



# Critical Reinsurance Supervision for the Royal Monetary Authority of Bhutan

## PREFACE

*The document highlights the most critical aspects in the reinsurance supervision that the Royal Monetary Authority of Bhutan (RMA) should consider. The document considers the existing and near-term expected reinsurance activity in Bhutan. An introductory section explains the basics of reinsurance providing a useful overview of what corresponds to normal use of reinsurance and what raises supervisory red flags. The next section guides the supervisor to identify when reinsurance should be closely looked into and on what the reinsurance supervision and regulation needs to focus on. The document concludes with the sections of best practice and on the general procedures on the reinsurance supervision. Annexes presenting details of the common forms of reinsurance contracts, a detailed form on the reporting of reinsurance treaties, and a glossary of terms completes the document<sup>1</sup>*

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<sup>1</sup> The document has been prepared by Dr. Rodolfo Wehrhahn on February 2019, using his expert experience and relevant past work with Asian Development Bank, The World Bank, The International Monetary Fund and several insurance supervisors.

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## Introduction

### Current situation on the reinsurance activities in Bhutan.

The Royal Monetary Authority (RMA) has identified reinsurance as an important activity in its market that remains with limited supervision. This document is intended to provide guidance to RMA to improve its risk-based supervisory approach of the reinsurance activity present in Bhutan. The reinsurance activity in the Bhutanese market consists both of inwards and well as outwards reinsurance. The reinsurer General Insurance Corporation (GIC) as well as two local insurers Bhutan Insurance Limited (BIL) and the Royal Insurance corporation of Bhutan (RICB) are writing inwards reinsurance and are protecting their portfolios through outwards reinsurance (Retrocession in case of GIC).

The supervision of inwards reinsurance follows the same principles as those applicable for the supervision of direct writers. For the inwards reinsurance activity capital commensurate to the risks is required, the understand of the risks assumed and the presence of effective internal controls and proper risk management is part of the supervised activities. The additional risks that appear under the activity of inwards reinsurance are related to the fact that the business is not located in Bhutan, and as such it is exposed to foreign currency risk. Also, the concentration risk is hardly manageable as the information on each risk assumed is limited. The concentration risk, if it becomes important would require sophisticated software and modeling as well as access to detailed information to track location of the risks. For this reason, the inwards reinsurance should remain limited in size if the insurers taking inwards reinsurance are not willing to invest in the sophisticated and costly risk management infrastructure.

### *Inwards reinsurance activity in Bhutan*

BIL was actively accepting inwards reinsurance, but recently (as of 2019) BIL has been prohibited to accept inwards reinsurance business by the Royal Monetary Authority (RMA) due to poor experience in the results. BIL would like to see this prohibition lifted to be able to maintain grow in the total premium of the company. It becomes clear that the RMA could only allow the continuation of inwards business after satisfying evidence to be provided by BIL of its full understanding and proper risk management in place to manage the inwards reinsurance activity. Also limiting the amount of inwards reinsurance to max 10% of the total premium seems reasonable as is done in other parts of the world without the requirement to have a reinsurer license.

RICB continues to actively write inwards reinsurance that makes up to 50% of their non-life business. The strategy that they use is to participate with small shares on business that is offered to them through known brokers. The oversight of the exposure and quality of that business requires very strong risk management and full understanding of the reinsurance risk that they accept. However, their reinsurance team at present is very young. The results of the business are becoming significantly negative with an important exposure to agriculture reinsurance business from India that has already a loss ratio higher than 100% even though the final claims have not been reported yet. The inwards reinsurance business at RIBC needs to be managed with stronger oversight by experienced reinsurance experts. RMA rightly is considering additional capital, better risk management and limitation of the inwards reinsurance activity at RIBC.

GIC holding an exclusive reinsurer license is fully dedicated to the inwards reinsurance activity. The technical support is provided by the large Indian reinsurer and sponsor, The General Insurer Corporation of India Re. The portfolio of GIC is mainly in the SAAR region with a limited exposure to Bhutan (less than 10%). The fact that the Bhutanese insurers and hence the Bhutanese policyholders are not significantly exposed to GIC justifies a lower supervisory attention that RMA should dedicated to this company.

