Reinsurance: how insurers protect themselves

(part 2)

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In the first part of this article (issued on March 28, 2013) we ran through some basic concepts about "reinsurance", i.e. the risk transfer mechanism used by Insurers to obtain capital relief, stabilize results and protect balance sheets. We also mentioned some quantitative data witnessing the significance of the economic impact of this industry on a worldwide basis. Eventually we touched upon "proportional reinsurance" arrangements. In the following 2nd part we will briefly look at "non-proportional" cessions, clarify the distinction between "treaty" and "facultative" agreements and ultimately summarize Generali Group's overall approach to ceded reinsurance arrangements.

Non proportional reinsurance

Whilst it may be said that proportional reinsurance focuses primarily on the **sharing of the business** between the reinsured and the reinsurers, in a sort of partnership or joint-venture, the purpose of **non proportional reinsurance** is more clearly to protect the balance sheet of the reinsured from the consequences of losses in excess of a given amount, which may be established depending on a variety of factors, among which the size of the portfolio, both in terms of number of risks and size of sums insured, the loss experience (actual and projected), the risk appetite of the insurer and the cost of the reinsurance protection. On the basis of non proportional arrangements, reinsurers will have to pay only for the portion of the losses which goes above the agreed level of the cedant's retention, that is to say the part of the losses that the cedant has agreed to keep for itself.

Arranging a **risk excess of loss** enables a cedant to write insurance policies with limits well above its net retention. So, for example, this cedant might decide to insure commercial property risks with policy limits up to 15 million, and then buy risk excess of loss reinsurance for 10 million in excess of 5 million. In this example a loss of 8 million on a given policy will result in the recovery of 3 million from the reinsurance arrangement. In other words the insurer will have its 8 million gross loss reduced by 37.5% to 5 million net, a loss level which the insurer is prepared to bear. In reality, as reinsurance does not come for free, the actual net recovery from reinsurers would not be 3 million, but 3 million less the premium paid for the reinsurance protection.

In **catastrophe excess of loss**, the cedant's retention is usually a multiple of the underlying policy limits, and the reinsurance contract is designed to protect the reinsured against catastrophic events that involve many policies. For example, if an insurance company plans to issue homeowners' policies with limits of up to 500,000 it might wish to buy catastrophe reinsurance for 95 million in excess of 5 million. In such a case, this insurance company would only recover from reinsurers in the event of multiple policy losses caused by the same event - e.g. hurricane, earthquake, flood - and only if the aggregate of losses is in excess of the 5 million limit. So, if the losses total 45 million, the gross recovery from the reinsurance market would amount to 40 million (45 million gross loss less 5 million deductible).

Aggregate excess of loss affords to the reinsured a protection against a high frequency of medium sized losses. For instance, if the cedant retains 1 million any one risk and arranges a protection for 5 million annual aggregate indemnity in excess of 5 million annual aggregate deductible, the cover would equate to 5 total losses (or more partial losses) in excess of 5 total losses (or more partial losses). Aggregate covers can also be linked to the cedant's gross premium income during a given period, usually 12 months, with limit and

deductible expressed as percentages and amounts. Such covers are known as **stop loss** contracts.

Prices are determined in a variety of methods, and, particularly in classes exposed to natural event catastrophe losses (earthquakes, floods, storms etc.) with the assistance of probabilistic models, whose use has been dramatically increasing in recent years. Catastrophic risk modeling has indeed become the main tool to assess and manage the exposures of an insurance company and to measure capital at risk. Despite their known (or suspected) shortfalls, models remain the best tools currently available to quantify the exposures which insurers carry within their book of business, and to provide indications as to the amount of excess of loss reinsurance that insurance companies should purchase in order to adequately protect their balance sheet and to optimize the use of their own capital. Over the years there has been a tendency for reinsurance to become less an art and more a science, or, better perhaps, an **art increasingly based on solid scientific grounds**. Thus insurers and reinsurers have progressively become more reliant on the outputs of actuarial models, and have been busy refining both the risk databases and the assumptions on which the models work. And, although there is still some room for commercial considerations, pricing has become increasingly dependant on models' guidance.

