

REINSURANCE

When a primary insurance company transfers or cedes some insurance risk to another company that accepts or assumes the risk, reinsurance results. For life insurers, the risk transferred may be mortality, surrender, investment risk, or a combination of the three.

Reinsurance has made possible greater face amounts of life insurance coverage in recent years even as the number of policies has fallen. An applicant who is an unusual risk—or who needs a life insurance policy with a face amount larger than a company's retention limit (the amount one company can judiciously retain by itself)—may still be able to obtain the policy if part of the risk is transferred to a reinsurer. A ceding company frequently wants to limit its mortality risk on an insured, and sometimes to limit such risk on a group of policies to avoid fluctuations in claim levels, or to lower the risk of claims involving multiple deaths from single events.

Reinsurance also can reduce the risk facing a company when policies are issued with a high probability of lapse or surrender, as in policies whose premiums rise sharply from one year to the next. Similarly, reinsurance may limit the investment risk inherent in high asset concentrations from single products, such as annuities.

In 2004, 85 percent of life insurers with life premiums ceded at least some of those premiums as reinsurance. Among insurers with accident and health premiums, 82 percent ceded accident and health premiums as reinsurance. In contrast, only 49 percent of insurers doing annuity business in 2004 ceded annuity considerations, excluding deposit-type funds.

ALLOCATING RISK

Reinsurance spreads the risk of loss between two companies. The risk can be spread even further if the ceding company uses more than one reinsurer, or the reinsurer in turn transfers some of that risk to another reinsurer, or *retrocessionaire*.

In the most basic reinsurance arrangement, a single primary insurer cedes business to a single reinsurer, usually an independent firm operating in the open marketplace. The reinsurer also can be an affiliate of the ceding company, when both companies are owned by a parent company. This *captive reinsurer* reinsures risks exclusively from an affiliated company or group of companies.

Reinsurance is frequently arranged between a primary ceding company and a group of reinsurers. Methods for allocating risk to a group include:

- **Quota share** Each reinsurer receives a specified percentage of each risk ceded to the group.
- **Layering** Risk is ceded in layers of insurance amounts: One reinsurer receives all reinsurance up to the limit of the first layer, a second reinsurer receives all reinsurance beyond the first layer up to the limit of the second layer, and so on.
- **Alphabet split** Risk is ceded among several reinsurers alphabetically based on the insureds' surnames: Those whose last names begin with A–F go to the first reinsurer, and so on, until all reinsurance is allocated. This arrangement is sometimes used for automatic insurance.

Once risk is ceded from a primary insurer, the reinsurer in turn may need to cede at least some of that risk, particularly if it is unusually large or exceeds the reinsurer's own retention limit. Transferring risk from one reinsurer to another, or *retroceding*, may involve similar arrangements: A reinsurer may retrocede risk to a group of reinsurers, or retrocessionaires, each of which may in turn retrocede some of that risk to another group of retrocessionaires.

Total reinsurance assumed in 2004 was \$68 billion, an increase of 4 percent from 2003 (Table 6.1). The average annual growth of reinsurance assumed between 1995 and 2004 was zero.

Table 6.1 Reinsurance Assumed

	Millions			Average annual percent change	
	1995 ¹	2003	2004	1995/2004	2003/2004
Life insurance premiums					
Individual	\$17,884	\$22,812	\$25,579	4.1	12.1
Group	5,921	3,675	3,918	-4.5	6.6
Credit	960	519	383	-9.7	-26.1
Total	24,764	27,006	29,880	2.1	10.6
Annuity considerations²					
Individual	15,563	18,484	19,389	NC	4.9
Group	2,290	3,401	3,030	NC	-10.9
Total	17,852	21,886	22,419	NC	2.4
Accident and health insurance premiums					
Individual	3,882	4,824	4,715	2.2	-2.2
Group	19,145	11,175	10,575	-6.4	-5.4
Credit	1,524	588	460	-12.5	-21.8
Total	24,550	16,587	15,750	-4.8	-5.0
Aggregate total	67,167	65,479	68,050	0.1	3.9

Source: ACLI tabulations of National Association of Insurance Commissioners (NAIC) data, used by permission.

