# REINSURANCE AND ITS TYPES

# What is Reinsurance?

- Reinsurance is an extension of the fundamental concept of insurance, namely the sharing of risks. It is a risk transfer mechanism, whereby the original insurer (called the reinsured, cedant or ceding company) cedes or transfers part of a single risk or several risks to another insurer or insurers. The company that accepts the transfer of risks is known as the reinsurer.

- In other terms, just like individual policyholders are clients of an insurance company; the clients of a reinsurance company are insurance companies.

# What is Reinsurance?

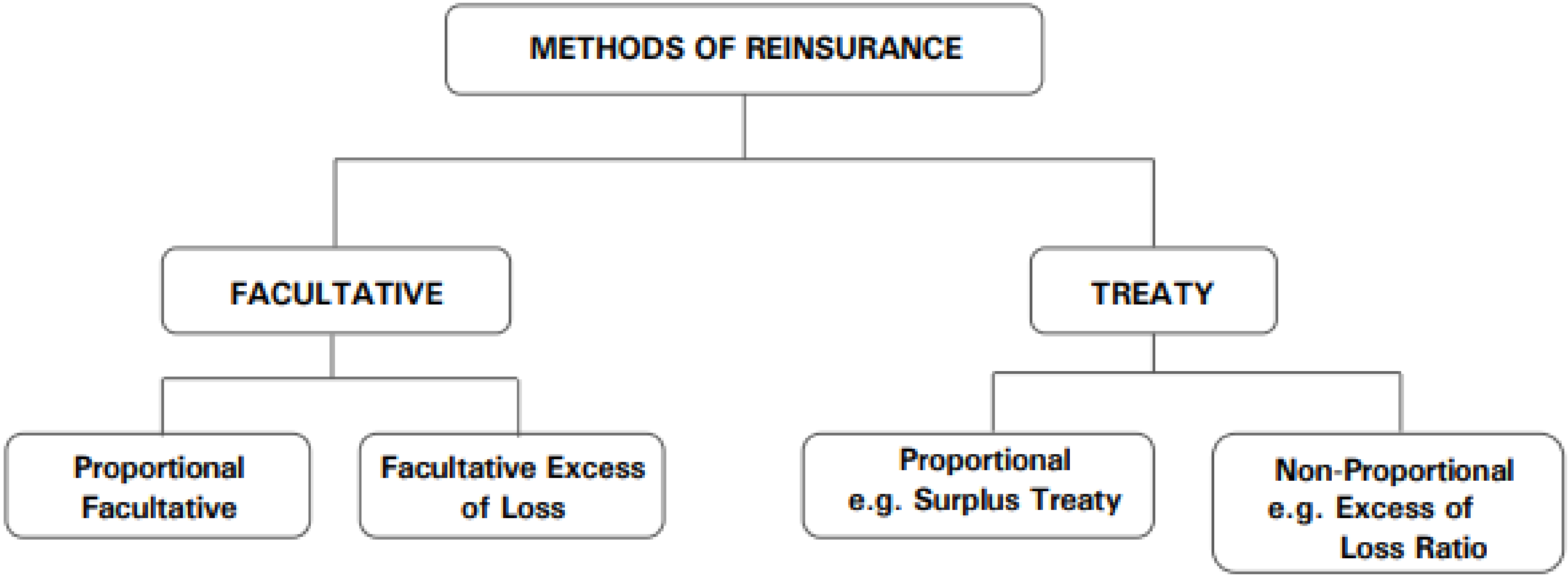
- A contract of reinsurance is strictly between the direct insurer and the reinsurer.
- The original insured is not a party to any reinsurance agreement that the direct insurer enters into.
- The direct insurer remains liable to the original insured for the whole risk that is accepted and will seek recovery from the reinsurer separately.
- There is no communication or any contractual relationship between the original insured and the reinsurer, as the reinsurer is not permitted to write direct business.
- Reinsurance can be defined as “insurance of risks assumed by an insurer”, or simply put as “insurance of insurance”. It is best thought of as “insurance for insurance companies”, a way for an insurer to protect against catastrophic or extraordinary losses.

