

Risk M A N A G E M E N T



The Art of 'Ceding' Risk

Paul Hughes and Dino A. Fabrizio

•••

In attending a recent reinsurance seminar in Chicago, one of the presenters referred to reinsurance as a mystical force managed by elves and witches. While this is obviously not the definition of reinsurance, it does highlight the fact that while it serves as the foundation for most insurance programs, it is not fully understood by many of those it affects on a daily basis. In recent years, many of the former carriers that once supported workers' compensation for PEOs, such as Reliance, Credit General, Legion, and Superior National, were rendered insolvent due to a variety of circumstances, including the placement of reinsurance that did not ultimately pay, or at least in the time frame to keep the company out of insolvency. Reliance and Legion acted as fronting companies; companies that transfer all of the insurance risk of their respective primary insurance programs to the reinsurance community. In these types of situations, if the reinsurance placed does not pay on these programs in a timely fashion, cash flow is suffocated, and a carrier's A rating can drop to insolvency in less than 12 months.

Many of the current insurance carriers that could support the workers' compensation programs of PEOs now cannot because PEOs are excluded in their current reinsurance treaties. Many PEOs have been told they could not write a particular client because the exposure was excluded

from their reinsurance treaty. So, what is it about reinsurance that makes it so important to insurance carriers?

What is Reinsurance?

A simplified definition for reinsurance is that it serves as insurance for insurance companies in covering some form of insurable risk within the primary insurance carrier's portfolio. The concept itself is one where a primary insurer cedes (lays off/transfers) some portion of the risk(s) it covers through a reinsurance treaty to another insurer, in this case considered a reinsurer. Insurers purchase reinsurance for essentially four reasons: to limit liability on specific risks; to stabilize loss experience; to protect against catastrophes; and to increase capacity.

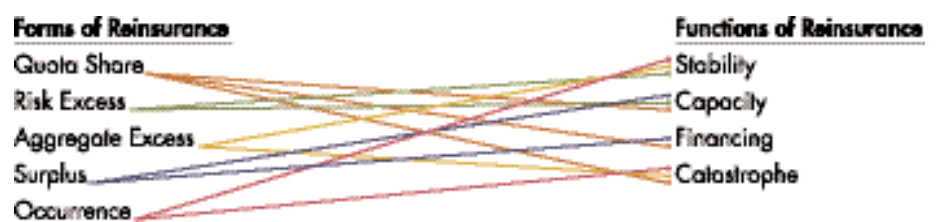
Depending on the insurance company's goals, different types of reinsurance contracts are available to bring about the desired result. There are two main types of reinsurance: treaty and facultative. Treaty reinsurance is the contract set in place between an insurer and a reinsurer. The treaty is typically for a one-year period and covers all of the business an insurer will

write in that year, within the bounds of the contract. Oftentimes, the exclusions of these treaty reinsurance contracts lead to the use of facultative reinsurance. Facultative is typically used on an "one off" basis, usually to cover an exposure the treaty reinsurer does not wish to cover for whatever reason. It also can serve as an additional layer of reinsurance if it makes sense for the primary insurer to lay off more risk on a given account due to some underlying factor.

There are five basic forms of reinsurance or methods of cession: quota share, risk excess, aggregate excess, surplus, and occurrence. Each form has its own specific function in providing stability, capacity, financing, and catastrophe protection, with some forms providing similar outcomes, but deploying different strategies to get there (See Figure 1).

Quota share and surplus share agreements are both types of proportional reinsurance, meaning the insurer (cedant) and the reinsurer share an agreed "fixed" percentage of risk. For example, Mystery Mutual enters into a quota share arrangement with ABC Re in which ABC participates on 50 percent of the profit or loss on the given book of business of Mystery Mutual. By "sharing" the risk, the insurer can achieve capacity and financial relief by the deduction of the ceded premiums from its income statement, as well as deduction of a structured ceding commission (often per-

Figure 1. Forms of reinsurance and their functions.



formance-based) from the premiums it cedes to the reinsurer. This process then allows the primary insurance carrier to write more business with its existing surplus base because it now has another insurer lending surplus to help support the program.

Although the cedant and reinsurer share the same loss ratio under these proportional arrangements, the insurer reduces its net incurred losses relative to the percentage ceded, thereby in our example splitting the total in half. The insurer's desired result is to proportionately increase its policyholders' surplus and reduce its writings to surplus ratios, arguably the most important factor in determining a company's financial rating. Low premium-to-surplus ratios tend to make regulators happy and ultimately lead to a stronger rating for the insurer, the ability to remain solvent, and growth opportunities for its policyholders.