The outwards reinsurance that is used in the market is very similar for both insurers. They have in place a surplus treaty that covers almost all lines of business. In addition, a non-proportional treaty protects their retention in case of catastrophic events. GIC has GIC-Re its sponsor as its main reinsurer. At first sight the reinsurance coverage appears to be appropriate for the market. However, a thorough supervision of the reinsurance programs with respect to the credit, basis and intermediation risks should be carried out as the materialization of any of those risks could leave the Bhutanese insurers uncovered and prone to failure. The supervisory guidance on reinsurance that is provided in this document will highlight the area of attention while carrying out the off and onsite supervision of this outwards reinsurance activity.

#### Reinsurance activity and the importance of its supervision.

Reinsurance is a financial transaction by which risk is swapped between an insurance company (cedant) and a reinsurance company (reinsurer) in exchange for a payment (reinsurance premium). In a traditional transaction, the cedant exchanges insurance risk for liquidity, credit, operational and (sometimes) basis risk, whereas the reinsurer assumes insurance, timing and operational risk. On a financial motivated reinsurance transaction, the reinsurer will also assume credit risk.

The International Association of Insurance Supervisors (IAIS) defines in its Insurance Core Principle (ICP) 13 reinsurance as “the form of insurance where the primary insurer reduces the risk by sharing individual risks or portfolios of risks with a reinsurer against a premium”. Reinsurance is “insurance for insurers”. The basis of most reinsurance arrangements is the spreading of risk and, in essence, reinsurance allows the insurer to take on an insurance risk and subsequently pass on all or part of that risk to a reinsurer. As a result, the original insurer is left with only a part of the original risk (although in law the insurer remains liable to the policyholder for the full amount of the claim, and if the reinsurer defaults or becomes insolvent the insurer is obliged to meet the full amount of any claims). Reinsurance contracts can take a number of different forms.

The importance of having an appropriate reinsurance program cannot be overstated, and the importance is reflected in the numerous ICP 13 recommendations. The most significant of these are:

- Senior management must develop a reinsurance strategy and program and appropriate systems and controls to ensure that the strategy is complied with.
- The Board must approve the reinsurance strategy and program (see ICP 7 Corporate Governance).
- For large and/or complex ceding insurers, or those with a complex reinsurance strategy, the insurer may wish to appoint a committee of the Board to oversee the implementation of the reinsurance strategy.

- The Board and Senior Management of the ceding insurer should regularly review the performance of its reinsurance program, to ensure that it functions as intended and continues to meet its strategic objectives. It is likely that such a review would take place as part of the feedback loop that is part of the risk management framework.
- The ICPs acknowledge that a key prudential tool for the management of reinsurance risk is the reinsurance strategy and further emphasizes the role of the Board of an insurer in approving the strategy and monitoring performance against it.

The terms of a reinsurance transaction are defined in a reinsurance treaty. A reinsurance contract is a contract of indemnity between the reinsurer and cedant and **does not constitute a legal transfer** of the ceded risk, in other words, if a risk event occurs the insurer is still liable to the policyholder irrespective of whether it has reinsured all or part of the risk. This is a key aspect for the supervision: the risk remains with the insurer and in case of defaulting of the reinsurer, the insurer might become insolvent. It should be noted that while in normal conditions the reinsurance receivables are up to 30 percent of the claims' reserves; however, in case of insolvency those receivables can be as high as 80 to 90 percent.

Reinsurance treaties are usually only signed months after the risk was underwritten by the insurers. This situation creates legal uncertainty with respect to the insurer's protection and the reinsurer's liability. To avoid such uncertainty, some jurisdictions require insurers to have signed treaties before the risk is transferred. This regulatory approach that is considered to be best practice may require a transition period before it can be introduced to allow insurers and reinsurers for adaptation. One of the main difficulties to have the reinsurance treaties duly signed is the complexity of the negotiations when several brokers and/or reinsurers domiciled in different countries are part of the agreement. However, recent developments in the using the blockchain technology and smart contracts are beginning to facilitate in a secure the fast signature of reinsurance contracts<sup>2</sup>. To mitigate the legal uncertainty of not having a signed reinsurance treaty at the same time as the risk is underwritten by the cedent, a short version of a treaty called a slip containing the most important terms of the agreement **should be signed before the risk is transferred** and accepted by the reinsurer.

Supporting the reader, Annex A provides details of the common forms of reinsurance contracts. Annex C contains a glossary of terms related to the reinsurance activity.

