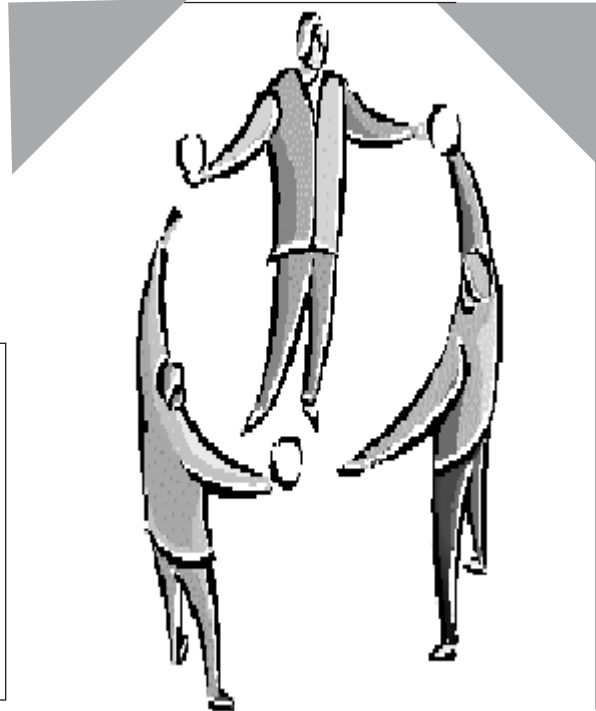


# Reinsurance

## Insuring the insurer

*Editorial Team*

**In today's dynamic insurance market, it is seen that one important entity has an affect on the operations of all the players - this being the reinsurer. Reinsurance primarily deals with catastrophe risks that are not predictable and cause greatest exposure for insurance company. The post-9/11 attack situation in America was similar.**



The term 'reinsurance' stands for the practice whereby a reinsurer, in return of a premium paid to it, indemnifies another person/company for a portion or all of the liability taken up by the latter due to a policy of insurance that it has issued. This latter party is called the 'reinsured'.

Reinsurance is a type of risk management involving transfer of risk from insurer to the reinsurer. What that reinsurer does is to provide insurance for the insurers on the basis of a contract of indemnity. It works like this — the insurer gives the reinsurer a portion of the premium it collects from the insured and in return is covered for losses above a particular limit. A reinsurer enters into

a reinsurance agreement for a very specific reason—either the nature of risk insured or the business strategies of the insurer or other possible reasons. It is an independent contract between the reinsurer and the insurer and the original insurer is not a part of the contract. If the claimant is an individual or even a group of individuals, an insurance company will find it , relatively easy to cover

**New Insurance companies, when entering reinsurance arrangement with both Indian foreign firms, are generally asked to supply quality in terms of the authenticity of the claim.**

the claims. But if there are a huge number of claims at the same time and the loss is massive and widespread, this may not be possible. It is in this context that reinsurance plays an important part in determining the success of the insurance business.

Reinsurance primarily deals with catastrophe risks that are not predictable and cause the greatest exposure for the insurance company.

The situation in the wake 9/11 attacks on America was similar.

A single insurer will not be able to bear the damaging financial impact of such losses. Therefore, an unbearable loss is broken down into bearable units by risk transfers. An insurance company limits the amount of risk it takes depending on the

reinsurance terms along with factors like the worth of its assets, trend of inflation in the economy, a price of the insurance products and the type of risk.

### The partnerships

The reinsurance business hinges on successful partnerships. As the Indian market grows, the regulator and the players are expected to realize the advantages of the reinsurer as a partner rather than as a means of risk reduction. If an insurance company relies too heavily on a weak reinsurer, it will be unable to meet heavy losses since the reinsurer itself might be insolvent. This could also result in lower sales of the insurance products as the customers might settle for investing in other options such as government securities and fixed depositions. Insurance companies should be prudent enough to arrange for insurance with stronger companies. They must also harness the power of the technology to upgrade reinsurance. The Internet can be utilised the passing on information to underwriters, supporting risk assessment and marketing.

### Types of reinsurance

#### ■ Treaty reinsurance

This method is defined to cover an entire category of risk or line of business in advance. It is obligatory and binding in nature for both the reinsured and reinsurers. So as long as a risk meets all the conditions as given in the reinsurance contract, acceptance of that risk by the insurer is automatic. Reinsurance by this method creates capacity for insurers. Capacity + Coverage of all perils

## Three Principles of Reinsurance

**Principle of Utmost Good Faith:** Reinsurers maintain utmost faith in underwriters of their company. These underwriters in turn maintain utmost good faith in the underwriters of the primary insurance company.

**Principle of Indemnity:** The principles of indemnity of the insured risk apply automatically on reinsurance. A reinsurer automatically follows the legal and technical future of the Reinsured in writing and underwriting a risk. Indemnity limit in reinsurance can be more than the sums insured in there are additional legal expenses against the insurer that are incurred while contesting a claim. If the reinsurer's indemnity limit is in foreign currency transactions, it is affected by foreign currency exchange rate fluctuations.

**No reinsurance without retention:** The insurer must retain a part of the Risk before reinsuring. Though there cannot be reinsurance of the complete risk, there can be complete retention of a risk. Those risks that are within the retention capacity of an insurer must be retained completely.



Reinsurers always try to attach a global spread of risks. When reinsurers are in global market they are not excessively affected by local market bad losses and are capable of meeting liabilities.

with adequate limits + confidence on security of reinsurers + continuity of reinsurance after a loss.

#### ► Facultative reinsurance

This is for the reinsurance of current single risk and options are open for both the reinsured and reinsurers. In a facultative contract relationship, the reinsurer retains the faculty or power to either accept or reject each individual risk offered to it by the insurer.

