ROUTE TO:

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REINSURANCE:
THE INVISIBLE INSURERS

by John T. Bogart

As an underwriter trainee in the home office Special Accounts department of a major old-line insurance company back when the world and I were both young, I was dazzled by the array of household-name accounts that my employer was writing. I sat in on underwriting meetings in which my seniors discussed the liability exposures of oil rigs, experimental pharmaceuticals, hazardous chemicals, firearms, flash-frozen foods, automobiles, hospitals and cosmetics. I was sent to our myriad underwriting sources to research vast construction projects and to calculate the area and depth of the water and the downstream exposures in the event of a dam collapse. I interviewed technical department experts on the flashpoint of component parts of the proposed insured's products and was even allowed, on one occasion at least, to interview the proposed insured himself. My employers, I knew, asked all the right questions and possessed all of the necessary data and therefore could assume these tremendous risks, answerable to no one. But I noticed that a pause and hush would come over these final underwriting meetings when someone would invariably ask, "But what will the **reinsurers** say?" The discussions would then lurch in a completely new direction as my mentors filled the air with unfamiliar terms such as "attachment point," "treaty exclusion," "facultative," ceding commission," etc. Their biggest concern seemed to be, "Will **they** agree?" Who, I wondered, were the "they" who could temporarily halt the rapid march toward a final quotation and jeopardize the elusive euphoria of a firm "order to bind." Having, at that point, never been admitted into the august presence of reinsurers, I pictured them as sitting at vast mahogany desks in thickly carpeted offices in penthouse suites of midtown Manhattan towers, smoking Benson & Hedges cigarettes in ivory holders, deciding where they would lunch and which underwriters might be allowed to accompany them and have the honor of picking up the check.

> ***"Reinsurance is an underwriting method whereby an insurance company protects itself against unforeseen or overwhelming losses."***

The **Reinsurers**. Did they sweat to research and uncover every possible exposure, as I did? Did they engage in ceaseless wrangling with brokers over proposed coverage extensions and the contract wording changes needed to accomplish them? Did they go nearly blind constructing all of the elements essential to determining the rate on which the premium would be based? The answer, I found to my astonishment and annoyance, was, NO, they didn't. The day arrived when I found that **I** would be permitted to make our company's presentation of a proposed major account to this pantheon. The reinsurers listened politely, scratched out a few notes, frowned, smiled, cleared their collective throats and began a barrage of questions. As I recall that long-ago afternoon, we did write the account. The **reinsurers** had agreed! In the years that followed, I was involved in more reinsurance negotiations

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than I care to remember and even, magically, was a reinsurer myself. *Ain't America great?*

Reinsurance is an underwriting method whereby an insurance company protects itself against unforeseen or overwhelming losses. It allows carriers to provide greater amounts of insurance (capacity), to stabilize the business in the face of the wide swings in profit and loss so common to insurance, and to protect the company's liquidity when presented with catastrophic losses such as natural disasters. A reinsurer contracts with a primary insurance company to share in its loss in return for a portion of the premium. It is a global business, with about 40 percent of all U.S. reinsurance premiums and two-thirds of all property catastrophe reinsurance written by foreign reinsurance companies.

The very first thing that reinsurers underwrite is the quality of the underwriters asking them to share the burden of risk. The professional skills of the primary underwriters are paramount in the minds of reinsurers. When a reinsurer knows and trusts the primary underwriters, their job is more than half done at the beginning. Since a reinsurer is essentially an insurance company for insurance companies, the reinsurer must first ascertain that the carrier offering to give (cede) part of the risk knows what it is doing before the reinsurer agrees to accept (assume) it. Likewise, the primary carrier's underwriter wants to examine the professional reputation and financial stability of the reinsurer before accepting the reinsurer's word that they will be ready, able and willing to pay losses when they appear. Concerns about the reinsurer's track record were shown vividly to me by the success of one major reinsurance company's advertising in the early 1970s, which showed a cartoon character with a briefcase labeled "ABC Insurance Company" staring horrified at an empty store window bearing the faded letters "XYZ Reinsurance Company." The caption on the cartoon read, "It's 1984. Do you know where your reinsurance is?" The ad hit home because uncollectible reinsurance is every prudent underwriter's nightmare.

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In **excess of loss** the primary carrier may retain a set amount of the loss before involving its reinsurer. Given a $1,000,000 loss, for instance, the primary carrier may pay the first $250,000 and then look to its reinsurer for the remaining $750,000. With **quota share** reinsurance (commonly used in excess layers or umbrella placements), the carrier may share the amount of the loss with its reinsurer in preagreed percentages, e.g., 50/50, 25/75, etc. There are two major ways in which a reinsurer will assume risk from their ceding carrier...**treaty reinsurance** and **facultative reinsurance**. These truths will be self-evident to our more sophisticated readers, but they bear repeating.

