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IASA 2014

Educational Conference & Business Show

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Reinsurance 101: an Overview
Session 107

Monday, June 9, 2014
1:30pm – 3:00pm
Introductions

**Tim Corley**

Tim is a Senior Solutions Executive for Inpoint in the area of Reinsurance Administration. Tim has worked in the field of reinsurance since 1989, when he joined an aviation insurance and reinsurance underwriting company serving as a statutory and reinsurance accountant. Tim earned his Bachelor of Business Administration and holds a Certified Public Accounting (CPA) license.

**Jon Morris**

Jon is an Account Executive for Inpoint in the area of Reinsurance Administration. Jon has worked in the field of reinsurance since 1999, holding a variety of positions in a major reinsurance broker and its subsidiary companies. Jon holds a Bachelor of Arts in addition to the Associate in Reinsurance (ARe) and Chartered Property Casualty Underwriters (CPCU) designations.
Topics to Be Covered

- Introduction
  - General Characteristics
  - Reinsurance Marketplace
- Functions & Purposes
- Forms & Types
- Contract Characteristics
  - Common Provisions
-Exiting the Business
Reinsurance:

“Reinsurance is a contract of insurance whereby one insurer (called the reinsurer or assuming company) agrees, for a portion of the premium, to indemnify another insurer (called the reinsured or ceding company) for losses paid by the reinsured under insurance policies issued by the reinsured to its policyholders.”
General Characteristics of Reinsurance

- No direct relationship between policyholder and reinsurer

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Policyholder → Insurer → Reinsurer
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- Contract of indemnity – *Transfer of Risk*
- Utmost good faith
- Negotiated terms and conditions
Introduction to Reinsurance
Similarities with Insurance

- Payment of premium
- Indemnification
- Concerned with uncertain future events
- Coverage of certain expenses
- Underwriting skill required
Introduction to Reinsurance
Differences from Insurance

Insurance
- Highly Regulated
- Policy forms are standardized
- Policy forms filed with state insurance regulator

Reinsurance
- Limited regulation
- Contracts are negotiated
- Contracts are not publicly available
Introduction to Reinsurance
Direct vs. Broker Market

Insurance Company

Reinsurance Company

Reinsurance Broker

Reins

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Functions of Reinsurance

- Catastrophe Protection
- Stabilization
- Capacity
- Finance
- Related Services
Catastrophe Protection

- Protection from accumulation of losses in natural disasters
  - Property
- Protection from severe liability judgments or clash scenarios
  - Casualty
Stabilization

- Management considerations
  - Control exposure on individual risks
  - Maximize spread of risk
  - Prevent wide swings in results

- Marketing consideration
  - Stable, well managed insurer
Provide high limits on a single risk
- No single risk greater than 10% of Surplus

- Premium Capacity
  - Ability to write higher premium volume
  - PW / PHS < 3:1
Example

- Current authorization for max policy limit of $500,000 on certain line of business
- Market demands minimum policy limit of $1,000,000
- Implement quota share cession of 50%
- Cede $500,000 / retain $500,000
Premium Capacity

Example

- Assume regulatory and market standard for premium to surplus ratio of 3:1
- Expected Annual GWP: $100,000,000
  - Surplus position: $25,000,000
- Expected premium to surplus ratio 4:1
- Implement 25% quota share cession
- Cede $25,000,000 / retain $75,000,000
- New premium to surplus ratio of 3:1
Financial Statement Strengthening

- Surplus relief
- Cession of unearned premium reserve
- Use of ceding/override commission
- Monitor/Control Financial Ratios
Forms of Reinsurance

- Placement
  - Facultative
  - Treaty

- Coverage
  - Proportional
    - “Pro-Rata”
  - Non-Proportional
    - “Excess of Loss”
## Types – Treaty vs. Facultative

<table>
<thead>
<tr>
<th>Treaty</th>
<th>Facultative</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Class or line</td>
<td>• Individual Risk</td>
</tr>
<tr>
<td>• Optional or obligatory to cede and/or accept</td>
<td>• No obligation to cede and/or accept</td>
</tr>
<tr>
<td>• Pre-negotiated cession terms</td>
<td>• Terms negotiated individually for each risk</td>
</tr>
</tbody>
</table>
# Proportional vs. Excess of Loss

