
Introduction to Reinsurance

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THIS ISSUE

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The *Primer Series on Insurance* provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

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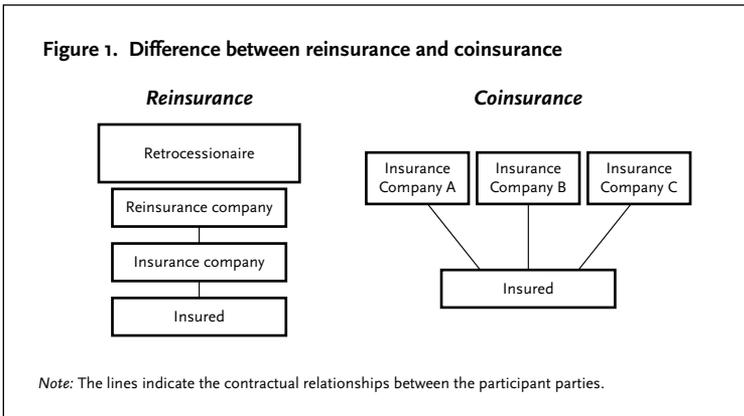
Introduction to Reinsurance

Rodolfo Wehrhahn

Definition

Reinsurance is a financial transaction by which risk is transferred (ceded) from an insurance company (cedant) to a reinsurance company (reinsurer) in exchange of a payment (reinsurance premium). Providers of reinsurance are professional reinsurers which are entities exclusively dedicated to the activity of reinsurance. Also in most jurisdictions insurance companies are allowed to participate in reinsurance. The terms of a reinsurance transaction are defined in a reinsurance treaty. Due to the complexity of reinsurance treaties it is not uncommon that the definitive treaties are only signed months after the risk transfer took place. To document the acceptance of the risk, a short version of a treaty call a slip containing the most important terms of the agreement is used instead. Slips are signed before the risk is transferred and accepted by the reinsurer. Some jurisdictions are requiring signed treaties before the risk is transferred.

Reinsurance is to be differentiated from coinsurance, where the risk is shared and not transferred among several insurance companies, each one of them having a direct contractual relationship with the insured for the portion of the risk accepted by that company. Thus, reinsurance always involves legal entities and not individuals. In reinsurance, the contractual relationship is between the cedant and the reinsurer. Only in special situations does the reinsurance treaty have a provision called the *cut through clause* that allows the insured to have a direct legal claim to the reinsurer; for example in case the insurer becomes insolvent.



Reinsurers can also transfer risks to other entities called retrocessionaires by means of a financial transaction similar to reinsurance called retrocession. Professional retrocessionaires are expected to keep and not to transfer the assumed risk to other entities. In this manner reinsurers and insurers that do accept risks not individually identified can be sure that they will never assume part of the risk they had already transferred. However, there have been situations in the past where retrocessionaires actually transferred further the assumed risks resulting in unexpected over retention for the retrocedants. Proper retrocession treaty wording can help here.

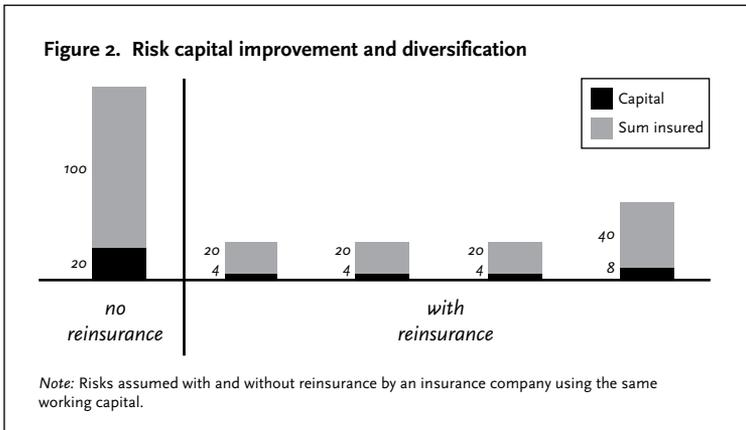
Figure 1 illustrates the contractual relationships in typical reinsurance and coinsurance transactions.

Reinsurance needs

There are several reasons for an insurance company to use reinsurance. We will discuss here the most important ones.

Increasing underwriting capacity

Insurance companies are often offered risks that may surpass their financial strength. Ceding part of the risk may allow them to accept the full risk thus satisfying client's needs. For this purpose insurance companies may also use coinsurance. However in this case the insur-



ance company will have to contact competitors to share part of the risk which might not be to its best interest, especially in a competitive market. Another disadvantage to the use of coinsurance is the burden put on the insured that will need to deal with each one of the participating insurance companies with regard to premium payments and claim settlements.

Risk capital improvement and diversification

Insurance companies having a more diversified portfolio of risks will tend to have more stable financial results. Using reinsurance will allow insurance companies to participate in a diversity of risks using the same working capital by ceding part of the risk and keeping a smaller portion of each risk. This reduction in the concentration on risk will diminish the volatility of the annual results. Figure 2 illustrates this reinsurance effect. Here, without reinsurance the company's capital commitment allows its participation in only one risk. Using reinsurance, the same committed capital allows the company to participate in four different risks with a total higher sum insured.¹

1. The diversification effect lowers the total required risk capital.

Surplus relief

The use of reinsurance allows insurance companies to partially transfer risks off their balance sheet. While the ultimate responsibility to the policy holders still remains with the insurance company, most jurisdictions recognize reinsurance as a risk managing tool that allows a reduction of statutory surplus requirements. The guarantee implicit on a reinsurance contract to pay the reinsured claims is recognized in the capital requirements for the cedant. Hence it is not uncommon to base the prudential requirements on the insured premium net of reinsurance.

Reinsurance thus removes a technical risk but it introduces a counterparty risk since, as mentioned above, the ultimate responsibility to the policy holders still remains with the insurance company. To offset the counterparty risk additional surplus is usually required. This additional capital will vary depending on the solvency rating of the reinsurer. Also the amount of surplus relief granted will depend on that rating.

Catastrophic protection

Well run insurance companies accept risk exposure according to their financial strength. However, the risks may also be exposed to extreme infrequent events, like earthquakes, floods, plane crashes and other mayor catastrophic events. Holding enough capital for those extreme events would make the insurance operation economically unviable or at least very expensive. Transferring this exposure to catastrophic events to the reinsurers is a more effective way to address very infrequent events. Reinsures offer catastrophic protection in a more economic feasible way than insurance companies by participating in catastrophic exposures through out the world and thus geographically better diversifying the risk. Usually reinsurers are also more capitalized than insurance companies. They also operate dedicated departments that have gained substantial knowledge of the physical characteristics and history of catastrophic events thus allowing them to price and underwrite properly the exposure and accept those risks.

Expertise transfer

Through the reinsurance activity reinsurers acting in several markets with different insurance companies have the ability to acquire significant knowledge of the different products, markets and insurance tech-

niques like underwriting, administration of the policies and claims assessment. This is particularly important when entering a new market, a new line of business or simply launching a new product. Transferring the risk through reinsurance may also include the shift of the underwriting, administration, or other activity related to the risk transferred to the reinsurer. Such a reinsurance agreement allows insurers to focus in their core business outsourcing to experts the non core activities.