No matter what kind of reinsurance contract it is, the risks between the insurer and the reinsurer can be shared on a proportional or non-proportional (also known as excess of loss) basis. In a proportional agreement the reinsurer pays for losses in the same proportion as the

**Will the FDI cap for reinsurance be relaxed**



**In India, the Finance Ministry is considering the end for relaxation in 26% FDI cap in relation to reinsurance companies. Since the capital requirement for reinsurance companies has been set at Rs 200 crore, the 26% cap would mean that the Indian partners would have to bring in Rs 148 crores as their 74% share. This possibility has prevented the establishment of a reinsurance venture in India even after four years of the enactment of the IRDA Act in 1999. Therefore, it remains to be seen whether reinsurance companies in India will be able to achieve a global spread or not.**

amount of premium it receives.

Such contracts can be on a quota or surplus share basis. In a non-proportional agreement, an attachment point is fixed. When a claim arises, the reinsurer pays nothing unless the claim amount is greater than the attachment point. Such a contract is written per risk, per occurrence or as an aggregate loss.

Reinsurers always try to attach a global spread of risks. Hence there are tie-ups with global reinsurers. When reinsurers are in the global market they are not excessively affected by local market bad losses and are capable of meeting liabilities.

**Advantages of reinsurance**

*The reinsurance safeguards capital and reinforces stability*

In a highly volatile market it may sometimes be hard to correctly price new products because of inadequate information. Incorrect pricing could lead to unanticipated claims that the insurance company cannot meet. If there were not reinsurance the insurance company would have to settle these claims out of its own capital therefore reinsurance helps to protect the solvency of the insurance company.

Reinsurance enables the insurer to take up large claims and expand capacity

In India, regulations restrict the insurer from risking more than 10 per cent of its surplus on any one risk. Reinsurance provides the insurer with ability to cover large, individual risks and guarantees timely settlement of the claim.



**In India, regulations restrict the insurer from risking more than 10 per cent of its surplus on any one risk.**

*Reinsurance helps insurance company to upgrade itself*

An insurance company can benefit immensely by tying up with a successful reinsurer. The reinsurer can provide important underwriting training and skill development and share expertise gained from other countries. Since the success of the reinsurer is linked to the profits of the insurance company, it is in the best interest of the reinsurer to measure that the company is sound. The reinsurer can contribute to designing the product, pricing and marketing new products. It can also offer back office support such as faster claims processing and automation of operations.

**Reinsurance can also help a company to withdraw from a line of business**

Reinsurance provides more diversification when risks are accepted on a worldwide basis and not just in a specific region or coun-

try. The reinsurer can also help an insurance company withdraw from a particular geographical territory or the line of business. Thus, the company can vary out its business decision with a swift transition for a known cost, without being restricted by policy duration and other considerations. This is also termed as portfolio reinsurance.

The insurance buyers are now much more aware of the way the market works. Increasingly they are demanding high quality insurance products and are conscious of the fact that reinsurance is an important criterion to be considered while selecting an insurance policy.

New insurance companies, when entering reinsurance arrangement with both India and foreign firms, will be asked to supply quality in terms of the authenticity of the claim.

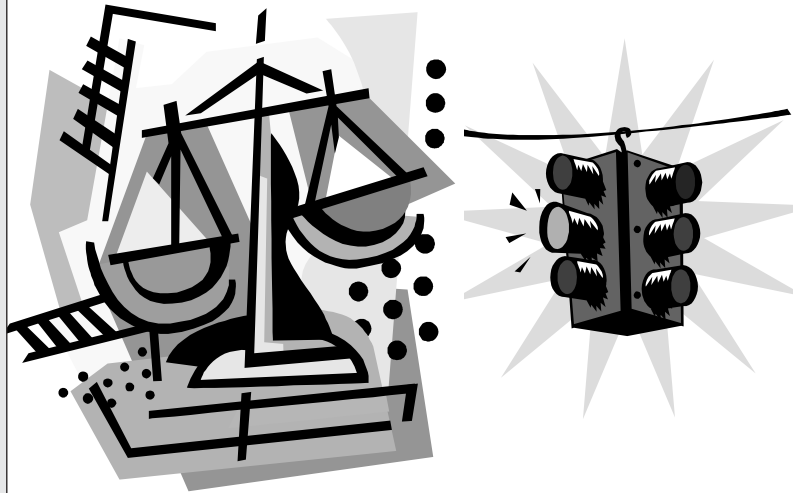
Thus, reinsurance will continue to remain a deciding factor that determines whether or not to enter business with an insurance company.

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## Regulating the reinsurance

Given the importance of reinsurance there are several guidelines laid down by the IRDA to ensure fair play. Some of these are as follows:

- ⊕ Every insurer should retain risk proportionate to its financial strength and business volumes.
- ⊕ Certain percentage of the sum assured on each policy by an insurance company is to be reinsured with the National Reinsurer. National reinsurer has been made compulsory only in the non-life sector.
- ⊕ The reinsurance programme will begin at the start of each financial year and has to be submitted to the IRDA, forty-five days before the start of the financial year.
- ⊕ Insurers must place their reinsurance business, in excess of limits defined, outside India with only those reinsurers who have a rating of at least BBB (S&P) for the preceding five years. This limit has been derived from India's own sovereign rating, which currently stands at BBB.
- ⊕ Private life insurance companies cannot enter into reinsurance with their promoter company or its associates, though the LIC can continue to reinsure its policies with GIC.
- ⊕ The objective of these regulations is to expand retention within India, ensure the best protection for the reinsurance costs incurred and simplify administration.