Notes: NAIC does not endorse any analysis or conclusions based on use of its data. Codification effective with 2001 Annual Statement filings changed the reporting of certain lines of business, particularly deposit-type contracts, as explained in numbered footnotes.

NC: Not calculated

¹Data for 1994 is not available.

²From 2001, excludes deposit-type funds as income due to codification, making data incomparable with previous years.

Within this overall expansion, however, reinsurance activity in life insurance, annuities, and accident and health insurance has fluctuated over the past ten years. Individual life premiums assumed spiked in 1998 and 2000, and increased more modestly since 2001. Codification effective with 2001 Annual Statement filings changed the reporting of certain lines of business—particularly deposit-type funds, which are now considered part of income and included in annuity data—and drove the recent surge in annuity reinsurance. In the accident and health market, individual premiums assumed grew at a 4.1 percent average annual rate between 1995 and 2004. Data for all three markets include retrocessions.

MANAGING RISK

The need to transfer mortality, surrender, or investment risk is the main reason for ceding companies to engage in reinsurance. In traditional reinsurance, the company transferring the risk retains its financial relationship with, and legal obligation to, the policyholder—to the point that policyholders may not even be aware the part of the risk on their policies is covered by an assuming company, or reinsurer. This type of reinsurance is sometimes called *indemnity reinsurance*, because one company indemnifies another for losses incurred.

Another type of reinsurance involves the total and permanent transfer of risk from one company to another. In *assumption reinsurance*, the reinsurer replaces the ceding company in transactions on sections of business, issuing new policyholder certificates. In effect, one company purchases a section of business from another company and becomes directly and legally responsible to the policyholder, while the original company terminates its future obligations.

References to reinsurance in this chapter signify only indemnity reinsurance.

Underwriting Strength

A closely related motivation for reinsurance is obtaining the reinsurer's underwriting assistance and proficiency.

Reinsurers review and maintain policy and claim records on a large volume of risks from many ceding companies whose policyholders are diverse and geographically distributed. The risk pool from which they develop and provide underwriting knowledge is larger and wider than is normally available to a single primary insurer.

Underwriting is further strengthened when risk is spread to more than one reinsurer or retrocessionaire, because of the exposure to an even broader range of policies and claims. Confidence that underwriters are competently and professionally meeting its underwriting needs allows a ceding company to concentrate on other activities to expand its business.

Product Flexibility

Another reason to reinsure is the opportunity it gives a ceding company to exit from some product lines and enter others. If a company's name is commonly associated with a particular product line that it wishes to discontinue, the company can reinsure most or all of the risk on the product.

Conversely, if a company wants to enter a particular product line, reinsurers can help with product development and assume some of the product's risk. Later, as the primary insurer gains more confidence in its ability to underwrite and develop the product, recapture provisions in the reinsurance treaty would allow it to take back some of the risk the reinsurer assumed.

Financial Positioning

Reinsurance also enables a ceding company to manage its financial position. A reinsurer can provide allowances based on its anticipation of future profits, which increases the ceding company's statutory earnings and surplus during the year paid.

If the reinsurer establishes a proportionate share of reserves on its books for policies reinsured, the ceding company is not limited to using that surplus to set up legally required reserves—an option especially valuable when issuing new policies, in which initial costs (expenses plus reserves) are higher than premiums received. Similarly, a company can improve its risk-based capital ratio by reinsuring part of its risk.

Companies further consider tax advantages when contemplating reinsurance arrangements. When the ceding company's primary goal is managing and improving its financial position, the risk transfers are known as financial reinsurance.