<table>
<thead>
<tr>
<th>Proportional</th>
<th>Non-Proportional</th>
</tr>
</thead>
</table>
| • Cedent & Reinsurer(s) share premium & loss  
  "from first dollar"  
  • Settlement through periodic reporting  
  • Ceding commission  
  • Two Types  
  • Quota Share  
  • Surplus Share | • Premium rate for specific limit/retention  
  • Claims settled individually  
  • No ceding commission  
  • Excess of Loss  
  • Per Risk  
  • Per Occurrence  
  • Aggregate “Stop Loss” |
# Quota Share – Example

Coverage: 25% Quota Share

<table>
<thead>
<tr>
<th>Risk</th>
<th>Policy Limit</th>
<th>Exposure Retained</th>
<th>Exposure Ceded</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$2,000,000</td>
<td>$1,500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>B</td>
<td>$500,000</td>
<td>$375,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>C</td>
<td>$1,000,000</td>
<td>$750,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>
Quota Share

Strengths

• Financial impact (surplus relief)
• Premium capacity (leverage)
• First dollar coverage
• Close ceding company / reinsurer partnership
Quota Share

- Weaknesses
  - Cede large amounts of premium
  - Potentially cede profits
  - Cat protection generally capped
  - Dollar retention varies by risk
## Surplus Share - Example

### Coverage:
- Retention: $100,000 of Liability
- Maximum cession: $500,000 of Liability

<table>
<thead>
<tr>
<th>Risk</th>
<th>Policy Limit</th>
<th>Exposure Retained</th>
<th>Exposure Ceded</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$400,000</td>
<td>$100,000 (25%)</td>
<td>$300,000 (75%)</td>
</tr>
<tr>
<td>B</td>
<td>$50,000</td>
<td>$50,000 (100%)</td>
<td>--- (0%)</td>
</tr>
<tr>
<td>C</td>
<td>$700,000</td>
<td>$200,000 *29%</td>
<td>$500,000 71%</td>
</tr>
</tbody>
</table>

*Initial $100,000 retention plus $100,000 liability limit above maximum cession
Surplus Share

**Strengths**
- Financial impact (PHS relief)
- Premium capacity (leverage)
- Flexibility
- Risk capacity

**Weaknesses**
- Cede large amounts of premium
- Potentially cede profits
- Difficulty of administration
Excess of Loss - Per Risk

- Retention of loss usually fixed
- Ceded premium based on historical expected losses and exposure
- Generally no ceding commission
- Layered reinsurance program
  - First: $100,000 X/S 100,000 Per Risk
  - Second: $300,000 X/S 200,000 Per Risk
  - Third: $500,000 X/S 500,000 Per Risk
Excess of Loss - Per Risk

- **Strengths:**
  - Risk capacity
  - Less premium transferred
  - Premium rate is closely related to exposure and experience
  - Controls exposure to individual losses

- **Weaknesses:**
  - Limited premium relief
  - Potential accumulation of retentions
  - Ineffective catastrophe protection
Excess of Loss - Catastrophe / Per Occurrence

- Accumulation of loss from occurrence (i.e., hurricane, earthquake, environmental) rather than single risk
- Severity coverage - not frequency
- Limited coverage - reinstatements may be available
- No ceding commission
- Layered coverage:
  - First: $1,000,000 X/S 1,000,000 Per Occ
  - Second: $3,000,000 X/S 2,000,000 Per Occ
  - Third: $5,000,000 X/S 5,000,000 Per Occ
Strengths:
- Catastrophe protection
- Less premium transferred
- Financial results stabilized from large loss occurrence

Weaknesses:
- Does not provide individual risk capacity
- Little protection from frequency of occurrences
- No immediate financial statement impact
Aggregate Excess / Stop Loss

- Coverage is excess a given loss ratio or aggregate dollar amount
- Usually “last line” of coverage
- Frequently financially oriented
- Generally no ceding commission
- Can replace working layers
Aggregate Excess / Stop Loss Example