## Business situations addressed through reinsurance

In this section the use of reinsurance to support the insurer in a series of situations are presented. The use of reinsurance is widespread and can be very effective in developing the insurance market. There are however situations where the use of reinsurance could be hiding serious solvency issues, under-reserving, tax avoidance or even money laundering activities. It is important for supervisors to understand situations that have a legitimate reason to be addressed by reinsurance and those where careful supervisory attention is necessary.

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<sup>2</sup> <https://www.swissre.com/reinsurance/search-page.html?searchterm=blockchain>

## Traditional uses of reinsurance

### *Capacity support*

- Underwrite risks beyond their own capacity/willingness to retain such risks
- large risks
- impaired risks
- unusual underwriting profile (medical conditions, firework deposits, taxis, motorbikes, etc.)

### *Catastrophic protection*

- Protection of the insurers' portfolio against the potential large accumulations of individual losses that can result from catastrophic events, for example, floods, earthquakes, epidemics, bush-fires and cyclones.
- Natural disasters are just one type of catastrophic loss that can negatively affect an insurer's business. In fact, catastrophic exposure comes in many forms. Business travel accidents, industrial accidents, terrorism events, and any number of fateful circumstances can cause multiple life loss.

### *Knowledge transfer*

- Develop new products
- Refine underwriting skills
- Pricing with limited statistics
- Risk management
- Risk prevention and mitigation

Use of reinsurance that requires supervisory attention:

### *Reinsurance credit to reduce prudential requirements*

- Reduce capital requirements
- Reduce reserve requirements
- Tax management/ optimization /avoidance
- Group capital management

## The reinsurance supervision

The IAIS guidelines on ICP 13 offer important information on the supervision of the reinsurance activity from the point of view of the insurer and the systemic risk protection of the industry<sup>3</sup>. There are three types of entity involved in the reinsurance discussion – direct insurers (users of reinsurance, outward reinsurance users or ceding insurers); direct insurers that write some reinsurance (direct insurers with inward reinsurance); and reinsurers that write reinsurance business solely. ICP 13 deals with both outward and inward reinsurance supervision: “The supervisor requires the insurer to manage effectively its use of reinsurance and other forms of risk transfer”. This refers to outward reinsurance and applies to direct insurers and direct insurers that write inward reinsurance only in relation to their outward reinsurance. “The

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<sup>3</sup> The ICP 13 guidance can be downloaded from the IAIS web page

supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction” (inward reinsurance). Many of the principles of the supervision of outward reinsurance and inward reinsurance are very similar. Given that the inward reinsurance supervision is quite similar to the insurer’s supervision, after a few comments on the inward reinsurance supervision, the rest of the chapter refers to the supervision of outward reinsurance.

### Inward reinsurance supervision

The supervision of inward reinsurance should follow the same approach as that of the supervision of insurers with the exception of the market conduct and consumer protection regulations. Market conduct and consumer protection regulations and supervision is important in the presence of significant knowledge asymmetries. Now, given that the relationship between reinsurers and insurers is a business to business relationship, the information or knowledge asymmetry is not expected to be large as is the case when considering insurance. This characteristic of the reinsurance activity thus turns the need for market conduct and consumer protection regulations of secondary relevance. Therefore, in those jurisdictions where reinsurers are active and domiciled, the major objective of the supervisor is the prudential supervision. Prudential supervision aims to minimize the instances of insolvencies of reinsurers.

Types of supervision can be classified in a number of ways. The IAIS identifies<sup>4</sup> five main approaches:

- (i) no supervision at all;
- (ii) supervision of reinsurance is restricted to ceded reinsurance of primary insurers only;
- (iii) the supervisor is authorized to request non-public information about a domestic reinsurer;
- (iv) every reinsurer doing business with a domestic reinsurer is licensed;
- (v) uniform licensing being extended with additional requirements for the insurer or the reinsurer.

Risks facing the reinsurance industry are based on many variables. The variability and their different weighting is the main reason for the relative complexity of this industry. In addition, reinsurers usually take more complex and larger risks and /or risks that have limited past experience or loss statistics than the insurers making concentration and underwriting risks of high relevance. The size of the reinsurer can also play a part in determining the risk profile. Larger undertakings generally tend to be more diversified in their risk portfolio and are better placed to absorb unexpected fluctuations in claims. As a result, reinsurance supervisors are faced with a range of risk factors that they must be familiar with in order to appreciate the risk exposure of an individual company.