The other three types of reinsurance — occurrence, risk excess, and aggregate excess — are considered forms of non-proportional reinsurance. Under these types of agreements, the reinsurer does not receive a proportionate share of the underlying profit and loss of a program, but rather participates in a layer of potential losses, either on a specified risk or aggregate basis. For instance, an insurance carrier may take the first half million of every loss, and then cede the next \$500,000 to one reinsurer, the next \$4 million to another, the next \$5 million to another, and so on until it has the proper

amount of support to protect its own balance sheet (See Figure 2).

What Reinsurance Does Not Do

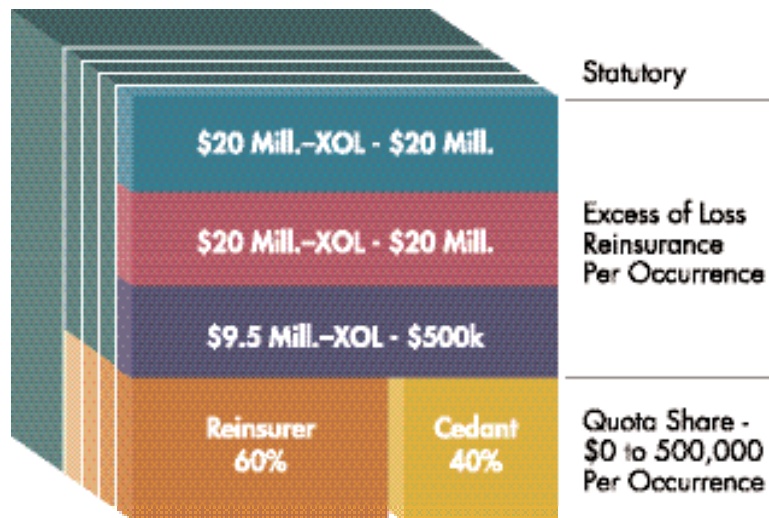
Although frequently perceived as such, reinsurance is not banking. It is not the lending of money, but it can have the same effect by deploying a reinsurer's balance sheet to help support writing a primary insurance carrier through the form of a reinsurance agreement. Reinsurance is not security. It does not convert an uninsurable risk into an insurable risk. It does not make loss either more or less likely to happen. It does not make loss either greater or lesser in magnitude and it does not convert bad business into good business. However, it can turn a bad quarter into an okay quarter. Unfortunately, the reinsurance market over the last five years has been hammered from a profitability perspective, in some cases due to the deceptive practices of some managing general agents and insurance carriers that were given authority to bind business on the reinsurer's behalf. As a result, those in the current reinsurance marketplace are now much more informed about the risks being added to their reinsurance treaties, and often retain binding authority. In turn, the primary insurance carriers are often requiring the reinsurers to collateralize expected losses, thereby reducing possible credit risk. All and all, it is a much less trusting market than in the profitable 1990s.

Bottom line, it would be impracticable

for an insurer to write volatile industry groups (such as PEOs) without some form of reinsurance. With lessons learned from 911, recent carrier insolvencies, rating downgrades, and the cyclical nature of underwriting results, it is no mystery why insurers have voluntarily withdrawn from certain markets and/or have made themselves financially unattractive if the reinsurance community is not there to support them. Well structured reinsurance contract(s) with a financially strong reinsurer are the only means for survival for small and medium-sized insurance carriers that do not have the balance sheets to support either the size or volatility of their respective books of business. The reinsurer and primary insurer become true partners in profit and loss. It is almost analogous to the PEO-client company relationship where the duties of insurance versus employment in our example are split; the reinsurer provides financial capacity and expertise at a high level, while the insurance carrier is responsible for the day-to-day underwriting and management of the book of business it underwrites. The end result is two separate businesses partnering towards the common goals of profit and efficacy. Without both parties, neither is able to accomplish its respective business goals on its own.

For more on this topic, please attend our educational session at NAPEO's Professional Employer and Marketplace 2003, Orlando, Florida, from October 1 through 4. Visit www.napeo.org for detailed program information, hotel information, and registration materials.

Figure 2. Layers of coverage under non-proportional reinsurance.



Paul Hughes is CEO of Risk Transfer Holdings, Inc., Orlando, Florida, principal agent providing product offerings in property, casualty, and health insurance with specialization in the PEO industry. He is a licensed reinsurer intermediary.

Dino Fabrizio is COO of Risk Transfer Holdings, Inc., specializing in enterprise risk management services in the areas of underwriting, loss control, claims management, and loss forecasting.

Viewpoints and interpretations expressed in this article are those of the authors and are not necessarily those of NAPEO, its officers, directors, or employees.