Assume Earned Premium of $200M
95% of 10,000,000 X/S
70% Loss ratio for current accident year

<table>
<thead>
<tr>
<th>Reinsurance</th>
<th>5% of $10M + additional losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retention</td>
<td>$9.5M = 4.8 loss ratio points</td>
</tr>
<tr>
<td></td>
<td>$140 M (70% of 200M)</td>
</tr>
</tbody>
</table>
Aggregate Excess / Stop Loss

- **Strengths:**
  - Ultimate vehicle for financial stabilization
  - Some catastrophe protection
  - Solid overall protection

- **Weaknesses:**
  - Little Premium Relief
  - Not for individual risk capacity
  - Can be very expensive
Limited Risk Reinsurance

- A.K.A. Finite Reinsurance or Structured Reinsurance
- Reinsurance where the primary objective is financial rather than risk transfer
- Risk transfer is present but is secondary to financial objectives
- Increased Regulatory Scrutiny of these transactions
Limited Risk Reinsurance

Reinsurance Spectrum

Financial Risk

Underwriting Risk

Financial Reinsurance

Limited Risk Reinsurance

Traditional Reinsurance

Financially Motivated Transactions Risk Motivated
Limited Risk Reinsurance
Examples of Limited Risk Products

- Aggregate Excess of Loss Contracts
  - Most effective on long-tail insurance business
  - Allows immediate recognition of time value of money

- Limited Risk Quota Share Coverage
  - Include aggregate caps and large slides
  - Often done on a “Funds Withheld” basis

- Loss Portfolio Transfers
  - Limited usefulness due to accounting rules for retrospective reinsurance coverage

- Multi-year Funding Covers
  - Limited usefulness due to accounting rules concerning asset and liability accrual
Disclaimer: Any Reinsurance Contract Language Presented is for Discussion Purposes Only
Important Treaty Provisions

- Basis of Attachment / Business Covered
- Term and Termination
- Retention and Limits
- Premium
- Claims Reporting and Loss Settlements
- Treatment of Loss Adjustment Expenses
- ECO/XPL
- Exclusions
- Other contractual provisions
Business Covered

- Defines the scope of business reinsured (e.g., lines / classes of business, profit center, etc.)

- New and renewal (“risks attaching”):
  - Covers losses on policies written or renewed during term of reinsurance

- In force, new, and renewal (“losses occurring”):
  - Covers losses occurring during term of reinsurance on policies written prior to or during term of reinsurance
A. By this Contract the Company obligates itself to cede to the Reinsurer and the Reinsurer obligates itself to accept quota share reinsurance of the Company’s net liability under policies, contracts and binders of insurance or reinsurance (hereinafter called “policies”) in force at the effective date hereof or issued or renewed on or after that date, and classified by the Company as ________________________________.

B. It is understood that the classes of business reinsured under this Contract are deemed to include:
Assume:

- Three subsequent reinsurance treaties eff: Jan. 1\textsuperscript{st}
- Each reinsurance contract placed with a different reinsurer
- Primary Policy is effective for one year
- One policy written by the insurance company

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- Reins. Treaty In Force
- Primary Policy In Force 12 months
- Primary Policy Inception Date: April 1, Year 1

January 1
TY 1

January 1
TY 2

January 1
TY 3
Accident Year Accounting

- Also known as: “Losses Occurring”
- **Date of Loss** determines reinsurance coverage

Date of Loss: Feb 1, Year 2

Loss Paid by Primary Insurer
March 15, Year 3

Primary Policy Inception Date:
April 1, Year 1

January 1, TY 1

January 1, TY 2

January 1, TY 3
- Also known as: “Risks/Policies Attaching”
- **Policy Inception Date** determines reinsurance coverage

Date of Loss: Feb 1, Year 2
Loss Paid by Primary Insurer: March 15, Year 3
Primary Policy Inception Date: April 1, Year 1
Calendar Year Accounting*

- Also known as: “Losses Incurred”
- **Date of Payment** by Insurer determines reinsurance coverage

*Calendar Year Accounting is the **least** frequently used of the three types.

