reinsurers also consider the primary insurer's experience, reputation, and management. The reinsurer relies on the quality of the management team, and a relationship of trust must underlie any reinsurance agreement. Whether it involves a one-time facultative agreement or an ongoing treaty agreement, the relationship between the primary insurer and the reinsurer is considered to be one of "utmost good faith." This is because each party is obligated to and relies on the other for full disclosure of material facts about the subject of the agreement. It would be considered a breach of this duty of utmost good faith if the primary insurer withheld material facts relevant to the reinsurer's underwriting decision, intentionally underestimated prior losses, or failed to disclose hazardous conditions affecting loss exposures.

Just as the reinsurer should evaluate the primary insurer, the primary insurer should evaluate the reinsurer's claim-paying ability, reputation, and management competence before entering into the reinsurance agreement.

Reinsurance Departments of Primary Insurers

Some primary insurers also provide treaty and facultative reinsurance, and the reinsurance departments of these companies serve as the second source of reinsurance.

A primary insurer may offer reinsurance to affiliated insurers, regardless of whether it offers reinsurance to unaffiliated insurers. To ensure that information from other insurers remains confidential, a primary insurer's reinsurance operations are usually separate from its primary insurance operations.

Many primary insurers are groups of commonly owned insurance companies. Intragroup reinsurance agreements are used to balance the financial results of all insurers in the group. The use of intragroup reinsurance agreements does not preclude using professional reinsurers.

Reinsurance Pools, Syndicates, and Associations

Reinsurance pools, syndicates, and associations
Groups of insurers that share the loss exposures of the group, usually through reinsurance.

The third source of reinsurance is **reinsurance pools, syndicates, and associations**. These entities provide member companies the opportunity to participate in a line of insurance with a limited amount of capital—and a proportionate share of the administrative costs—without having to employ the specialists needed for such a venture. Whether a pool is a reinsurance device is determined by the organizational structure, the type of contract issued, and the internal accounting procedures. The terms "pool," "syndicate," and "association" are often used interchangeably, although there are some fine differences.

In a **reinsurance pool,** a policy for the full amount of insurance is issued by a member company and reinsured by the remainder of the pool members according to predetermined percentages. Some pools are formed by insurers whose reinsurance needs are not adequately met in the regular marketplace, while others are formed to provide specialized insurance requiring underwriting and claim expertise that the individual insurers do not have. Reinsurance intermediaries also form reinsurance pools to provide reinsurance to their clients. A reinsurance pool may accept loss exposures from nonmember companies or offer reinsurance only to its member companies. Some reinsurance pools restrict their operations to narrowly defined classes of business, while others reinsure most types of insurance.

Reinsurance pool

A reinsurance association that consists of several unrelated insurers or reinsurers that have joined to insure risks the individual members are unwilling to individually insure.

In a **syndicate,** each member shares the risk with other members by accepting a percentage of the risk. These members collectively constitute a single, separate entity under the syndicate name. For example, syndicates are a key component of Lloyd's (formerly Lloyd's of London), an association that provides the physical and procedural facilities for its members to write insurance. Each individual investor of Lloyd's, called a "Name," belongs to one or more syndicates. The syndicate's underwriter, or group of underwriters, conducts the insurance operations and analyzes applications for insurance coverage. Depending on the nature and amount of insurance requested, a particular syndicate might accept only a portion of the total amount of insurance. The application is then taken to other syndicates for their evaluations.

Syndicate

A group of insurers or reinsurers involved in joint underwriting to insure major risks that are beyond the capacity of a single insurer or reinsurer; each syndicate member accepts predetermined shares of premiums, losses, expenses, and profits.

An **association** consists of member companies that use both reinsurance and risk-sharing techniques. In many cases, the member companies issue their own policies; however, a reinsurance certificate is attached to each policy, under which each member company assumes a fixed percentage of the total amount of insurance. One member company is usually responsible for inspection and investigation, while a committee comprising underwriting executives from the member companies establishes the association's underwriting policy. Organizations of this type allow members to share risks that require special coverages or special underwriting techniques, and can increase the primary insurer's capacity to insure extra-hazardous risks.

