

In Defense of Reinsurance

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If you are in or around the reinsurance business, your ears must be burning. Articles, blogs, letters to the editor, tweets, and unsolicited commentary are replete with attacks on the reinsurance industry. It's the greedy reinsurers that are causing insurance premiums to go up, so they say. Reinsurers, especially offshore reinsurers, are reaping big profits while the policyholders still have to pay large premiums for homeowners' insurance in coastal areas even though there were no hurricanes this year, according to these pundits. Reinsurance is being described by some as a sham.

Perhaps, in the face of this current accusatory atmosphere, we need to go back and consider what reinsurance is and what reinsurers do.

The Nature of Reinsurance

Earlier Commentaries discussed why reinsurance matters, March 2000, and the reinsurance relationship, December 2000. We even commented on the effect of having the government act as a reinsurer, June 2007, and the changing reinsurance marketplace, August 2008. Now let's talk about what reinsurance is and does, at least from one commentator's perspective.

Reinsurance, at its essence, is a risk transfer and risk spreading mechanism that is consistent with and further supports the basic theory of insurance. Insurance is about spreading of risk. Insurance works only because many policyholders pool their risks of loss and transfer portions of those risks to an insurance company. The insurance company, having accepted potential losses from many policyholders, is able to charge an affordable premium to each policyholder based on the probability that only a few of the potential losses will actually occur and have to be paid. Thus, by pooling risks together through an insurance company, insureds are able to insure their risks at a reasonable price, which would otherwise not be possible if the risks of all insureds had not been pooled together through an insurance company.

Spreading Risk Through Reinsurance

Just as policyholders spread their risks of loss by purchasing insurance from a company that collects premiums from many policyholders, an insurance company spreads its risk of loss – the risks it assumed from its policyholders – to other insurance companies – reinsurers – in exchange for a share of the premium received by the insurance company from its policyholders. In other words, the same risks that were pooled together through the insurance company get spread further through the distribution of those risks to many other insurance companies called reinsurers. The reinsurers aggregate the pooled risks

assumed by many insurance companies just like the insurance companies aggregate the pooled risks of the policyholders.

Let's consider an example. You own a factory. There is a risk that your factory might burn down from a fire. You purchase property insurance to protect against that risk of a fire loss and, in essence, transfer the risk that your factory might burn down to your insurance company in exchange for a premium. Your insurance company writes hundreds of property insurance policies like yours and has determined the probability that only a few of its insureds will suffer property damage losses in any given year and at varying degrees of severity. But to protect against the insurance company's accumulation of so much property damage and fire risk, it purchases reinsurance, further spreading your fire damage risk to other insurance companies. If your factory burns down and you file a claim, your insurance company will be able to recover a portion of its payment of your claim back from its reinsurers after it has paid your claim.

In the traditional reinsurance setting, the obligation to pay a loss suffered by a policyholder rests and remains with the insurance company that issued the insurance policy to the policyholder. A policyholder that suffers a loss must notify its insurance company, not the reinsurer (which it is unlikely to know about), and the insurance company is generally obligated to address the claim. The reinsurance company has no direct contractual or other relationship with the original insured and, generally, only pays the insurance company after the insurance company has paid the underlying policyholder and has submitted a reinsurance claim for indemnification. If, in the example, your insurance company, for whatever reason, fails to pay your fire loss claim, generally you would have no direct right of action against the reinsurance company because there is no contractual privity between you as the original policyholder and the reinsurer. The contractual relationship in the reinsurance context is only between the insurance company and the reinsurer, and that is a separate contract of indemnity.

Reinsurance as a Financial Tool

Reinsurance is also used for other purposes, often for financial or regulatory reasons, none of which are mutually exclusive. On the financial side, reinsurance is often described as a transaction where the reinsurer lends its capital to the reinsured. Insurance laws and rules generally regulate how much insurance risk an insurance company can underwrite based on its financial condition. These rules are in place to prevent an insurance company from becoming insolvent because of an overextension of its business. Reinsurance can be used to mitigate this risk by transferring (ceding) some of the liabilities on the books of the insurance company (risks assumed under policies it wrote for its policyholders) to the reinsurer. The obligation of the reinsurer to assume those ceded risks becomes an asset on the financial statement of the insurance company assuming it meets all the statutory and regulatory requirements.