Date of Loss: Feb 1, Year 2

Loss Paid by Primary Insurer
March 15, Year 3

Primary Policy Inception Date:
April 1, Year 1
Term and Termination

- Fixed term vs. Continuous contracts
- Cut-off vs. Runoff at termination
- Special Termination:
  Triggered by certain events (e.g., downgrade, x% decline in surplus)
- Commutation:
  Cedent reassumes reserves in exchange for financial settlement
B. Notwithstanding the provisions of paragraph A above, the Company may terminate a Subscribing Reinsurer’s percentage share in this Contract at any time by giving written notice to the Subscribing Reinsurer in the event any of the following circumstances occur:

1. The Subscribing Reinsurer’s policyholders’ surplus at the inception of this Contract has been reduced by more than 20.0% of the amount of surplus 12 months prior to that date; or

2. The Subscribing Reinsurer has become merged with, acquired by or controlled by any other company, corporation or individual(s) not controlling the Subscribing Reinsurer’s operations previously; or

3. The Subscribing Reinsurer has become insolvent or has been placed into liquidation or receivership; or

4. Other conditions as negotiated between the parties.
Types of Limits

- **Excess of Loss Reinsurance:**
  - Per risk or per occurrence
  - Sub-limits
  - Aggregate limit

- **Proportional Reinsurance:**
  - Maximum cession
  - Maximum policy limit
Reinsurance Premiums

- Proportional Reinsurance:
  - Premium a function of primary pricing
  - Reinsurer pays ceding commission

- Excess of Loss Reinsurance:
  - Premium independent of primary pricing
  - Rated basis (e.g., % of “subject premium”) or flat premium
Claims

- Claims managed by ceding company
- Reinsurer may have right to associate
- Claims reported to Reinsurer on individual basis (e.g., catastrophe reinsurance) or by bordereau (e.g., quota share)
  - Various Reporting Requirements
- Loss Settlements / Cash Calls
- Reinsurer has right to audit claims files
- Definition of “Ultimate Net Loss”
Loss Adjustment Expenses

- “Unallocated” expenses typically not covered (e.g., overhead, salaries of employees)
- Proportional Reinsurance: expenses covered pro rata based on reinsurer’s contractual share of indemnity loss
- Excess of Loss Reinsurance:
  - expenses + indemnity subject to limit
  - or -
  - expenses covered pro rata in addition to indemnity limit
“Ultimate net loss” as used herein is defined as the sum or sums (including loss in excess of policy limits, extra contractual obligations and any loss adjustment expense, as hereinafter defined, which reduces the Company’s limit of liability under the policy involved) paid or payable by the Company in settlement of claims and in satisfaction of judgments rendered on account of such claims, after deduction of all salvage, all recoveries and all claims on inuring insurance or reinsurance, whether collectible or not. Nothing herein shall be construed to mean that losses under this Contract are not recoverable until the Company’s ultimate net loss has been ascertained.
Loss Adjustment Expense

Assume:
- Reinsurance Retention: $2,000,000
- Reinsurance Coverage: $8,000,000

Included in UNL

Pro-Rated in addition to UNL

LAE

$10M
“Ground Up”

$8M

$2M

Retention

Coverage
LAE Included in Ultimate Net Loss

- Subject Loss = $5,000,000
- LAE = $250,000
- Loss Payable by Reinsurer:
  $5,000,000 + $250,000 = $5,250,000 (UNL)

Less Retention:
$5,250,000 - $2,000,000 =

*Ultimate Net Loss to Reinsurer:*
$3,250,000
LAE Pro-Rated in Addition

- Subject Loss = $5,000,000
- LAE = $250,000
- Payable by Reinsurer:

\[
\text{Paid Loss - Retention} \div \text{Paid Loss} = \text{??%}
\]

\[
\text{??%} \times \text{Total Expenses} = \text{Reinsurer’s Pro-Rated Share Of Expenses}
\]
Ceded Loss: $3Mil.

Retained Loss: $2Mil.