Financing new business

As discussed in Module 1 a rapidly growing insurance activity can require upfront financing. This is particularly true in the case of Life Insurance business. Here the insurance company has to finance the agents or broker's commissions that can be as high as the full first year's premium as well as the underwriting costs that may include medical examinations and financial assessments. Reinsuring part of the business can provide a source of financing especially if the reinsurer agrees to advance the future expected profits of the business in the form of reinsurance commission. This source of financing of insurance business can be attractive compared to other sources such as bank loans or equity. Reinsurers, knowing the business, will have lower risk charges than non insurance financing sources. Also, in most reinsurance agreements the pay back is contingent on the performance of the reinsured business. i.e. the advancement of future profits are only recovered by the reinsurer if the business actually generates those expected profits. If the payback of the reinsurance financing is totally contingent on the performance of the reinsured business, in most jurisdictions no liability needs to appear in the balance sheet of the cedant.

Other reinsurance needs and a word of warning

Insurance companies enter reinsurance agreements for one or more of the above mentioned reasons. There might be other special situations where reinsurance is used as a valid financial and operational tool, however if none of the above mentioned needs is present, special scrutiny of the transaction is required. The great flexibility of reinsurance treaties that allows effective tailor-made solutions to meet individual insurance company's needs has been abused in the past to design tax avoidance, money laundry and other illegal activities. A reinsurance agreement that does not transfer any type of risk is always questionable.

Types of reinsurance agreements

Most reinsurance contracts are either automatic treaty or facultative. Under a treaty reinsurance arrangement all risks that are defined to be object of the agreement are ceded automatically to the reinsurer, and the reinsurer agrees to accept all those risks. On a facultative treaty the cedant decides if a risk will be offered to the reinsurer and the reinsurer will decide on an individual basis if it will accept or not the offered risk. There is a third less common treaty structure called facultative-obligatory reinsurance. Here, the offering of the risks to the reinsurer is on a facultative basis but the acceptance of the risks is obligatory for the reinsurer.

Treaty reinsurance

Treaty reinsurance allows the cedant to act in an independent and fast reacting way when accepting risks that fall under the object of the reinsurance agreement. In treaty reinsurance the acceptance of the risk by the reinsurer together with all financial conditions has already been negotiated and agreed upon. This characteristic of treaty reinsurance to offer “blind acceptance” of the risks to the cedant requires that the reinsurer know and trust the cedant. Treaty reinsurance is therefore only offered after the reinsurer has done proper due diligence on the insurance company to determine the quality of the business that would expect to reinsure. The important aspects that a reinsurer will pay attention to include: the expertise of the company, its risk attitude, its track record, the expected amount of business to be reinsured and other technical aspects. Further, on a regular basis the reinsurer will audit the cedant to ensure that the terms of the treaty are followed: the underwriting guidelines are respected, the types of accepted risk comply with the object of the treaty, all risks that needed to be ceded have been ceded, proper accounting and administration was done, etc.

Facultative reinsurance

Insurance companies are offered from time to time the opportunity to insure risks that are very large or complex or simply unusual. In these situations facultative reinsurance is the best alternative. Here the reinsurer participates in the underwriting and assessment of the risk. Depending on the risk the reinsurer might or might not accept the reinsurance. In case of acceptance the reinsurer will provide the particular

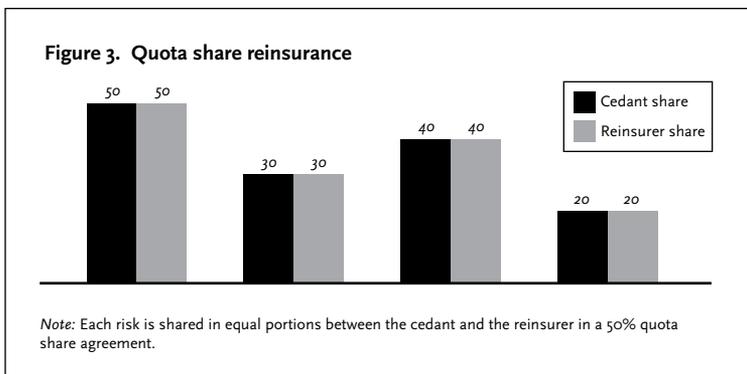
terms, like premium, exclusions, and so forth. The already negotiated facultative treaty will govern all other general terms of the agreement.

Forms of reinsurance

Basically there are two forms of reinsurance: proportional reinsurance and non-proportional reinsurance. As the names suggest, there is or there is not a proportional sharing of premium, claims, expenses, and so forth. Proportional reinsurance creates a type of partnership between the cedant and the reinsurer as they have a strong alignment of interests in the performance of the underlying business. In non-proportional reinsurance the interests are usually not aligned and can even be opposed with respect to the performance of the business.

Proportional quota share reinsurance

Under a Quota Share reinsurance treaty the cedant transfers the same proportion or quota of each and every risk that falls under the object of the reinsurance agreement to the reinsurer (See figure 3). The premium, expenses and claims are also shared in the same proportion with the reinsurer. The reinsurer pays the cedant a reinsurance commission to compensate it for the acquisition and administrative expenses of the business. Also, it is quite typical to include a profit sharing formula that allows for sharing profits of the reinsured business with the cedant. This is done to reward the cedant for the quality of its underwriting and selection of the accepted business. The propor-



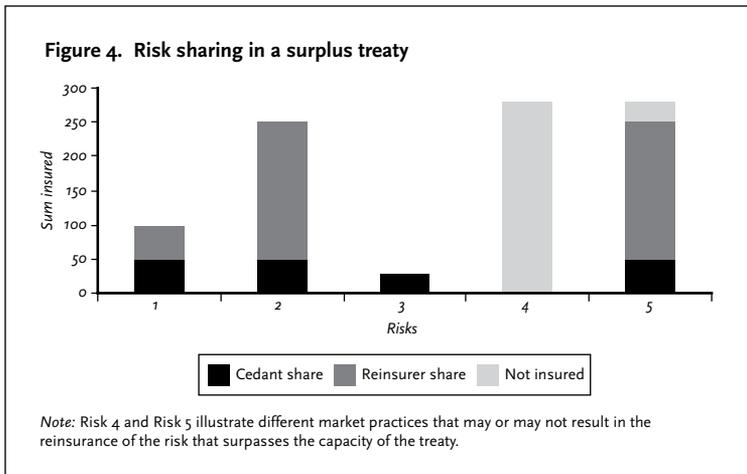
tionality of the agreement also applies to any type of reserves that the business may require. The reinsurer is responsible for maintaining the appropriate reserves for its share in the business. Some jurisdictions require that certain reserves should be kept with the cedant or in a trust. In these cases the reinsurer will send the necessary assets to the cedant or the trust to build the reserve corresponding to the reinsured business. The above indicated terms are usually first documented in a reinsurance slip when making a reinsurance offer. The slip will then be used to draft the definitive treaty. A slip containing the most important terms of a Quota Share agreement is attached in Annex 1.

Surplus or excedent reinsurance

This type of proportional reinsurance is basically a Quota Share agreement that assigns a different proportion to be reinsured to each risk (see figure 4). To determine the proportion of the risk to be reinsured, the insurance company fixes an amount called *retention* or *surplus line* as the maximal sum insured that the company will retain on own account. Any amount above the retention and up to a given amount called *capacity* of the contract will be reinsured. The capacity sometimes is given in number of surplus lines.

Surplus reinsurance allows the cedant to change the level of participation on any type of risk by choosing a given surplus line for that specific type of risk. As an illustration let us consider a treaty where the retention is US\$50 and the capacity US\$200 or four surplus lines:

- Here a particular risk that has a sum insured of US\$100 will be shared among the insurer and the reinsurer in a 50% proportion (risk 1 in figure 4).
- For a risk having a sum insured of US\$250, the proportion will be 20% for the insurer and 80% for the reinsurer (risk 2 in figure 4).
- A risk that has a sum insured lower than the retention will not be reinsured at all (risk 3 in figure 4).
- Similarly risks with a higher sum insured than the capacity will not be part of the reinsurance agreement (risk 4 in figure 4).
- However, note that there are different practices and in some markets reinsurers will accept risks having a sum insured higher than the capacity to be reinsured up to the capacity of the surplus treaty (risk 5 in figure 4).