The face amount of life reinsurance assumed decreased 5 percent to \$1.9 trillion in 2004 (Table 6.2). This decrease was driven by a 4 percent decrease for individual life reinsurance assumed and an 18 percent decrease for group life reinsurance assumed. The number of life policies assumed increased 2 percent in 2004.

Table 6.2 Life Reinsurance Assumed (face amount)

	1995 ¹	2003	2004	Average annual percent change	
				1995/2004	2003/2004
Face amount (millions)					
Individual	\$549,211	\$1,782,822	\$1,712,590	13.5	-3.9
Credit	33,288	13,084	23,836	-3.6	82.2
Group	118,634	160,274	132,244	1.2	-17.5
Total	701,133	1,956,180	1,868,670	11.5	-4.5
Policies (units)					
Individual	25,884,924	34,721,128	35,052,209	3.4	1.0
Credit	5,034,122	1,997,337	3,330,739	-4.5	66.8
Group	4,112,686	4,403,947	3,424,555	-2.0	-22.2
Total	35,031,732	41,122,412	41,807,503	2.0	1.7

Source: ACLI tabulations of National Association of Insurance Commissioners (NAIC) data, used by permission.

Note: NAIC does not endorse any analysis or conclusions based on use of its data.

¹Data for 1994 is not available.

TYPES OF REINSURANCE

Various reinsurance plans are available based on ceding companies' needs and their reasons for reinsuring. Plans can be broadly classified as either proportional reinsurance, specifying in advance the amounts or percentages of risk for which the reinsurer is liable, or non proportional, specifying instead the loss limits, time limits, or conditions beyond which a reinsurer will assume some or all of the benefit payments.

Proportional Reinsurance

Specified amounts or percentages are shared between ceding companies and reinsurers in proportional reinsurance. *Excess of retention* allocates risk by amount: The ceding company establishes a dollar amount for which it is willing to retain risk, and the reinsurer assumes risk over this amount, up to the reinsurer's retention limit. In contrast, *quota share* allocates by percentage, where the ceding company and reinsurer establish the percentage of risk for which each will retain or assume responsibility.

Proportional plans, commonly used in life insurance, encompass four categories:

- **Yearly renewable term (YRT) reinsurance** The mortality risk, but not the permanent plan reserves, is transferred to the reinsurer for a premium that varies each year with the amount at risk and ages of the insured. While YRT

reinsurance allows a ceding company to transfer mortality risk, it leaves the company responsible for establishing reserves.

- **Coinsurance** The ceding company transfers a proportionate share of all the policy risks and cash flows except the policy fee. The reinsurer receives its share of premiums, pays its share of benefits, sets up its share of reserves, and pays an allowance to the ceding company. Unlike YRT reinsurance, coinsurance relieves strain on the ceding company's surplus.
- **Coinsurance with funds withheld** The ceding company keeps the premiums normally paid to a reinsurer, while the reinsurer keeps the allowances normally paid to the ceding company. This arrangement limits cash flow between the two companies, reinforcing the stability of their cash accounts.
- **Modified coinsurance** The reinsurer transfers its share of reserves back to the ceding company while the risk remains with the reinsurer. The ceding company, however, must pay interest to replace what the reinsurer would have earned had it retained its share of the reserve.

Both coinsurance with funds withheld and modified coinsurance enable a ceding company to take statutory credit in certain circumstances, reduce credit risk, secure credit, and retain control over investments.

Non proportional reinsurance

Non proportional plans, commonly used in health insurance, include four types:

- **Stop loss** The reinsurer remits some or all of a ceding company's aggregate claims above a predetermined dollar amount (the attachment point), or above a percentage of premium during a specified period.
- **Spread loss** The ceding company pays back the remitted sum over a period of years, usually through interest-increased reinsurance premiums.
- **Excess of time** Most often used for disability or long-term care reinsurance, this type of plan specifies the time after which a reinsurer pays some or all of the claims.
- **Catastrophe** The reinsurer covers claims that exceed a specified amount or number of insureds due to a single event resulting in more than one loss, as in an accident or natural disaster.