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Reinsurance Overview

What is Reinsurance?

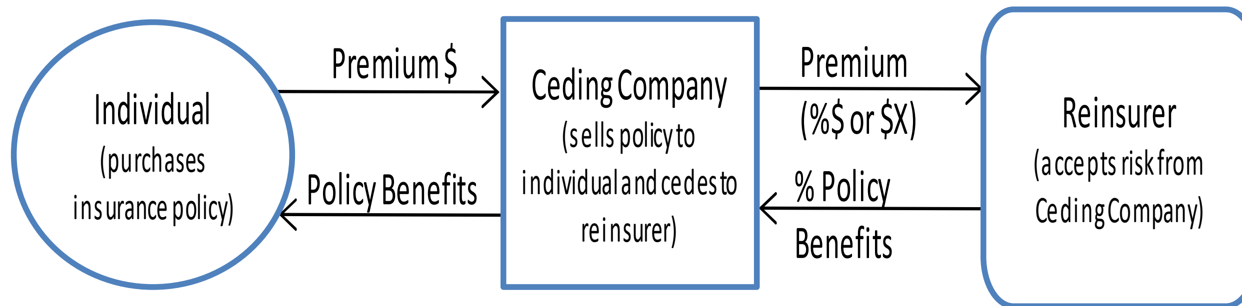
- Reinsurance is insurance purchased by an insurance company to cover all or part of certain risks on policies issued by that company

Definitions:

- Ceding company: An insurer which underwrites and issues an original policy to an insured and transfers (cedes) a portion of the risk to a reinsurer
- Reinsurer: A company that contractually accepts a portion of the ceding company's risk
- Reinsurance Intermediary: Agent or broker to ceding company that facilitates placing and binding of reinsurance with reinsurer
- Retrocessionaire: A reinsurer's reinsurer

How Does Reinsurance Work?

- The ceding company sells a policy to an individual and transfers a portion of the risk to the reinsurer



Reasons for Reinsurance

- Business Creation or Transfer
  - Entering New Markets: Utilize reinsurer's expertise
  - Divesting a Product Line: Reinsure inforce business to exit certain businesses
  - Mergers and Acquisitions: Increase capital through transferring risk of an inforce block
- Risk Transfer
  - Mortality/Morbidity Risk Transfer: Ceding Company only retains risk up to a certain limit (called retention limit) or as a percentage (called quota share)
  - Lapse or Surrender Risk Transfer: Mainly used for products with large first year commissions
  - Investment Risk Transfer: Utilize benefits of reinsurer's investment facilities or to shift part of risk to reinsurer
- Capital Needs
  - Financial Planning/Capital Management: May need to increase capital levels through reinsurance
  - New Business Financing: Shift costs of acquiring business to reinsurer

John E. Tiller, *Life, Health, & Annuity Reinsurance,* Third Edition

Reasons for Reinsurance (Continued)

- Business Performance Focus
  - Reduce Volatility of Returns: Reinsurance can reduce the cedant's exposure to large claims
  - Tax Planning: Done to maintain Life/non-Life status or utilize an expiring tax loss carry-forward
  - Regulatory Benefits: Opportunity to access a jurisdiction that would otherwise not be open to trade
  - Increase Product Profitability: Differences in cost structures between cedant and reinsurer could cause the product to be more profitable when reinsured
- Other
  - Enterprise Risk Management: Reduce concentration of risk or utilize a reinsurer's lower cost of capital
  - Functional Assistance: Reinsurers can assist with underwriting, asset management, data requirements, pricing governance