Association

An organization of member companies that reinsure by fixed percentage the total amount of insurance appearing on policies issued by the organization.

Reinsurance Professional and Trade Associations

Unlike many primary insurers, reinsurers do not use service organizations such as Insurance Services Office, Inc. (ISO) and the American Association of Insurance Services (AAIS) to develop loss costs and draft contract wording. However, the reinsurance field has several associations that serve member companies and provide information to interested parties.

Intermediaries and Reinsurance Underwriters Association (IRU)

The Intermediaries and Reinsurance Underwriters Association (IRU) was founded in 1967 and is composed of intermediaries and reinsurers that broker or assume non-life treaty reinsurance. IRU publishes the *Journal of Reinsurance*, which discusses concepts and research affecting the reinsurance market. IRU conducts claim seminars, sponsors an internship program for college students, and holds conferences for members.[3]

Brokers & Reinsurance Markets Association (BRMA)

The Brokers & Reinsurance Markets Association (BRMA) represents intermediaries and reinsurers that are predominately engaged in U.S. treaty reinsurance business obtained through reinsurance brokers. BRMA seeks to identify and address industry-wide operational issues through various member committees and is described as a forum for treaty reinsurance professionals.

Of particular importance are BRMA's efforts in the area of reinsurance contract wording. The organization has compiled the *Contract Wording Reference Book*, which has become a benchmark for treaty reinsurance contracts. It is available on BRMA's website.[4]

Reinsurance Association of America (RAA)

The Reinsurance Association of America (RAA), headquartered in Washington, D.C., is a not-for-profit trade association of professional reinsurers and intermediaries. All members are domestic U.S. companies or U.S. branches of international reinsurers.

The RAA engages in many activities, serving its members and providing information on reinsurance issues to interested parties outside the industry. In addition to member advocacy and lobbying at both the state and federal levels, the RAA analyzes aggregate data and conducts seminars countrywide.[5]

SUMMARY

Reinsurance is the transfer of insurance risk from one insurer to another through a contractual agreement under which the reinsurer agrees, in return for a reinsurance premium, to indemnify the primary insurer for some or all the financial consequences of the loss exposures covered by the reinsurance contract. Reinsurance performs these principal functions for primary insurers: increase large-line capacity, provide catastrophe protection, stabilize loss experience, provide surplus relief, facilitate withdrawal from a market segment, and provide underwriting guidance.

The two types of reinsurance transactions are treaty reinsurance and facultative reinsurance. Treaty reinsurance agreements provide coverage for an entire class or portfolio of loss exposures and involve an ongoing relationship between the primary insurer and the reinsurer. Treaty reinsurance agreements are usually obligatory; loss exposures must be ceded to and accepted by the reinsurer. Facultative reinsurance agreements insure individual loss exposures. Under a facultative agreement, the reinsurer is usually not obligated to accept the loss exposure submitted by the primary insurer.

Reinsurance is available from professional reinsurers; reinsurance departments of primary insurers; and reinsurance pools, syndicates, and associations. A direct writing reinsurer is a professional reinsurer that deals directly with primary insurers. Reinsurers also may deal with primary insurers through reinsurance intermediaries. Some primary insurers also serve as reinsurers, either only to affiliates or to both affiliated and unaffiliated insurers.

Reinsurance pools, syndicates, and associations are groups of insurers that share the loss exposures of the group. Several reinsurance professional and trade associations serve member companies and provide information to interested parties.

ASSIGNMENT NOTES

1. Many of the definitions of terms in this section were adapted from the Reinsurance Association of America's (RAA) *Glossary of Terms*. The RAA's website is www.reinsurance.org (accessed March 31, 2010).
2. Insurers that are publicly traded are usually referred to as "stock insurers" to differentiate them from "mutual insurers," which are owned by their policyholders.
3. Intermediaries and Reinsurance Underwriters Association, www.irua.com (accessed May 12, 2010).
4. Brokers & Reinsurance Markets Association, www.brma.org (accessed May 12, 2010).
5. Reinsurance Association of America, www.reinsurance.org (accessed May 12, 2010).