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<sup>4</sup> Reinsurance and reinsurers: Relevant issues for establishing general supervisory principles, standards and practices, February 2000

## Importance of proper outward reinsurance supervision

Reinsurance is a powerful tool to develop the insurance market but sometimes it can be misused to hide insolvencies, allow tax evasion or even money laundering. It is for this reason that sufficient understanding of these risk is of paramount importance for the supervisor. At the same time due to the complexity of reinsurance supervision, supervisors are not expected to become reinsurance experts, but to be able to recognize situations that require further analysis or external expertise. Supervisors have several tools and measures available to deal with the problem once the situation is recognized as problematic.

## Indicators concerning the relevance of reinsurance for prudential supervision

The supervisory approach based on risk thus needs to recognize situation where reinsurance will be of importance for the financial stability of the insurer:

- As a starting point, supervisors need to assess the impact of reinsurance on the solvency of the insurer. This can be done by requiring solvency calculations that disregard the reinsurance treaties in place.
- Another indicator of the importance of reinsurance is the size of the reinsurance receivables, recoverables, premium and commissions in relation to the capital. Supervisors are recommended to introduce a market wide benchmark on these parameters to develop an early warning indicator.
- It should also be noted that in most cases reinsurance is not the first problem that the company is facing but rather it is used to hide those problems. Hence a company that is depleting its capital or is suffering from deteriorating loss ratio, and suddenly appears to have recovered by entering a reinsurance agreement, should be subject of further investigation with respect to the efficiency of the reinsurance treaty.

For all the cases indicated above a deeper analysis of the reinsurance agreements is recommended and should be started. The section that follows guides supervisors in identifying the main concerns with respect to the use of reinsurance. It should be noted that reinsurance can be very complex and should the impact on the solvency of the insurer be of a significant size, access to external reinsurance expertise is recommended.

## Main Concerns in Reinsurance Supervision and Regulation

### Counterparty risk supervision

As discussed in the introduction, reinsurance transforms insurance risk into credit risk and liquidity risk. Once risks are ceded, the insurer no longer has to hold capital against them. Instead of meeting claims from its own resources, a ceding insurer is relying on the reinsurer' ability to make timely payments. In

other words, the supervisor's main concern is about credit or counterparty risk of the reinsurer, the financial soundness of reinsurer and its financial stability are of paramount importance to the supervisor.

The supervisor's first concern is how well the ceding insurer is managing the credit risk. Part of the management of the credit should entail the ceding insurer evaluating and understanding the financial strength of the reinsurer and the quality of agreements it has with the reinsurer. The following recommendations are not exhaustive but rather are the minimum activities to be undertaken by the supervisor.

- Reinsurers and reinsurance brokers should be supervised either directly or indirectly
- Have regular home supervisor reports readily available
- Interview annually reinsurers and reinsurance brokers
- Set rating requirements for reinsurer.

### Basis Risk

Basis risk is the risk, with reinsurance, that the reinsurance treaty coverage is different than the original policy coverage. Thus, some insured losses suffered by the insurer will not be covered, by the reinsurance treaty. The different level of coverage found in reinsurance treaties is not uncommon and can have different origins: the insurer might feel more comfortable with some aspects of the risk and is willing to retain them, or the reinsurance costs of certain aspects of the original coverage are too high or the reinsurer does not have the risk appetite for them. If the basis risk is assumed with knowledge by the insurer, it is a calculated risk and the insurer will plan accordingly with sufficient mitigation, capital, etc. The difficulties that have led in many cases to insolvency have been in situations where the insurer was in the believe that more risk was covered under the reinsurance treaty than it actually was the case. In this situation, the insurer was not taking the necessary precautions to manage the retained risk. It is therefore of paramount importance to assess the level of coverage that the reinsurance treaty provides. This should be done by carefully reading the section describing the risks covered under the treaty, the exclusions and any other special conditions, like type to report a claim, etc. In complicated treaties it is advisable to request from the reinsurer or broker a confirmation based on an example on how the reinsurance treaty will actually operate in case of large or unusual claims. For the regulatory point of view, the reinsurance credit should only be given by the amount of risk transferred. This implies a full understanding of the reinsurance coverage limitations.