# OBJECTIVES OF REINSURANCE

- Security & Confidence: Like insurance, reinsurance aims to reduce or eliminate the uncertainty of losses and provides peace of mind, and confidence to the direct insurer.
- Stability: Reinsurance helps to stabilise the direct insurer's losses by smoothing the fluctuations of the losses from year to year. The profitability of the direct insurer will then fluctuate less drastically, and this will help to stabilise the direct insurer's financial performance.
- Capacity: Owing to its financial limitation, the direct insurer may not be able to accept risks that are beyond its underwriting capacity. By transferring part of the risks to the reinsurer, the direct insurer will be able to increase its capacity to accept more or larger businesses for its own portfolio.
- Catastrophe Protection: In the event of a catastrophe, which can result in massive claims, the financial resources of an insurer may be severely strained. By way of reinsurance, the effects of a catastrophe can be cushioned.

# METHODS OF REINSURANCE

- There are basically two methods of reinsurance, namely facultative and treaty



# Facultative Reinsurance

- Under this arrangement, the ceding company reinsures or cedes each risk or policy on an individual basis.
- The ceding company is at liberty to decide which risk that it wants to reinsure, how much it wants to be reinsured, and how much it will retain for itself.
- It also has the freedom to offer the reinsurance to any reinsurer that it wishes.
- Similarly, the reinsurer is under no obligation to write the risk being offered, i.e. it is at liberty to decline the risk, or write a share, if it sees fit.
- To place a facultative reinsurance, the ceding company must make available to the reinsurer all the relevant underwriting details. As such, this method of placement is generally time-consuming and costly to administer. It is usually sought for risks that are considered more complex or hazardous and/or those that are beyond the insurer's financial capacity.
- Facultative reinsurance may be placed on a proportional basis (also called Proportional Facultative Reinsurance), or on a non-proportional basis (usually known as Facultative Excess of Loss)

# Treaty Reinsurance

- This is an agreement by which one or more reinsurers will automatically accept all reinsurance risks which fall within the pre-determined terms and limits.
- Most treaties are “blind”. This means that the reinsurers are bound to accept risks, without prior knowledge.
- he reinsurer cannot decline the risks that fall within the treaty, nor can the insurer select which risks that it can retain for its own account.
- This method of placement is administratively less cumbersome and less costly, as compared to the facultative method.
- Treaty reinsurance may be placed on a proportional basis, e.g. Surplus Reinsurance and Quota Share Reinsurance.
- Treaty reinsurance can also be placed on a non-proportional basis. Excess of Loss Reinsurance and Excess of Loss Ratio Reinsurance are examples of non-proportional treaties

# TYPES OF REINSURANCE

- Both facultative and treaty reinsurance can be arranged either on a proportional or non-proportional basis.

**Types of Reinsurance**

**Proportional**

- Proportional Facultative
- Quota Share Treaty
- Surplus Treaty

**Non-proportional**

- Facultative Excess of Loss
- Excess of Loss Treaty
- Excess of Loss Ratio Treaty (Stop Loss)
- Catastrophe Excess of Loss

# Proportional Reinsurance

- Under proportional reinsurance, the amount of risks and premiums are shared in the same proportion by the direct insurer and the reinsurer. Examples of proportional reinsurance are:

  - Proportional Facultative Reinsurance;
  - Quota Share Treaty Reinsurance; and
  - Surplus Treaty Reinsurance.

# Non-Proportional Reinsurance

- Non-proportional reinsurance is a form of reinsurance in which the ceding company and its reinsurers do not share either the premiums or the losses in the same proportion, as in the case of proportional reinsurance.
- Under this type of reinsurance, the reinsurer automatically accepts liability for all losses in excess of an agreed amount.
- This agreed amount is referred to as “deductible” or “priority” or “retention”.
- Examples of non-proportional reinsurance are:
  - Excess of Loss Reinsurance (Facultative or Treaty) and
  - Excess of Loss Ratio Treaty Reinsurance.

  The Excess of Loss Ratio Reinsurance is also known as Stop Loss Reinsurance.