For life and health insurance, reinsurance is often used much more as a financial tool than as a device to spread risk, although it often has both features. Because of the nature of life and health insurance and related products, a great deal of capital must be allocated to

required reserves. Reinsurance provides a mechanism for infusing capital into an insurer by ceding blocks of life and health insurance policies to the reinsurer in exchange for that capital.

Using Reinsurance to Protect Against Catastrophic Loss

Reinsurance is also used by many insurance companies to protect against catastrophic loss. An insurance company may have plenty of capital to pay the losses it anticipates from the insurance policies it writes, but may be concerned about losses it does not anticipate. Using the property insurance example again, the insurance company that writes your factory's fire insurance policy may wish to protect itself from a massive fire that burns down many of its insureds' properties in a concentrated factory district. In the homeowners' situation, insurance companies that write property insurance on the coast are always concerned about the losses they will sustain in the event of a serious hurricane that destroys hundreds or thousands of homes.

Various types of reinsurance are available to protect an insurance company for these catastrophic losses. Insurance companies may buy excess-of-loss reinsurance, which is reinsurance that responds when a specific loss exceeds a certain dollar figure. Insurance companies also may purchase aggregate excess-of-loss reinsurance, which is reinsurance that responds based on the aggregate losses paid by an insurance company within a period of time. Property catastrophe reinsurance is what companies purchase to protect themselves against large losses arising out of a large event like a hurricane. This type of reinsurance may respond based on the aggregated loss payments made by the specific insurer arising from one storm or based on the total value of all losses suffered industry wide for that storm.

Reinsurance and Premiums

Insurance companies that use reinsurance to spread its risk of loss or to protect themselves from catastrophic risk will factor the cost of reinsurance into the premiums charged to their policyholders. If the cost of reinsurance goes up, the premiums charged to policyholders likely will go up also. But the cost of reinsurance is only one of many factors that affect the cost of insurance, which also includes interest rates, taxes and fees, the cost of running the insurance operation, and the cost of acquiring the policyholders' business.

Determining the price a reinsurer will charge is a complicated exercise often based on actuarial models. Typically, insurance and reinsurance companies look to past experience to predict the cost of future losses so that a proper premium can be determined. Those predictions are never perfect, but over the long term should follow the ultimate loss costs reasonably well.

Predicting future losses in property catastrophe reinsurance for coastal homeowners' insurance is very difficult. We have now seen a few years with very few hurricanes. This followed a few years with some of the most catastrophic storms in history. The

probabilities are that hurricanes will strike again, and insurance and reinsurance companies are trying to match premiums to reflect this probability.

Life Without Reinsurance

So what happens if we cut out the reinsurers and save on that cost? Certainly, extremely well-capitalized direct writers of insurance may not need to purchase traditional reinsurance. These companies may only purchase catastrophe reinsurance or go into the capital markets and obtain other catastrophe loss protection like Cat Bonds or Loss Warranties. But the reality is that most insurers have reinsurance programs because reinsurance is a significant tool used by insurers to manage their business and their overall risk exposure.

Without reinsurance, an insurance company will have to shoulder all the risks of loss it has assumed from all of its policyholders. Unlike its policyholders, it will not have the advantage of spreading its risk of loss to other companies and policyholders. Should it accumulate too much business in a particular geographic location or in a particular line of insurance, it may find that its capital will be severely strained. By using reinsurance, accumulation risk, catastrophic risk, and overall risk is lessened.

Moreover, most insurance companies are not large mega-companies. There are literally thousands of small, regional insurers that are crucial to the existence and well-being of local businesses and coastal communities. These smaller companies necessarily rely more on reinsurance to spread their risk of loss and to avoid accumulation and catastrophic exposures. These companies also often rely on the underwriting and claims expertise of their reinsurers to improve their products and better serve their insureds. Without strong reinsurance relationships, these smaller and regional insurers likely would not exist.

Conclusion

While reinsurance bashing has seemingly taken over for insurance bashing, it is important to put in perspective the reasons why reinsurance exists and the importance of reinsurance to the economy. Reinsurance is the backbone of insurance because it enables risks of loss to be spread more widely across companies and borders. Without the spreading of risks of loss through reinsurance, policyholders would find it even more difficult to obtain affordable insurance.