Financing elements

Proportional reinsurance creates a strong alignment of interest between the insurer and the reinsurer since premium, expenses and claims are shared in a proportional manner. The reinsurance premium volume is high as compared to the non-proportional reinsurance because of the sharing of the expenses. A high volume premium may allow the reinsurer to finance substantial upfront costs in exchange of the future profits of the reinsured business.

Pricing

The pricing or determination of the amount of the reinsurance premium in proportional reinsurance is basically dictated by the underlying insurance premium, as it usually is a percentage of that premium. Also the amount of reinsurance commission should directly reflect the actual costs that the cedant undergoes in acquiring and administering the business. More involved calculations are needed when determining the profit sharing formula. Here sophisticated stochastic models are used. Finally, when the reinsurance agreement includes some sort of financing, for instance in the form of advancing future profits, considerations of cost of capital, credit risk and risk of the business not performing as expected have to be taken into consideration when pricing the reinsurance allowance.

Non-proportional reinsurance

Insurance companies that are looking mainly to protect their portfolio from adverse experience that could result from too many claims or too high claims will usually enter non-proportional reinsurance agreements. In non proportional reinsurance the protection is provided based on the actual loss the insurer suffers and not the sum insured of the risk.

Surplus proportional reinsurance as describe above requires that the sum insured of every individual risk is known to determine the proportionality in sharing the risk. There are however several insurance products where the sum insured is not always known, such as MTPL in the UK or commercial liability in the US, etc. In these cases when individual differentiated risk protection is desired, non proportional reinsurance can be used.

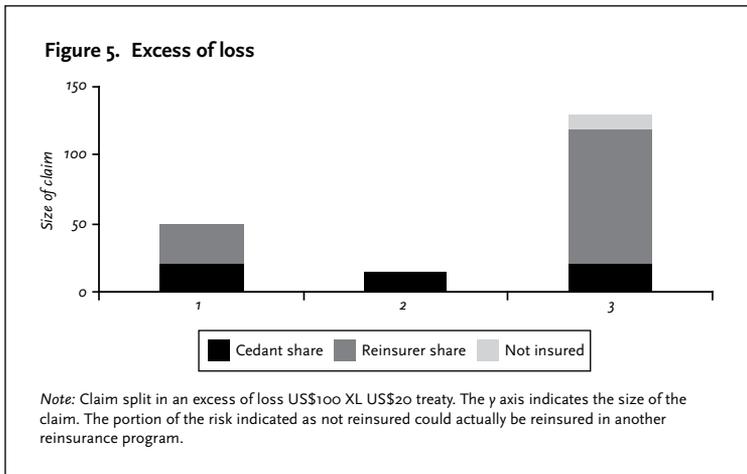
Excess of Loss reinsurance

The basic type of non proportional reinsurance is the excess of loss reinsurance (XL). In an excess of loss agreement per risk the cedant will pay in case of an event affecting a reinsured risk the claimed amount up to a fixed chosen quantity called the *priority* of the agreement. The reinsurer will then pay any excess amount claimed above the priority up to the *capacity* of the contract.

As an example, consider in figure 5 an excess of loss agreement where the priority is US\$20 and the capacity is US\$100 (US\$100 XL US\$20):

- A claim of US\$50 will cost US\$20 to the cedant and US\$30 to the reinsurer (see figure 5 risk 1).
- A claim of US\$15 will be totally paid by the cedant since the total amount is below the priority (see figure 5 risk 2).
- A claim of US\$130 will cost US\$20 +US\$10=US\$30 to the cedant and US\$100 to the reinsurer. Here the full capacity of the treaty has been exhausted leaving an additional US\$10 uncovered amount for the cedant (see figure 5 risk 3).

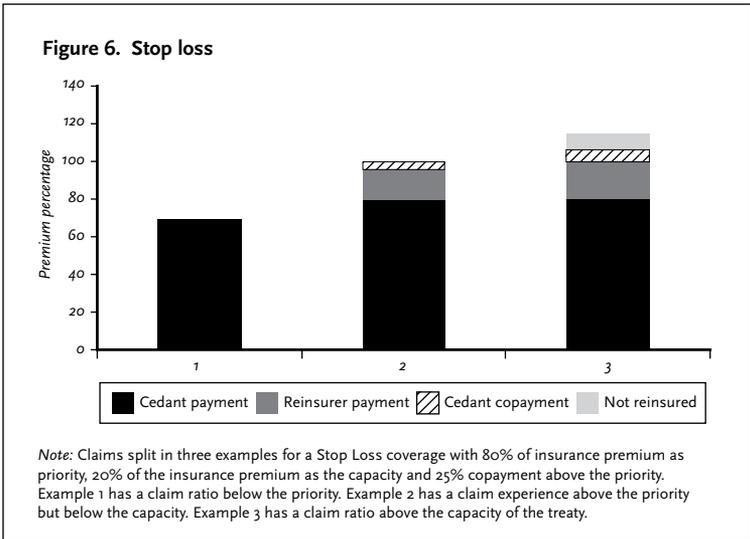
Note the important difference to the surplus reinsurance that the excess reinsurance only covers actual losses above the priority, so that small claims on the reinsured risk are not protected.



The reinsurance premium for an excess of loss agreement is not proportional to the direct premium collected by the insurer and is determined by the probability of having claims above the priority and attendant cost of capital. Also, as mentioned before there might be a conflict of interests between the cedant and the reinsurer: The financial incentive of the cedant on settling the claim disappears the moment the claimed amount is higher than the priority since beyond the priority the liability is transferred in full to the reinsurer up to the capacity of the treaty. To avoid these situations some agreements require either that the reinsurer has to approve payments above the priority or that the cedant retains a copayment of the liability above the priority.

Stop loss reinsurance

An excess of loss agreement on the whole portfolio is called a Stop Loss coverage. The reinsurer will protect the cedant only in case the priority is exceeded by adding up all claims paid during the period of coverage, usually one year. In a typical Stop Loss coverage the priority is expressed as a percentage of the insurance premium and in most cases a copayment in excess of the priority is required. Annex 2 contains a stop loss slip with the main parameters.



To better understand figure 6 illustrates the way a stop loss coverage works consider a stop loss agreement that has as priority 80% of the insurance premium, 20% of the insurance premium as capacity and a copayment of 25% above the priority.

- In example 1 the total annual amount paid in claims is 70% of the insurance premium and hence it does not exceed the priority of 80%. Here the reinsurer will not participate in the payment of claims.
- In example 2 the total amount paid in claims is 100% of the insurance premium. The reinsurer pays an amount equal to 16% of the insurance premium. The cedant pays the full priority of 80% and a copayment of 4% of the insurance premium.
- In example 3 the total amount paid in claims is 115% of the premium. The reinsurer pays an amount equal to the full capacity of 20% of the insurance premium. The cedant pays the full priority of 80% and a copayment of 6.67% of the insurance premium. The remaining amount of 8.33% of the insured premium is not reinsured and the cedant remains responsible for that amount.

Catastrophic excess of loss reinsurance

There is a third class of non proportional reinsurance form called catastrophic excess of loss reinsurance (Cat-XL). Here, in addition of the necessity to exceed the priority to have reinsurance protection also the catastrophic event has to have taken place. Catastrophic events can be for instance an earthquake, an explosion that has a toll of at least 3 lives, and so forth.