Treaty reinsurance is a formal contract wherein a reinsurer agrees to share in a predetermined percentage of all of a ceding carrier's risks within a certain class. Subject to preagreed restrictions (exclusions), the treaty reinsurer formally agrees to follow the fortunes of their ceding carrier's underwriters without ever seeing or knowing about the individual risks being assumed. At various times and with advance notice, the reinsurers may examine a sampling of the underwriting and/or claims files of their cedant carriers (audit), and they regularly receive reports of the status of the entire book of business that they are reinsuring. Reinsurers pay a negotiated percentage of the premiums they receive (ceding commissions) back to the primary carrier, regardless of the eventual profitability of the treaty. There may or may not also be a contingent commission paid if the results are very profitable for the reinsurer. Because of the "long tail" inherent in comprehensive general liability insurance, such contingent commission arrangements are more common in property and automobile insurance.

It may be of interest to note that reinsurance companies, looking to hedge their bets, so to speak, arrange their own treaties with other reinsurers to cover themselves against catastrophic losses. These are called retrocessions. This topic is far too involved for this brief overview, so suffice it to say that, by the time all treaties and retrocessions are finished, a small part of the primary insurance

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company's reinsured losses may end up back with that same carrier, since many major insurance companies also own

"By the time all treaties and retrocessions are finished, a small part of the primary insurance company's reinsured losses may end up back with that same carrier, since many major insurance companies also own their own reinsurance companies for diversity."

their own reinsurance companies for diversity. This may seem incestuous, but it all works out in the final analysis. That, at least, is the theory and the purpose.

Facultative reinsurance concerns itself with individual risks. It is the reinsurance of all or a part of a single policy. In contrast to treaty reinsurance, the primary and reinsurance underwriters negotiate the terms and conditions of every risk, including the amount of ceding commission the reinsurer will pay to the primary carrier. When the terms are agreed, the reinsurer will issue its certificate of reinsurance memorializing the terms. As in treaty reinsurance, the policyholder knows nothing of these arrangements. The insured looks to the primary carrier for relief from loss, and the insolvency or denial of a reinsurer is no excuse for an insurance company to evade its obligations. When, as a broker, I once urged a reluctant underwriter to accept the reinsurance I had found, he said, dubiously, "Yeah, but it's my name on that policy!" He understood his obligations perfectly.

When does an underwriter decide to seek facultative reinsurance on a given account?

- When a risk is excluded under the terms of the treaty but the underwriter still wants to write it.

- When the exposure may be covered by treaty but the underwriter doesn't want to subject its excellent and advantageous treaty to this particular risk.

- When the underwriter wants to protect the company's net retention. The company may have arranged a treaty wherein they sustain the first $750,000 of a given loss. The underwriter may feel that this particular risk has a good chance of reaching that level and may negotiate facultative reinsurance for $650,000 in excess of $100,000. At that point the treaty will take over, but the company's assets are exposed for only $100,000, regardless of how high the loss.

- When writing new lines of business with which the underwriter may not be familiar. The primary underwriter may wish to carefully enter this market and searches the reinsurance market for a reinsurer especially skilled in this new area. If the book develops to the satisfaction of both the primary and reinsurance underwriters, they may graduate to an automatic facultative arrangement wherein the reinsurer still looks at individual risks but approval is facilitated. This is neither fish nor fowl (as treaty versus facultative) but it is an arrangement that can fill a gap and is one with which I personally have had great success.

- When an underwriter, for marketing or competitive reasons, needs to write greater amounts of insurance than is available to him under his net and treaty arrangements. The underwriter may wish to use his capacity in various layers of the account's total limits of liability and can thus safely stretch his available line and present a policy for amounts greater than he would otherwise be able to do.

There are many more subplots, twists, angles and methods to reinsurance than we have touched on, but in understanding the basics of this fascinating end of insurance, we get the flavor of one aspect of the world of risk transfer. The reinsurers are indeed the invisible insurers, but then a catalytic converter in your new BMW is invisible, too. Without it, though, your engine would sputter and die. The engine of risk transfer, which finances the ever-expanding global development of our society,

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would also sputter and die without the catalytic converter of reinsurance. So our proposal is ready for presentation to the prospective corporate insured, for the **reinsurers have agreed!** RHA

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FROM NEAR AND FAR

More than 150 people have died as a result of widespread flooding in central India. Since the middle of July more than 2,000 villages have been awash with flood waters. Insured property losses are estimated at about $8 million and insured crop losses at more than $3 million.

In China, according to *Insurance Day* and *JTW News*, broker Marsh, Inc., is appealing a three-month suspension imposed by CIRC, China's insurance regulatory body. CIRC found that Sedgwick Insurance & Risk Management Consultants (China), a subsidiary of Marsh, Inc., was operating unlicensed businesses, had a serious shortage of registered capital and had managers who lacked sufficient qualifications.

According to State Farm's top 10 list of the most dangerous intersections in the country, our office is in a very dangerous place. Three of the top five are all within a few miles of our Dallas headquarters. Number one is at the junction of Belt Line Road and Midway in Addison, Texas; number two is at Park and Preston Road in Plano, Texas; and number five is at Belt Line Road and Preston in Dallas.

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