Types of Reinsurance

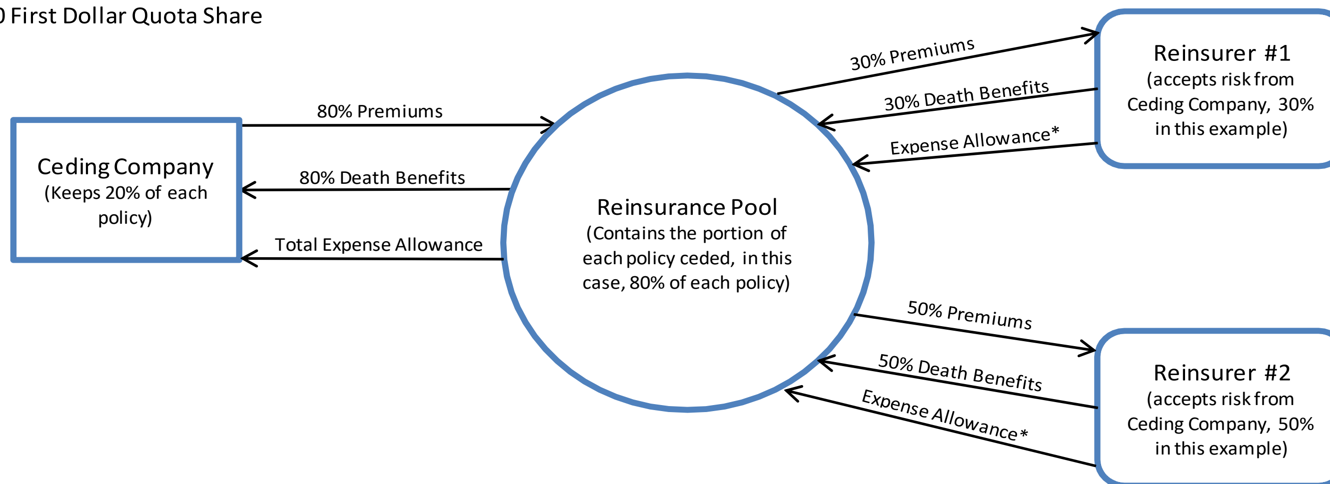
Coinsurance

- Reinsurance coverage ceded to the reinsurer on an individual policy is in the same form as that of the policy issued to the policyholder
- "Same form" means that the ceding company and reinsurer are exposed to the same risks, they are essentially sharing the responsibility of insuring the policy, hence the name co-insurance.
- Since the cedant generally continues to maintain the policy administration, the reinsurer will allocate a portion of the premium to return to the cedant to cover a portion of these administration expenses.
- In addition to covering the administration expenses, the reinsurer will also return a portion of the premium to the cedant to cover agent commissions and underwriting expenses.
- The total returned premium is called an expense allowance.
- The absolute level of the expense allowance can vary from reinsurer to reinsurer.

John E. Tiller, *Life, Health, & Annuity Reinsurance,* Third Edition

Coinsurance

- Typical arrangements are for term life insurance where the cedant retains a percentage of each policy and sends the rest of the policy to several other reinsurers through the use of a "pool."



John E. Tiller, *Life, Health, & Annuity Reinsurance*, Third Edition

Yearly Renewable Term (YRT)

- Reinsurance coverage for which the premium rates are not directly related to the premium rates of the original plan of insurance
- The premium rates are typically set as a percentage of an industry mortality table and are multiplied to the Net Amount at Risk (NAAR)
- NAAR is defined as the excess of the death benefit of a policy over the policy reserve
- Since a mortality rates generally increase each year, the premium rates per $1,000 will be increasing
- There is generally not an expense allowance
- The reinsurers reserves under a YRT arrangement are typically much smaller than those produced under a coinsurance arrangement (to be explained in the reserve section)
- YRT is generally thought of as “mortality only” reinsurance and is one of the cheapest forms of mortality risk transfer

John E. Tiller, ***Life, Health, & Annuity Reinsurance,*** **Third Edition**

Yearly Renewable Term (Continued)

- Can easily be utilized for any type of life contract
- Actual rates charged to the cedant are only guaranteed for one year, and the reinsurer has the right to increase rates
- Utilizes a reinsurance pool concept without an expense allowance
- One alternate version of YRT is called zero-first year premium (ZFY)
  - In ZFY reinsurance, no premium is paid to the reinsurer
  - This helps cedants recover a portion of first-year acquisition costs