Catastrophic reinsurance does not cover every event. Typical standard exclusions in a Cat-XL agreement are the claims related to nuclear or radioactive incidents. Terrorism is also a common exclusion. For these risks as well as other political risks, government or national industry pools have been established. We discuss pools later in the module.

Pricing

The pricing of non proportional reinsurance is an involved activity that is done by experienced actuaries. Among the methods used in determining the cost of reinsurance are the burning cost evaluation, scenario modeling and exposure pricing. Burning cost evaluation looks at the past experience of the claims above the priority and below the capacity with adjustments made for inflation, changes in conditions, etc. The resulting cost is the necessary amount to pay expected claims or the so called risk premium. The reinsurance premium is then the risk premium loaded for expenses and profit. The scenario modeling uses mathematical models that utilize claim distributions to simulate the risk exposure of the reinsured portfolio. Several simulations are run to determine the probable loss above the priority and below the capacity of the treaty. Again this cost is loaded for expenses and profit to determine the reinsurance premium. Finally the exposure pricing looks at the existing reinsured portfolio and assigns empirical probabilities for claims to occur to every risk reinsured that could result in amounts above the priority.

In non-proportional reinsurance the typical duration of an agreement is annual since changes in the market conditions, the economy and the reinsured portfolio affect directly the reinsurance costs. A non proportional agreement does not offer a profit sharing participation that in case of the proportional reinsurance is used to compensate the cedant for good underwritten business because of the different exposure that the cedant and the reinsurer have here.

Reinsurance programs

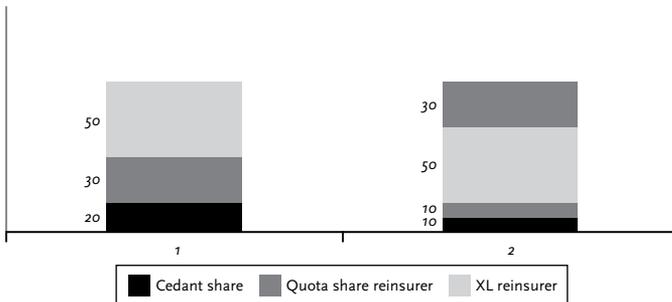
Reinsurance provides a flexible and effective tool to insurance companies for the management of the risks they are assuming. A combination of several reinsurance agreements is called a reinsurance program. A well structured reinsurance program will provide important competitive advantage but can be quite complex.

Several reinsurers may participate in a reinsurance program accepting different percentages of the program. This structure is sometimes called a *reinsurance pool*.

As a simple example consider the effect of combining a 50% Quota Share with a US\$50 XL US\$20 in different order. Figure 7 indicates the participation of the cedant, the Quota Share reinsurer and the XL reinsurer in case of a claim of US\$100.

- In example 1 the claim is first split 50% between the cedant and the Quota Share reinsurer. Then the XL coverage protects the share in the claim of the cedant of US\$50 paying US\$30 in excess of US\$20.
- In example 2 the XL pays US\$50 of the claim and the cedant is left with a claim of US\$70. Then the Quota Share reinsurer assumes half of that payment.

Figure 7. Effect of a quote share and an excess of loss applied in a different order



Note: The shares in a claim depending on the order applied to the reinsurance coverage. In example 1 first the Quota Share then the XL protection applies. In Example 2 the order is reversed.

Participants of the reinsurance industry

As discussed above the main participants in the reinsurance industry are the professional reinsurers, the retrocessionaires and the insurance companies. Reinsurance brokers also play a fundamental role in the placement of reinsurance programs, in particularly when dealing with special programs. Captives, Pools and Offshore Reinsurers complete the reinsurance industry.

Reinsurance brokers

For complex reinsurance programs or when the reinsurance capacity is scarce, insurance companies utilize the services of reinsurance brokers. Reinsurance brokers are companies or professional individuals that are licensed and supervised dedicated to provide professional advice to insurance companies on the placement of their reinsurance programs. Reinsurance brokers are paid through reinsurance commissions that are proportional to the placed reinsurance premium. Reinsurance brokers also offer administrative services and product development. In most jurisdictions reinsurance brokers are required to hold an error and omissions liability policy for the protection of the insurance companies.

In recent years the press has reported on major financial scandals related to the non transparency of the reinsurance commissions. Professional reinsurance brokers have reacted offering detailed disclosure of their commissions. As an example we have attached in Annex 3 a disclosure commitment issued by Guy Carpenter.

Captives

Large industrial conglomerates that are interested in keeping their risks within the group usually operate with a captive. A captive is a legal entity, usually a stock insurance company owned by the group that accepts and retains risks emanating only from the same industrial group.

Pools

Insurance companies may want to insure an unusual or new type of risk but fear they will not have enough business of that type to benefit

from the law of large numbers. In an insurance pool, several companies agree to share all their risks of this type. This will provide a large enough sample to give more predictable and consistent results from year to year. The pool could be reinsured or the sharing of each policy in the pool may be according to how much business each company puts into the pool or it could be a formula relating to how much risk each company would accept on any one case. Pooling was in fact the way insurance of modern passenger airplanes began. The World Bank has been promoting pools to cover catastrophic risks like the Turkish Catastrophic Insurance Pool (TCIP) and the Caribbean Catastrophic Risk Insurance Facility (CCRIF).

Offshore reinsurance

Offshore reinsurance companies are reinsurers which operate in special geographic zones, often with less demanding regulatory and favorable tax environments. A great deal of reinsurance is conducted through these centers although much of the actual management of these companies is done in the parents' home offices in Europe, London and New York. The purpose of offshore reinsurance has been to optimize the use of capital and thus create competitive advantage. However, special scrutiny is required when offshore reinsurance is involved. The lack of a strict regulation or the low capital requirements in some offshore centers can lead to failing reinsurers in case of major claims. Also money laundering activity has used this type of reinsurance in the past.

Regulatory and supervisory issues²

The authorities in many countries are becoming concerned about the quality of reinsurance purchased by domestic insurers. The reinsurance credit that is granted to the cedants in the form of a reserve or capital reduction can only be justified if the reinsurer is at least as solvent as the insurance company. Minimum security to operate as a reinsurer is usually required and the amount of reinsurance credit granted will depend on the quality of the security. In some jurisdictions additional risk capital is required when using low rated reinsurers.

2. The remaining sections of the module were taken from a course on reinsurance developed by Rodney Lester and Serap Orguz of the World Bank.

Virtually every insurance supervisor in the world has the right to monitor reinsurance arrangements for domestic insurers and to require that they be strengthened. Regular information on the reinsurers can be obtained from the supervisory authorities at their legal domicile.

Professional reinsurers play an important role somewhat related to supervision. Reinsurers impose discipline on the reinsured companies particularly in emerging markets. It is the reinsurers who tell them what reserves to hold and what premiums to charge. In countries where there is little or no insurance regulation this an extremely important role played by the reinsurer.

Accounting and control issues

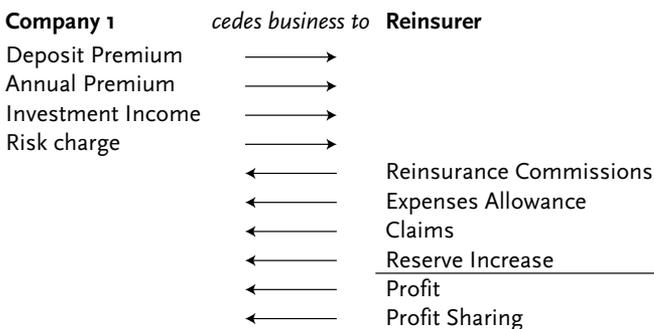
Reinsurance accounting is very complex and only partly covered here. A dedicated module on accounting for insurance activities will be published later in this series.