### Intermediation risk

A large number of reinsurance treaties are placed by reinsurance brokers and it is not uncommon that more than one broker is involved in the placement of a reinsurance treaty. The role of the reinsurance broker is manifold: from advising on the type of coverage, finding and negotiating with the reinsurers, placing the coverage, pricing the reinsurance coverage, administering the treaty, handling claims, etc.

The dependence on the reinsurer broker of the insurer, especially of smaller insurers or those underwriting complex or very large risks is important and needs to be managed. The necessary trust that is required to engage a broker should be underpinned by proper due diligence. In addition to proper background checks, references from the home supervisor, and proof of their liability insurance policy should be requested. To manage conflict of interests, a broker's disclosure statement should be considered and proof of the broker's power to bind reinsurers if acting as an underwriting agency is necessary.

### Risk transfer in reinsurance

In the center of a reinsurance transaction is the risk transfer element. Risk transfer is the purpose of a valid reinsurance transaction. Often the insurer is not aware of the limitation that the reinsurance contract entails and thus in case of an important insured claim it remains uncovered by the reinsurance contract. However, in some occasions, it is in common agreement between the insurer and the reinsurer that the "reinsurance" agreement is structured in a way that severely limits risk transfer. This is done to lower reinsurance costs but also to bypass regulations that require reinsurance for larger risks in respect to the insurer capital. No matter what the reason for the limitation in risk transfer in a given reinsurance contract are, it is important to understand those limitations that could result in the insolvency of an insurer.

### Review of certain key reinsurance provisions related to possible risk transfer limitations

The risk transfer test requirements should be closely supervised in reinsurance treaties that include critical provisions that could hint to lack of risk transfer.

#### *Aggregated limit (per event)*

- Common in non-proportional reinsurance.
- Depending on the market it may also apply to proportional reinsurance

#### Important features:

- Limits the partnership in a proportional treaty
- Limits risk transfer
- Is it sufficient?
- Is the reinsurance program considering the limitation of the coverage?

#### *Reinstatement clause*

- This clause allows the reinsured to have access to protection in case of multiple events that affect its portfolio during the duration of the contract.
- It is usually used for catastrophic protection.

#### Important features:

- Is the reinstatement premium reasonable?
  - A reinstatement premium that is close to the reinstated capacity limits severely the risk transfer component.

- Is the use of the full capacity allowed before the reinstatement capacity is required?
  - If the capacity needs to be reinstated whenever affected with disregard of the amount affected the reinsured might be paying with the reinstatement premium the claims itself. Thus, limiting the risk transfer element of the treaty.

#### *Reinsurance exclusions*

- The reinsurer excludes risks from the reinsurance treaty using explicit exclusions or referring to standard exclusion clauses of a particular market (Lloyds market exclusions number xxx)

#### *Important features:*

- Is there full understanding of the referred exclusions?
- Are they the same as those from the original policy?
- Which risks are not transferred?
- Can the insurer administer the exclusions?

#### *Termination Provisions*

- Termination provisions affect the cession of new business under an arrangement

#### *Important features*

- Are the provisions reasonable
- Are they equal for both parties?
- Do not create systemic risk?
- Allow for sufficient time to adjust
- Does not leave the insurer exposed to risk without coverage

#### *Recapture Provisions*

- Recapture provisions affect all business ceded under the agreement
- Recapture is a useful tool for the ceding company to maintain flexibility in reinsurance arrangements
- Recapture is sometimes prohibited if the reinsurance account has a negative experience to prevent anti-selection by ceding company

#### *Important features*

- Is this limiting risk transfer?
- Will the insurer be without coverage when most needed?
- Are the recapture payments reasonable?

#### *Best practice*

The following section contains a series of best practice that is recommended for the RMA consideration in the regulation and supervision of the reinsurance activity.

Reinsurance and risk transfers agreements are part of the reporting requirements.

- Changes to the reinsurance/retrocession plan must be submitted within 14 days after taking effect.
- Important insurance elements in profit and loss account, balance items and ratio indicators are reported both gross and net of reinsurance.
- Exposure to reinsurers is included and discussed in the annual report.

Legal certainty is enhanced by timely executed comprehensive reinsurance treaties.

- Treaties need to be signed before the risk is transferred.
- No backdating of slips is allowed.
- Integrity of the reinsurance contracts is guaranteed by the prohibition of side letters.

Authenticity of the reinsurance treaties.