In the recent past, both in the property and casualty areas, there has also been a shift from proportional to non-proportional reinsurance, that is to say from partnership reinsurance, where the partners share basically the same business, to **commercial reinsurance**, where cedants pay a price in exchange for the protection they want to have for their books of business and, ultimately, for their balance sheet and their shareholders' fund.

Treaty and facultative reinsurance

All the reinsurance forms that we have seen can be arranged in two ways: treaty and facultative. Broadly speaking, **treaty reinsurance** is achieved by concluding a master contract in which the parties agree to cede proportionally all the policies included in a given book of business (proportional reinsurance) or to protect the same book of business from losses in excess of a given amount (non-proportional reinsurance). In this way all the policies that are included in that book of business and all the losses affecting such policies will automatically be covered by that contract, which is usually termed "treaty" (even if it is merely a contract between private entities and not an agreement between states), without need for individual *ad hoc* contracts.

Facultative reinsurance is an individual deal negotiated separately in respect of an individual insurance contract. For example, on insuring a large petrochemical plant an insurer may consider sharing with reinsurers part of such risk (proportional arrangement) or limit its possible loss to a predetermined amount (non proportional deal). As this specific account may exceed the automatic capacity of the company or may be excluded from cession to the treaties, it can be dealt with by way of facultative reinsurance, which is indeed a contract concerning the transfer of a part of a specific risk, and is therefore negotiated

on a case-by-case basis. Treaty and facultative differ also in the **timing** of their negotiation: while the former is usually negotiated during a specific time of the year (most commonly during the last quarter), facultative is run on an "as needed" basis.

In general, treaty reinsurance is much more cost-effective than facultative reinsurance: the administrative costs per unit connected with the cession of an entire portfolio are obviously lower than those associated with the cession of risks on an individual basis. So it is by far the preferred choice of prime insurance companies and groups, whose aim is to have few large consolidated reinsurance channels rather than a web of individual deals which is more labor intensive and may even prove less efficient. From their side, reinsurers may see facultative placements more favorably, as they allow them more negotiating power and a better insight into the features of each individual risk.

Generali Group's reinsurance approach

As it has been illustrated through this brief review, reinsurance is a contractual arrangement with several faces and a fairly significant number of variables. For major insurance market players like the Generali Group it is one of the **risk and capital management key tools** which contributes to the achievement of our primary targets: the supply of effective and competitively priced insurance products to satisfy to the maximum possible extent our customers' coverage requirements. To take advantage of a vastly diversified risk portfolio, to enhance its bargaining power *vis-à-vis* the reinsurance market and to create synergies and scale economies, the Group has decided to adopt an innovative strategy which provides that all risk transfer transactions that were previously


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conducted out of each individual country should be first accepted and then managed at a **combined level** by a Group Head Office specialist unit. This new challenging development is in line with the increasing integration of the various Group's units and with the need to deal with the reinsurance market at a global level.

In fact, as **Franco Urlini**, Head of Reinsurance, Claims and Processes, confirms "*Reinsurance is a powerful tool to mitigate volatility within the insurance portfolio and, more important, to efficiently manage the risk and the capital of the insurer. It is also a strategic component of the process which leads to the development of superior insurance services that the Generali Group can offer to its corporate and individual clients in respect of major risks such as natural perils. To maximize the benefits that can be obtained from a dynamic management of the reinsurance matter, the Group has implemented a centralized business model supported by an advanced stochastic platform with the aim of achieving better control on reinsurance conditions and costs and a more accurate selection of the reinsurance partners thus improving our competitiveness on the marketplace whilst simultaneously safeguarding and optimizing our capital position.*"

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Non-Life Treaty Retrocession