Because of the importance of reinsurance in the impact of the finances of the insurance companies, the governance structure of the insurer should ensure that the boards take particular interest in this topic and the internal control systems should ensure that the appropriate reinsurance program is in place.

Understanding a reinsurance treaty

Treaty format

A reinsurance treaty in very general terms defines payments between insurance companies. In diagram form it looks like this:



In this diagram Company 1 cedes business to the Reinsurer. The treaty calls for Company 1 to make payments to or transfer funds to the reinsurer. These payments are usually called something like (1) deposit premium, (2) annual premiums (3) investment income, and (4) risk charge. Not all treaties will have all these items and some may have more.

The reinsurer must also make payments or transfer funds to Company 1. These payments will be called something like (1) reinsurance commissions, (2) expense allowance, (3) claims and (4) increase in reserves. Again not all treaties will have all these items and some might have more.

The treaty may also have a provision to share the profit with Company 1 and that share of the profit goes back under such names as profit sharing, experience rating refund or profit charge or profit commission.

In most cases the payments between the companies are netted so that only one transfer of funds takes place. This is called the right of offset. Each company has the right to offset what it owes and what it is owed.

The flexibility in reinsurance is that each one of these terms can be defined in many ways.

Some points to look for include:

- Who is the reinsurer? Is it a strong reputable company?
- What is the definition of the business reinsured? The block of business should be identified in a clear manner giving the date of issue, the policy form used for the business, the type of business and any information needed to identify the premiums, reserves etc.
- What is the risk actually reinsured? Is it all of the risk that the direct writing company has assumed? If it is not are the reserves calculated accordingly? Are the reserves to be held by each side actuarially correct?
- Under what conditions does the reinsurer have to pay? Is there liquidity in the treaty? Will the reinsurer have to pay cash immediately upon a claim or will it be able to delay payment?
- Under what conditions can the reinsurer cancel the contract? On cancellation what are the remaining responsibilities of the reinsurer?
- How long does the treaty run? Is it indefinite or for a fixed time period? Will the reinsurer stop accepting new risks at a certain time? Does it stop insuring the risks it has already accepted at that time?

- Who has responsibility for the claims run off tail on any business that takes a long time to settle such as liability and marine?
- Is there an arbitration clause to settle disputes?

Some standard terms of a reinsurance treaty include:

- Parties to the agreement are the ceding company and the reinsurer. The policyholder is not involved and hence normally has no claim on the reinsurer. In most cases the policyholder will not know the policy is reinsured.
- Reinsurance is usually an indemnity arrangement. The reinsurer indemnifies the ceding company for what it pays in claims.
- Both parties have the right to defend against a claim and if one chooses not to it will pay its share to the other company and leave the other to absorb all legal costs. If the defense is successful the one that did not join the defense does not get a refund.
- The reinsurer has the right to inspect the records of the ceding company at any time.
- A choice of law will be stated. In case of a dispute between the parties there will be no time wasted arguing which law applies. The clause will say that the law of Country X applies. The choice will likely be the law of the jurisdiction of the defendant.
- The errors and omissions clause says that unintentional clerical errors will be set right in the next statement and are not cause to cancel the contract.
- An “actuarially equivalent” clause can save pages of formula for what happens if the treaty is terminated at different times. The treaty may say that something happens if termination is December 31 and if at other times the actuarially equivalent adjustments will be made.

Tax issues

Reinsurance sent outside the country is often subject to excise tax, usually from 1% to 3% of reinsurance premiums. Tax treaties between countries sometimes address the issue of excise tax and in some cases exemptions are granted. For instance there is no US excise tax on reinsurance treaties with the UK. The path that reinsurance follows is highly dependent on the tax treaties between nations. Hence reinsurers will have a good knowledge of these treaties as the tax of say 2% of premiums is significant. Another consideration is the withholding

tax on dividends paid by reinsurance companies to their parents. The absence of such withholding tax or the exemption within a tax treaty also influences reinsurance activity.

Concluding remarks

The complexity of the reinsurance business has been treated in numerous publications. Basically every professional reinsurer offers excellent learning material that go from basics into complex topics. Here we have aimed to pass enough information to the reader to make her/him familiar with the basic concepts of reinsurance in a compressed manner. At the same time we hope that the course will allow and encourage the reader to reach out for further literature to satisfy the individual needs of knowledge in the matter.

For the convenience of the reader we have added a glossary of the most important reinsurance terms in annex 4 (adapted from <http://www.captive.com>).

Further suggested reading

- Elliott, Michael W., Bernard L. Webb, Howard N. Anderson, and Peter R Kensicki. 1995. *Principles of Reinsurance*. Insurance Institute of America: Malvern, Pennsylvania.
- Pfeiffer, Christoph. 1980. *Introduction to Reinsurance 4th ed.* Cologne Reinsurance Co.: Cologne, Germany.
- Heinz Stettler, Fritz Eugster, and Michael Kuhn et al. 2005. *Reinsurance Matters, A Manual of the Non Life Branches*. Swiss reinsurance Company: Zurich.
- Gerathewohl, Klaus. 1980. *Reinsurance Principles and Practices, Vol. 1*. Verlag Versicherungswirtschaft.
- Riley, Keith. 1997. *The Nuts and Bolts of Reinsurance (Practical Insurance Guides)*. Informa Finance: London.

Annex I: Quota share slip

| | |
|----------------------|---|
| CEDING COMPANY | Insurer A |
| TREATY CLASS | Quota Share |
| BUSINESS | Group of Workers |
| TYPE OF INSURANCE | Term 5 year |
| COVERAGE | Death from any cause and accidental death |
| INCEPTION DATE | January 1 2002 |
| EXPIRATION DATE | December 31, 2002 |
| CURRENCY | US\$ |
| LIMIT PER PERSON | US\$1,000,000 per person and for benefit |
| RETENTION | 20% with a maximum of US\$200,000 |
| REINSURER'S SHARE | 20% |
| ANNUAL PREMIUM RATES | |
| LIFE COVERAGE | 1.75‰ |
| RIDERS | 1.216‰ |
| COMMISSION | 10% |
| EXCLUSIONS | Policy exclusions |
| ACCOUNTING REPORT | Monthly |
| BALANCE PAYMENT | Monthly |

Annex II: Stop loss slip

| | |
|--------------------|--|
| CEDING COMPANY | Insurer A |
| REINSURANCE METHOD | Stop Loss |
| RISKS COVERED | Group policies issued |
| RISK SELECTION | According to the documentation presented |
| TERRITORY | Worldwide of the policies underwritten in the domicile of the ceding company |
| PRIORITY | The priority limit for this cover will be 95% of the original premium net of taxes. |
| COVERAGE | Capacity of the contract 30% of the original premium net of taxes corresponding to the risks covered. Maximum: US\$30 million. |
| CLAIMS | The reinsurer will pay 90% of all claims corresponding to the risks covered in excess of the priority. The Ceding Company will run for own account the resulting co-payment of the 10% loss. |
| INCEPTION | January 1, 2005 |
| EXPIRATION | December 31, 2005 |
| RATE | 6% of the original premium net of taxes corresponding to the risks covered |
| MINIMUM PREMIUM | US\$3 million |

| | |
|------------------|--|
| DEPOSIT PREMIUM | US\$2 million |
| PREMIUM PAYMENT | Four installment payable at the beginning of each quarter. First quarter as of February 1, 2005 |
| SETTLEMENTS | Premiums and losses will be calculated in local currency. Settlement will be in US dollars based on the exchange rate at the time the premium is due |
| LOSSES REPORTING | All losses on a quarterly basis |
| PROFIT SHARING | There is no profit sharing |
| CLAUSES | The standard clauses of the reinsurer apply |

Annex III: Reinsurance broker disclosure statement

Guy Carpenter Affirms Commitment to Full Disclosure (New York, December 16, 2004)

In a letter to clients dated December 1, 2004 announcing the new policy, Guy Carpenter's Chairman & CEO, Salvatore D. Zaffino, noted there is a "need within the industry to address issues of full disclosure to clients within the reinsurance marketplace."