- Treaties are signed in different parts of the world by persons that are hard to identify and with signatures and seals that can hardly be read and that are easy to replicate.
- Insurers need to have a process in place to make sure the treaties are authentic, and the reinsurers/brokers are aware of those treaties.
- Requesting confirmation of the reinsurers should always be carried out when there is a suspicion on the authenticity of the treaty.
- In case the supervisor is not convinced of the authenticity of the reinsurance treaty, confirmation from the underwriting reinsurer on the scope and treaty conditions should be requested. This could be achieved by a direct request to the reinsurer or through the home supervisor. In the latter case a memorandum of understanding with the home supervisor might be necessary.

Operational risk is manageable

- Sufficient reinsurance expertise available
  - Experience of reinsurance manager
- Procedures and systems over the reinsurance transactions are in place:
  - Adequate IT system capabilities,
  - effective tracking of aggregate claims which may give rise to a recovery under the reinsurance program,
  - Timely collection of reinsurance receivables as they fall due,
  - Timely reporting to reinsurers
- Reporting systems are tested and inspected.

Overdue reinsurance recoverable are deducted

- Capital requirements for delayed reinsurance receivables are enforced
- Disputed reinsurance claims are reserved

Liquidity considerations

- Liquidity risk management requirements include reinsurance payment patterns.
- Cash calls are mandatory or other forms of liquidity management tools

#### Effectiveness of reinsurance programs

- Large claims reinsurance share is monitored to assess effectiveness of reinsurance programs
- Stress testing includes failure of reinsurers or delayed in payments

#### Financial soundness of reinsurers

- Supervisors should require insurers to submit the following annual information and comment on possible negative developments of their main reinsurers (i.e. reinsurers reinsuring risks equal or higher than their capital):
  - Audited financial statements
  - Annual report
  - Credit rating
  - Good standing letter from home supervisor

#### General procedures on the supervision of reinsurance

The following activities can be used to monitor the reinsurance practice of insurance companies:

- Analysis of annual financial statements of domestic reinsurance companies. All available information is stored in a database and used as reference when reviewing the returns of domestic insurers and assessing the credit risk of the companies' reinsurance recoverables;
- Review of annual returns of insurers:
  - A description of the reinsurance strategy by line of business (cover obtained, net retention, type of reinsurance, measures taken regarding catastrophe risks);
  - A list of all reinsurers with whom the insurer has signed a non-proportional reinsurance contract (excess of loss, stop loss);
  - A list of all reinsurers with whom a proportional reinsurance contract has been signed that transfers more than 10% of the gross premium (quota share, surplus);
  - For each reinsurer an overview is provided of any outstanding balances, the reinsurance premiums ceded, the reinsurer's share in claims incurred and in the technical provisions;
  - Collateral or deposits placed with the company should be disclosed if they exceed 10% of the reinsurer's share in the technical provisions.
- Critical information on the main reinsurance contracts following the Ceded Reinsurance Contract Review Form Annex B, should be collected un regularly updated.
- On-site investigations, which include interviews with management and a review of a sample of reinsurance contract and transactions. During the interview, the supervisory authority discusses:
  - the nature and magnitude of the risks ceded,
  - the policy on net retention,

- measures taken concerning catastrophe risks and accumulation of risks,
- the chosen types of reinsurance,
- the exposure to individual reinsurers, and
- the selection criteria used to identify appropriate reinsurers.
- During the sample testing, the conditions of the reinsurance contracts are reviewed, and the internal control procedures are tested.

## Further Suggested Reading

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Heinz Stettler, Fritz Eugster, and Michael Kuhn et al., Reinsurance Matters, A Manual of the Non Life Branches, Swiss reinsurance Company, Zurich, 2005.

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Gerathewohl, Klaus, Reinsurance Principles and Practices, Vol. 1, Verlag Versicherungswirtschaft , 1980.

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[http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1242281415644/Introduction\\_to\\_Reinsurance.pdf](http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1242281415644/Introduction_to_Reinsurance.pdf)

## **Types of reinsurance agreements**

Most reinsurance contracts are either automatic treaty or facultative. Under a treaty reinsurance arrangement all risks that are defined to be object of the agreement are ceded automatically to the reinsurer, and the reinsurer agrees to accept all those risks. On a facultative treaty the cedant decides if a risk will be offered to the reinsurer and the reinsurer will decide on an individual basis if it will accept or not the offered risk. There is a third less common treaty structure called facultative-obligatory reinsurance. Here, the offering of the risks to the reinsurer is on a facultative basis but the acceptance of the risks is obligatory for the reinsurer.