Modified Coinsurance (ModCo)

- Same as the coinsurance plan, except ceding company retains the assets with respect to all the policies reinsured
- Establishes and retains the total reserves on the policies
- The assuming company (reinsurer) is paid the gross investment income on the assets retained by the ceding company.
- Periodic settlements are made between the two companies for premiums collected and for death benefits, surrenders, dividends, etc., at the end of the year
- Reinsurer is charged by the ceding company for its proportionate part of the increase in reserves on the reinsured policies.
- This modification removes one of the major disadvantages of strict coinsurance in that the original insurer's assets are not diminished.

Funds Withheld

- A provision in a reinsurance treaty under which some or all of the premium due the reinsurer, usually an unauthorized reinsurer, is not paid but rather is withheld by the ceding company
- Either to enable the ceding company to reduce the provision for unauthorized reinsurance in its statutory statement or to be on deposit in a loss escrow account for purposes of paying claims.
- The reinsurer's asset, in lieu of cash, is funds held by or deposited with reinsured companies.

Inforce vs. Flow

Inforce Reinsurance

- Reinsurance agreement on a block of existing business where all policies were written and inforce previous to the effective date.

New Business Reinsurance

- Reinsurance agreement which may or may not have policies inforce at inception, but is open to covering new policies written after the effective date.

Regulatory Concerns

Solvency

- Potential concerns that the cession of a large block could materially affect, either favorably or unfavorably, the capital position of either party

“Fronting”

- To the extent that all of the business or all of a certain product line of a company is being ceded, certain jurisdictions impose limitations and or requirements around the reporting and nature of such transactions.

Bulk Reinsurance

- Inforce reinsurance is subject to additional insurance law in some jurisdictions which governs the approval process necessary to cede large books of business under certain conditions.

Regulatory Concerns (Continued)

Risk Transfer

- The equitable transfer of all significant risks and responsibility for payment of future benefits, from the cedant in exchange for reserve credit, to the reinsurer in exchange for compensation.

Reputation

- All parties involved, including the cedent, reinsurer and each of their regulators must be considered for the ultimate approval of a transaction

Assets Backing Reinsured Liabilities

- Through reinsurance, reinsurers may have the ability to invest in assets that wouldn’t be permitted by the cedent’s regulator

Reinsurance Treaty Provisions

Treaty Provisions: Automatic

- Normal underwriting standards
- Age and rating ranges
- Retention limit
- Automatic binding limit
- Jumbo limit
- Other: US citizen; no prior fac; etc.

Treaty Provisions: Facultative

Cedant sends underwriting papers to reinsurer

Reinsurer underwrites; may make offer

Reinsurer must make an offer and cedant must accept for reinsurance to occur

- Standard principles of contract law
- Cedant must notify reinsurer of acceptance – variety of ways to do so
- Facultative not covered by errors and omissions provision (see below)

Reasons for facultative submissions

- Cases outside normal limits
- Underwriting opinion from reinsurer desired
- Cedant looking for best offer

Treaty Provisions: Considerations

Critical provisions	• Automatic reinsurance • Premium • Claims
Required provisions	• Entire agreement • Insolvency • Arbitration (not always)
Keys to effectiveness	• Completeness • Clarity

Reinsurance Reserve Credit

Reserve Credit

- When a reinsurance arrangement is entered, the insurance company transfers a portion of the risk to the reinsurer; **however, the insurance company is still liable to the policyholder**
- This is true even in the event of a reinsurer insolvency
- Because the reserve provides additional protection to the policyholder, the insurance company needs to have certainty that it can access the assets backing the reserve in the event of a reinsurer insolvency
- When an insurance company sells a policy to a policyholder, it will need to hold a reserve to ensure payment of death benefits; when the insurance cedes a portion of the risk through reinsurance, this company will be able to reduce the amount of reserves it needs to hold, given that certain conditions are met by the reinsurer