"Guy Carpenter's relationship with its clients is built on longstanding trust and our ability to help our clients make important decisions in a difficult environment. Transparency and full disclosure should strengthen the trust among all parties to the reinsurance contract and foster better decision-making. Since we announced our commitment to transparency, the feedback from clients and reinsurance markets worldwide has been overwhelmingly positive," Zaffino said.

"The industry faces many challenges at the moment, from ratings downgrades and financial security to claims payment performance and standards of practice around the world. Guy Carpenter intends to be a positive force in addressing these and other issues, individually with our clients, and as an agent of change across the industry," Zaffino concluded.

Guy Carpenter's "Disclosure Doctrine" addresses the firm's varied forms of compensation, including standard rates of brokerage for treaty placements, fee for services and the firm's history with market agreements, all of which have expired or have been terminated.

As part of its “Disclosure Doctrine” Guy Carpenter has committed to making the following disclosures on an ongoing basis:

- When a client appoints Guy Carpenter broker of record, we will disclose to our client the compensation that we anticipate receiving for the services to be provided on the client’s behalf.
- Prior to subsequent renewals of reinsurance contracts, we will review with our client Guy Carpenter’s expected compensation based on standard commission rates.
- Guy Carpenter will continue to strive for consistency in rates of brokerage to be earned by Guy Carpenter within a layer and will disclose any variation in rates to all parties within that layer.
- Brokerage for each reinsurance transaction will be listed on the Cover Note for all treaty business.

The above policy covers treaty placements globally, which represent in excess of 90 percent of Guy Carpenter’s revenues, and will be extended to include facultative placements once a worldwide review of current practices is completed.

Treaty placement

In light of recent developments affecting the industry, Guy Carpenter believes it is important to address the issue of compensation in the reinsurance broker marketplace and take this opportunity to reaffirm our commitment to our clients in this regard. Therefore, Guy Carpenter developed this *Disclosure Doctrine*, which identifies our procedures with regard to the services we provide, the ethics we espouse, and general manner in which Guy Carpenter is compensated.

Compensation and Services

The following outlines the manner in which Guy Carpenter receives payment for treaty placement services rendered as a reinsurance intermediary:

Broker Commissions (Brokerage)

Guy Carpenter’s longstanding practice is to conform to rates of brokerage in accordance with industry custom and usage. We also

continue to support consistency of rates within a placement and disclosure of brokerage rates. To that end, Guy Carpenter sets forth below the rates of brokerage that would apply to the majority of business we place. These rates are guidelines and are generally standard in the marketplace but can vary depending on the specifics of a particular placement:

- Guy Carpenter generally receives brokerage on pro rata placements of between 1% and 2.5% of gross premium. There are some placements where brokerage is greater than 2.5%.
- For excess of loss placements, Guy Carpenter generally receives brokerage of 10% of contract premium.
- When excess of loss placements are made into the London market, an additional 5% brokerage is charged and retained by the London correspondent broker. A Guy Carpenter affiliated London broker is often used on these placements.
- In some markets, Guy Carpenter receives brokerage of up to 5% on reinstatement premiums.
- On some placements a stated margin is paid to the reinsurer. In such cases, Guy Carpenter generally receives 20% of the margin.

Fee for Service

In addition to our traditional reinsurance intermediary role, Guy Carpenter also provides other “nontraditional” reinsurance related services for which we receive fees. Revenue from these activities represents a small portion of Guy Carpenter’s annual revenue. Currently, the two primary examples of these services are:

- Reinsurance Solutions International, LLC is a Guy Carpenter subsidiary that receives fees for providing unbundled services such as policy administration, claims administration, premium/reinsurance collections, statutory/GAAP accounting, regulatory compliance and auditing. In addition, RSI provides specialized consulting services focusing on process reengineering, benchmarking, and performance management metrics and measures.
- Guy Carpenter & Company, Inc., of Pennsylvania is a subsidiary of Guy Carpenter and is a licensed reinsurance manager overseeing a reinsurance underwriting facility for certain reinsurers. This underwriting facility assumes business from smaller regional and mutual companies.

History of Market Agreements

In the past, Guy Carpenter entered into a limited number of agreements with certain reinsurers that provided payments to Guy Carpenter. These agreements, in the aggregate and in any one year, represented a very small percentage of Guy Carpenter's total revenue. All of such agreements have either expired or have been terminated.

Disclosure

Guy Carpenter believes that the reinsurance marketplace would benefit from more transparencies with the clients with regard to broker compensation. In order to promote this objective, Guy Carpenter will implement the following steps effective on January 1, 2005:

- When a client appoints Guy Carpenter broker of record, we will disclose to our client the compensation that we anticipate receiving for the services to be provided on the client's behalf.
- Prior to subsequent renewals of reinsurance contracts, we will review with our client Guy Carpenter's expected compensation based on standard commission rates.
- Guy Carpenter will continue to strive for consistency in rates of brokerage to be earned by Guy Carpenter within a layer and will disclose any variation in rates to all parties within that layer.
- Brokerage for each reinsurance transaction will be listed on the Cover Note for all treaty business.

Annex IV: Glossary of terms*

Admitted Reinsurance—A company is “admitted” when it has been licensed and accepted by appropriate insurance governmental authorities of a state or country. In determining its financial condition a ceding insurer is allowed to take credit for the unearned premiums and unpaid claims on the risks reinsured if the reinsurance is placed in an admitted reinsurance company.

Arbitration Clause—Language providing a means of resolving differences between the reinsurer and the reinsured without litigation. Usually, each party appoints an arbiter. The two thus appointed select a third arbiter, or umpire, and a majority decision of the three becomes binding on the parties to the arbitration proceedings.

Bordereau (plural **Bordereaux**)—A form providing premium or loss data with respect to identified specific risks which is furnished the reinsurer by the reinsured.

Burning Cost—A term most frequently used in spread loss property reinsurance to express pure loss cost or more specifically the ratio of incurred losses within a specified amount in excess of the ceding company’s retention to its gross premiums over a stipulated number of years.

* Adapted from www.captive.com.

Cancellation—(a) Run-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall continue until the expiration date of each policy; (b) Cut-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall cease with respect to losses resulting from accidents taking place on and after said cancellation date. Usually the reinsurer will return to the company the unearned premium portfolio, unless the treaty is written on an earned premium basis.

Capacity—The percentage of *surplus* or the dollar amount of exposure that an insurer or *reinsurer* is willing to place at risk. Capacity may apply to a single risk, a program, a line of business, or an entire book of business.

Catastrophe Reinsurance—A form of reinsurance that indemnifies the ceding company for the accumulation of losses in excess of a stipulated sum arising from a catastrophic event such as conflagration, earthquake or windstorm. Catastrophe loss generally refers to the total loss of an insurance company arising out of a single catastrophic event.

Cede—When a company reinsures its liability with another, it “cedes” business.

Ceding Commission—The *cedant's acquisition costs* and overhead expenses, taxes, licenses and fees, plus a fee representing a share of expected profits—sometimes expressed as a percentage of the gross reinsurance premium.