$5,000,000 - $2,000,000 = $3,000,000

$3,000,000

$5,000,000 = .60

Reinsurer pays 60% of Ground Up Loss

And Same Share of LAE:

60% of $250,000 = $150,000
In the event of loss hereunder, loss adjustment expense incurred by the Company in connection therewith which does not reduce the Company’s limit of liability under the policy involved shall be shared by the Company and the Reinsurer in the proportion the ultimate net loss paid or payable by the Reinsurer bears to the total loss paid or payable by the Company, prior to any reinsurance recoveries, but after deduction of all salvage, subrogation and other recoveries.
Excess of Policy Limits / Extra-Contractual Obligations

- Reinsurance Usually Covers ECO and XPL—Breach of Defense or Additional Damage Covers
- Extra Contractual Obligations (ECO)
  - Punitive Damages or Compensatory Damages Not Otherwise Covered
- Excess of Policy Limits (XPL)
  - Compensatory Damages Paid By the Insurance Company That Are Covered Under The Primary Policy But Are in Excess of Policy Limits
Exclusions

- Typical exclusions include:
  - War, Nuclear, Terrorism
  - Reinsurance Assumed
  - Pools & Associations
  - Financial Guaranty
  - Pools & Associations
  - ECO / XPL
  - …but exclusions are specifically negotiated!
Other Contract Features

- Reinsurer’s right of inspection
- Right of Offset
- Warranties
- Security for reserves ceded to non-admitted reinsurers
- Arbitration of disputes
- Broker of Record
Right of Inspection / Access to Records

- The Reinsurer or its designated representatives shall have access at any reasonable time to all records of the Company which pertain in any way to this reinsurance.
Right of Offset

- The Company and the Reinsurer shall have the right to offset any balance or amounts due from one party to the other under the terms of this Contract. The party asserting the right of offset may exercise such right any time whether the balances due are on account of premiums or losses or otherwise.
Warranties - Example

- The Company shall purchase or be deemed to have purchased inuring excess facultative reinsurance to limit its loss subject hereto from any one coverage, any one policy (exclusive of loss in excess of policy limits or extra contractual obligations) to the following amounts...

- Other warranties negotiable...
Security for non-admitted reinsurers

- Requires collateralization of Unearned Premium and Outstanding Loss (usually includes IBNR) Reserves from any reinsurer who is not authorized to write reinsurance in the ceding companies State of Domicile or other licensed states.

- Collateralization can be in the form of:
  - Cash
  - Trust Account
  - Letter of Credit
Each state has different requirements and provisions. Some common requirements include:

- Clean, irrevocable & unconditional
- NAIC Approved Bank
- Evergreen Clause
- Trust Agreements from Alien Reinsurers
  - Letter of Credit/Outstanding Cash Advance (OCA)
Arbitration

- Arbitration Before Experts in Reinsurance
  - Each party selects an arbitrator, and:
    - Arbitrators agree on an arbitration ‘judge’
- All Contracts Should Have Arbitration Clause
- Intent is to Keep Disputes Out of the Courts
- Reduced precedent in case law
Company X or one of its affiliated companies is hereby recognized as the Intermediary negotiating this agreement. All communications relating to this agreement will be transmitted to the Company or the Reinsurer through the Intermediary. Payments made by the Company to the Intermediary will be deemed payment to the reinsurer. Payments made by the reinsurer to the Intermediary will be deemed payment to the Company only to the extent that such payments are actually received by the Company.
Exiting the Business

Companies have a variety of options for exiting business:

- Exiting the reinsurance business all together
- Exiting a line of business or reinsurance treaty
  - Novation
  - Commutation
  - Loss portfolio transfer
  - Run off
  - Sale
Run off vs. Cut off

- **Cut off:**
  - The Liabilities and Unearned Premiums Associated With Policies In Force on the Date of Termination are Cut off From the Old Contract and Either Returned to the Company or Rolled Forward Into a New Reinsurance Contract
  - Reinsurer is **NOT** Liable For Loss Occurring at or After Date of Termination

- **Run off:**
  - Coverage continues until liabilities close
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- Forms & Types
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Questions