Reserve Credit Security

NAIC Model Act on Credit for Reinsurance

- Establishes conditions that a reinsurer must meet in order for a domestic ceding company to take credit for reinsurance, either as an asset or as a reduction in liability for reinsurance ceded
- Credit is allowed under the following conditions:
  - Reinsurer is licensed in the state
  - Reinsurer is accredited as a reinsurer in the state
  - Reinsurer is domiciled and licensed in a state that has substantially similar standards as the Model Act
  - Reinsurer maintains a trust for the payment of claims
  - If any of the above items are not met, credit can be taken if:
    - The insurance contract was written in a jurisdiction where such reinsurance is required by law
    - The reinsurer agrees to submit to US court in event that it fails to perform
    - The reinsurance contract utilizes a funds withheld arrangement
    - The reinsurer provides a clean, irrevocable, unconditional letter of credit by a qualifying US institution

John E. Tiller, *Life, Health, and Annuity Reinsurance*, Third Edition

Authorized Insurer

- Either licensed or accredited in the ceding company's state of domicile or a state with substantially similar laws as the ceding company's state
  - Licensing: Obtain a certificate of authority from the state that specifies the lines of business that the company is licensed to write
  - Accreditation: (all 4 must be met)
    - ✓ Meets financial conditions of the ceding company's state of domicile
    - ✓ Is licensed in one state
    - ✓ Submits to that state's jurisdiction
    - ✓ Senior management is of acceptable character

Unauthorized Insurer

- Neither licensed or accredited in the ceding company's state of domicile
- State Regulatory Concerns
  - No jurisdiction over unauthorized reinsurers
  - Difficult to enforce contractual reinsurance benefits
  - No control over the financial condition of unauthorized reinsurers
  - Upon reinsurer insolvency, the ceding company's financial position could be severely impaired
- As stated in the Model Act, unauthorized reinsurers are required to provide security through:
  - Assets in trust or escrow accounts
  - Letters of credit
  - Funds withheld
- This additional security allows ceding companies to take credit for the reserves that the reinsurer is contributing

Assets In Trust Or Escrow

- The beneficiary, normally the ceding company, must have a right to withdraw assets from the trust account at any time without notifying the reinsurer
- Assets deposited in the trust must be valued according to their market value
- The assets must consist of only the following
  - Cash
  - Certificates of Deposit
  - Investment as specified by the individual State's Insurance Code
- The reinsurance agreement may state the trust assets could be withdrawn only for reimbursing the ceding company for amounts due from the reinsurer

Letters of Credit

- A letter of credit (LOC) is a document issued by a qualified bank on the orders of one party which provides that the beneficiary will be able to withdraw funds up to a specified limit
- Rules covering the use of letters of credit in reinsurance vary from state to state
- Section 11 of Credit for Reinsurance Model Regulation state LOCs must be
  - Clean: Beneficiary only needs to present a demand for payment
  - Unconditional: There can be no further qualifications outside of the letter of credit
  - Irrevocable: Can be modified only with consent of both parties
  - Evergreen: The LOC will renew automatically unless the issuing bank gives advance written notice of non-renewal

Funds Withheld

- This is a form of reinsurance where the assets are left on deposit with the ceding company
- These assets on deposit can originate from amounts due to the reinsurer or from a deposit from the reinsurer
- The amount of the deposit should be at least equal to the reserve credit to be taken
- This is an acceptable form of security since the ceding company has control of the assets

Other Ways to Receive Credit

- Certified Reinsurance:
  - Revised credit for reinsurance model act reduced collateral requirements for certain reinsurers
  - Must be in a qualified jurisdiction (Bermuda, France, Germany, Ireland, Japan, Switzerland, UK)
  - Reduction in collateral based on financial strength rating - 0% to 100% credit based on six levels of security based on financial strengths ratings from two or more NRSROs
- Covered Agreement
  - A reinsurer in an EU country that meets minimum size ($250 million in capital and surplus) and capitalization (100%+ SCR ratio) requirements will not have to post any collateral for sessions assumed from US cedants; similar requirements for US reinsurer of EU business

Questions?

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