Ceding Company—The original or primary insurer; the insurance company which purchases reinsurance.

Claims-Made Basis—A form of reinsurance under which the date of the claim report is deemed to be the date of the *loss event*. Claims reported during the term of the reinsurance agreement are therefore covered, regardless of when they occurred. A claims made agreement is said to “cut off the tail” on liability business by not covering claims reported after the term of the reinsurance agreement—unless extended by special agreement. See **Occurrence Basis**.

Commission—In reinsurance, the primary insurance company usually pays the reinsurer its proportion of the gross premium it receives on a

risk. The reinsurer then allows the company a ceding or direct commission allowance on such gross premium received, large enough to reimburse the company for the commission paid to its agents, plus taxes and its overhead. The amount of such allowance frequently determines profit or loss to the reinsurer.

Commutation Clause—A clause in a reinsurance agreement, which provides for estimation, payment and complete discharge of all future obligations for reinsurance losses incurred regardless of the continuing nature of certain losses such as unlimited medical and lifetime benefits for Workers' Compensation.

Contingent Commissions (or Profit Commission)—An allowance payable to the ceding company in addition to the normal ceding commission allowance. It is a pre-determined percentage of the reinsurer's net profits after a charge for the reinsurer's overhead, derived from the subject treaty.

Contributing Excess—Where there is more than one reinsurer sharing a line of insurance on a risk in excess of a specified retention, each such reinsurer shall contribute towards any excess loss in proportion to his original participation in such risk. Example: Retention US\$100,000, Reinsurer A accepts one-half contributing share part of US\$1,000,000 in excess of said US\$100,000. Reinsurer B accepts remaining one-half contribution share part of US\$1,000,000.

Earned Premium—(1) That part of the premium applicable to the expired part of the policy period, including the short-rate premium on cancellation, the entire premium on the amount of loss paid under some contracts, and the entire premium on the contract on the expiration of the policy. (2) That portion of the reinsurance premium calculated on a monthly, quarterly or annual basis which is to be retained by the reinsurer should there cession be canceled. (3) When a premium is paid in advance for a certain time, the company is said to "earn" the premium as the time advances. For example, a policy written for three years and paid for in advance would be one-third "earned" at the end of the first year.

Errors and Omissions Clause—A provision in reinsurance agreements which is intended to neutralize any change in liability or benefits as a result of an inadvertent error by either party.

Excess of Loss—A form of reinsurance under which recoveries are available when a given loss exceeds the *cedant's retention* defined in the agreement.

Ex Gratia Payment—A payment made for which the company is not liable under the terms of its policy. Usually made in lieu of incurring greater legal expenses in defending a claim. Rarely encountered in reinsurance as the reinsurer by custom and for practical reasons follows the fortunes of the ceding company.

Expense Ratio—The percentage of premium used to pay all the costs of acquiring, writing and servicing insurance and reinsurance.

Experience—(1) The loss record of an insured or of a class of coverage. (2) Classified statistics of events connected with insurance, of outgo, or of income, actual or estimated. (3) What figures show to have happened in the past.

Experience may be compiled on different bases to provide various means of appraisal, namely Accident Year, Calendar Year, or Policy Year, but, for underwriting purposes, should always compare earned premium with incurred losses after the latter have been modified by an allowance for loss development and incurred but not reported losses (I.B.N.R.).

Extra Contractual Obligations (ECO)—A generic term that, when used in reinsurance agreements, refers to damages awarded by a court against an insurer which are outside the provisions of the insurance policy, due to the insurer's bad faith, fraud, or gross negligence in the handling of a claim. Examples are *punitive damages* and *losses in excess of policy limits*.

Facultative—Facultative reinsurance means reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the "faculty" to accept or reject each risk offered.

Financial Reinsurance—A form of reinsurance which considers the time value of money and has loss containment provisions. One of its objectives is the enhancement of the cedant's financial statements or operating ratios, for example, the *combined ratio*; *loss portfolio transfers*; and *financial quota shares* are examples.

Flat Rate—In reinsurance, a percentage rate applied to a ceding company's premium writings for the classes of business reinsured to determine the reinsurance premiums to be paid the reinsurer.

Following the Fortunes—The clause stipulating that once a risk has been ceded by the reinsured, the reinsurer is bound by the same fate thereon as experienced by the ceding company.

Incurred Loss Ratio—The percentage of losses incurred to premiums earned. (See Experience.)

Inflation Factor—A loading to provide for increased medical costs and loss payments in the future due to inflation.

Intermediary—A third party in the design, negotiation, and administration of a reinsurance agreement. Intermediaries recommend to *cedants* the type and amount of reinsurance to be purchased and negotiate the placement of coverage with *reinsurers*.

Intermediary Clause—A provision in reinsurance agreements which identifies the intermediary negotiating the agreement. Most intermediary clauses shift all credit risk to reinsurers by providing that:

1. the *cedant's* payments to the *intermediary* are deemed payments to the *reinsurer*; and
2. the *reinsurer's* payments to the *intermediary* are not payments to the *cedant* until actually received by the *cedant*.

This clause is mandatory in some states.

Layer—A horizontal segment of the liability insured, for example, the second US\$100,000 of a \$500,000 liability is the first layer if the *cedant* retains US\$100,000 but a higher layer if it retains a lesser amount.

Lead Reinsurer—The *reinsurer* who negotiates the terms, conditions, and premium *rates* and first signs on to the *slip*; *reinsurers* who subsequently sign on to the *slip* under those terms and conditions are considered following *reinsurers*.

Letter of Credit—A financial guaranty issued by a bank that permits the party to which it is issued to draw funds from the bank in the event of a valid unpaid claim against the other party; in reinsurance, typically

used to permit reserve credit to be taken with respect to *non-admitted reinsurance*; and alternative to *funds withheld* and *modified coinsurance*.

Loss Adjustment Expense—All expenditures of an insurer associated with its adjustment, recording, and settlement of claims, other than the claim payment itself. The term encompasses both allocated loss adjustment expenses (ALAE) which are loss adjustment expenses identified by a claim file in the insurer's records, such as attorney's fees; and unallocated loss adjustment expenses (ULAE), which are operating expenses not identified by claim file, but functionally associated with settling losses, such as salaries of claims department.

Loss Development—The difference between the original loss as originally reported to the reinsurer and its subsequent evaluation at a later date or at the time of its final disposal. A serious problem to reinsurers who, being involved in the more serious cases, must frequently wait many years for the final disposition of a loss.

Loss Event—The total losses to the ceding company or to the reinsurer resulting from a single cause such as a windstorm.

Loss Ratio—Proportionate relationship of incurred losses to earned premiums expressed as a percentage.

Non-Admitted Reinsurance—A Company is "non-admitted" when it has not been licensed and thereby recognized by appropriate insurance governmental authority of a state or country. Reinsurance is "non-admitted" when placed in a non-admitted company and therefore may not be treated as an asset against reinsured losses or unearned premium reserves for insurance company accounting and statement purposes.

Occurrence—An adverse contingent accident or event neither expected nor intended from the point of view of the insured. With regard to limits on occurrences, property *catastrophe* reinsurance agreements frequently define adverse events having a common cause and sometimes within a specified time frame, for example 72 hours, as being one occurrence. This definition prevents multiple *retentions* and reinsurance limits from being exposed in a single *catastrophe* loss.

Offset Clause—A provision in reinsurance agreements which permits each party to net amounts due against those payable before making

payment; especially important in the event of insolvency of one party which ceases to remit amounts due to the other.

Participating or Pro Rata Reinsurance—Includes Quota Share, First Surplus, Second Surplus, and all other sharing forms of reinsurance where under the reinsurer participates pro rata in all losses and in all premiums.

Peril—This term refers to the causes of possible loss in the property field—for instance: Fire, Windstorm, Collision, Hail, and so on. In the casualty field the term “Hazard” is more frequently used.

Per Risk Excess Reinsurance—Retention and amount of reinsurance apply “per risk” rather than on a per accident or event or aggregate basis.

Policy Year—The year commencing with the effective date of the policy or with an anniversary of that date.

Pool—An organization of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, and expenses shared in agreed ratios.

Portfolio Reinsurance—In transactions of reinsurance, it refers to all the risks of the reinsurance transaction. For example, if one company reinsures all of another’s outstanding Automobile business, the reinsuring company is said to assume the “portfolio” of Automobile business and it is paid the total of the unearned premium on all the risks so reinsured (less some agreed commission).

Portfolio Run-off—The opposite of Return of Portfolio—permitting premiums and losses in respect of in-force business to run to their normal expiration upon termination of a reinsurance treaty.

Premium, Deposit—When the terms of a policy provide that the final earned premium be determined at some time after the policy itself has been written, companies may require tentative or “deposit” premiums at the beginning which are readjusted when the actual earned charge has been later determined.

Premium, Pure—The portion of the premium calculated to enable the insurer to pay losses and, in some cases, allocated claim expenses or

the premium arrived at by dividing losses by exposure and in which no loading has been added for commission, taxes, and expenses.

Premium (Written/Unearned/Earned)—Written premium is premium registered on the books of an insurer or reinsurer at the time a policy is issued and paid for. Premium for a future exposure period is said to be unearned premium for an individual policy, written premium minus unearned premium equals earned premium. Earned premium is income for the accounting period, while unearned premium will be income in a future accounting period.

Professional Reinsurer—A term used to designate a company whose business is confined solely to reinsurance and the peripheral services offered by a reinsurer to its customers as opposed to primary insurers who exchange reinsurance or operate reinsurance departments as adjuncts to their basic business of primary insurance. The majority of professional reinsurers provide complete reinsurance and service at one source directly to the ceding company.

Profit Commission—A provision found in some reinsurance agreements which provides for profit sharing. Parties agree to a formula for calculating profit, an allowance for the reinsurer's expenses, and the cedant's share of such profit after expenses.

Quota Share—The basic form of participating treaty whereby the reinsurer accepts a stated percentage of each and every risk within a defined category of business on a pro rata basis. Participation in each risk is fixed and certain.

Reinstatement Clause—When the amount of reinsurance coverage provided under a treaty is reduced by the payment of a reinsurance loss as the result of one catastrophe, the reinsurance cover is automatically reinstated usually by the payment of a reinstatement premium.

Reinstatement Premium—A pro rata reinsurance premium is charged for the reinstatement of the amount of reinsurance coverage that was reduced as the result of a reinsurance loss payment under a catastrophe cover.

Reinsurance—The practice whereby one party called the Reinsurer in consideration of a premium paid to him agrees to indemnify another party, called the Reinsured, for part or all of the liability assumed by the latter party under a policy or policies of insurance which it has issued.

The reinsured may be referred to as the Original or Primary Insurer, or Direct Writing Company, or the Ceding Company.

Reinsurer—An insurer or reinsurer assuming the risk of another under contract.

Retention—The net amount of risk which the ceding company or the reinsurer keeps for its own account or that of specified others.

Retrocession—A reinsurance of reinsurance. Example: Company “B” has accepted reinsurance from Company “A”, and then obtains for itself, on such business assumed, reinsurance from Company “C”. This secondary reinsurance is called a Retrocession. The transaction whereby a reinsurer cedes to another reinsurer all or part of the reinsurance it has previously assumed.

Retrospective Rating—A plan or method which permits adjustment of the final reinsurance ceding commission or premium on the basis of the actual loss experience under the subject reinsurance treaty—subject to minimum and maximum limits.

Risks—A term used to denote the physical units of property at risk or the object of insurance protection and not Perils or Hazard. Reinsurance by tradition permits each insurance company to frame its own rules for defining units of Risks. The word is also defined as chance of loss or uncertainty of loss.

Salvage and Subrogation—Those rights of the insured which, under the terms of the policy, automatically transfer to the insurer upon settlement of a loss. Salvage applies to any proceeds from the repaired, recovered, or scrapped property. Subrogation refers to the proceeds of negotiations or legal actions against negligent third parties and may apply to either property or casualty coverage.

Self-Insurance—Setting aside of funds by an individual or organization to meet his or its losses, and to absorb fluctuations in the amount of loss, the losses being charged against the funds so set aside or accumulated.

Sliding Scale Commission—A *ceding commission* which varies inversely with the *loss ratio* under the reinsurance agreement. The scales are not always one to one: for example, as the *loss ratio* decreases by 1%, the *ceding commission* might increase only 5%.

Slip—A *binder* often including more than one *reinsurer*. At Lloyd's of London, the slip is carried from underwriter to underwriter for initialing and subscribing to a specific share of the risk.

Special Acceptance—The facultative extension of a reinsurance treaty to embrace a risk not automatically included within its terms.

Spread Loss—A form of reinsurance under which premiums are paid during good years to build up a fund from which losses are recovered in bad years. This reinsurance has the effect of stabilizing a *cedant's loss ratio* over an extended period of time.

Stop Loss—A form of reinsurance under which the *reinsurer* pays some or all of a *cedant's* aggregate retained losses in excess of a predetermined dollar amount or in excess of a percentage of premium.

Subject Premium—A *cedant's* premiums (*written* or *earned*) to which the reinsurance premium rate is applied to calculate the reinsurance premium. Often, subject premium is gross/net written premium income (GNWPI) or gross/net earned premium income (GNEPI), where the term “gross/net” means gross before deducting reinsurance premiums for the reinsurance agreement under consideration, but net after all other adjustments, for example, cancellations, refunds, or other reinsurance. Normally, *subject premium* refers to premium on subject business. Also known as base premium.

Surplus—The excess of assets over liabilities. Statutory surplus is an insurer's or *reinsurer's* capital as determined under statutory accounting rules. Surplus determines an insurer's or *reinsurer's capacity* to write business.

Surplus Share—A form of proportional reinsurance where the reinsurer assumes pro rata responsibility for only that portion of any risk which exceeds the company's established retentions.

Treaty—A general reinsurance agreement which is obligatory between the ceding company and the reinsurer containing the contractual terms applying to the reinsurance of some class or classes of business, in contrast to a reinsurance agreement covering an individual risk.

Ultimate Net Loss—This term usually means the total sum which the assured, or any company as his insurer, or both, become obligated to pay either through adjudication or compromise, and usually

includes hospital, medical and funeral charges and all sums paid as salaries, wages, compensation, fees, charges and law costs, premiums on attachment or appeal bonds, interest, expenses for doctors, lawyers, nurses, and investigators and other persons, and for litigation, settlement, adjustment and investigation of claims and suits which are paid as a consequence of the insured loss, excluding only the salaries of the assured's or of any underlying insurer's permanent employees.

Unearned Premium—That portion of the original premium that applies to the unexpired portion of risk. A fire or casualty insurer or reinsurer must carry a reserve against all unearned premiums as a liability in its financial statement, for if the policy should be canceled, the company would have to pay back the unearned part of the original premium.

Working Layer—The first layer above the *cedant's retention* wherein moderate to heavy loss activity is expected by the *cedant* and *reinsurer*. Working layer reinsurance agreements often include *adjustable features* to reflect actual underwriting results.