## **Forms of reinsurance**

Basically, there are two forms of reinsurance: proportional reinsurance and non-proportional reinsurance. As the names suggest, there is or there is not a proportional sharing of premium, claims, expenses, and so forth. Proportional reinsurance creates a type of partnership between the cedant and the reinsurer as they have a strong alignment of interests in the performance of the underlying business. In non-proportional reinsurance the interests are usually not aligned and can even be opposed with respect to the performance of the business.

### *Proportional quota share reinsurance*

Under a Quota Share reinsurance treaty, the cedant transfers the same proportion or quota of each and every risk that falls under the object of the reinsurance agreement to the reinsurer. The premium, expenses and claims are also shared in the same proportion with the reinsurer. The reinsurer pays the cedant a reinsurance commission to compensate it for the acquisition and administrative expenses of the business. Also, it is quite typical to include a profit-sharing formula that allows for sharing profits of the reinsured business with the cedant. This is done to reward the cedant for the quality of its underwriting and selection of the accepted business.

The proportionality of the agreement also applies to any type of reserves that the business may require. The reinsurer is responsible for maintaining the appropriate reserves for its share in the business. Some jurisdictions require that certain reserves should be kept with the cedant or in a trust. In these cases, the reinsurer will send the necessary assets to the cedant or the trust to build the reserve corresponding to the reinsured business. The above indicated terms are usually first documented in a reinsurance slip when making a reinsurance offer. The slip will then be used to draft the definitive treaty.

### *Surplus or excedent reinsurance*

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<sup>5</sup> This Annex is taken from the World Bank publication: Introduction to Reinsurance, Rodolfo Wehrhahn, [http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1242281415644/Introduction\\_to\\_Reinsurance.pdf](http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1242281415644/Introduction_to_Reinsurance.pdf)

This type of proportional reinsurance is basically a Quota Share agreement that assigns a different proportion to be reinsured to each risk. To determine the proportion of the risk to be reinsured, the insurance company fixes an amount called retention or surplus line as the maximal sum insured that the company will retain on own account. Any amount above the retention and up to a given amount called capacity of the contract will be reinsured. The capacity sometimes is given in number of surplus lines. Thus, the Surplus reinsurance allows the cedant to change the level of participation on any type of risk by choosing a given surplus line for that specific type of risk.

### *Non-proportional reinsurance*

Insurance companies that are looking mainly to protect their portfolio from adverse experience that could result from too many claims or too high claims will usually enter non-proportional reinsurance agreements. In non-proportional reinsurance the protection is provided based on the actual loss the insurer suffers and not the sum insured of the risk.

Surplus proportional reinsurance as describe above requires that the sum insured of every individual risk is known to determine the proportionality in sharing the risk. There are however several insurance products where the sum insured is not always known, such as MTPL in the UK or commercial liability in the US, etc. In these cases when individual differentiated risk protection is desired, non-proportional reinsurance can be used.

### *Excess of Loss reinsurance*

The basic type of non-proportional reinsurance is the excess of loss reinsurance (XL). In an excess of loss agreement per risk the cedant will pay in case of an event affecting a reinsured risk the claimed amount up to a fixed chosen quantity called the priority of the agreement. The reinsurer will then pay any excess amount claimed above the priority up to the capacity of the contract. The reinsurance premium for an excess of loss agreement is not proportional to the direct premium collected by the insurer and is determined by the probability of having claims above the priority and attendant cost of capital. Also, as mentioned before there might be a conflict of interests between the cedant and the reinsurer: The financial incentive of the cedant on settling the claim disappears the moment the claimed amount is higher than the priority since beyond the priority the liability is transferred in full to the reinsurer up to the capacity of the treaty. To avoid these situations some agreements require either that the reinsurer has to approve payments above the priority or that the cedant retains a copayment of the liability above the priority.

### *Stop loss reinsurance*

An excess of loss agreement on the whole portfolio is called a Stop Loss coverage. The reinsurer will protect the cedant only in case the priority is exceeded by adding up all claims paid during the period of coverage, usually one year. In a typical Stop Loss coverage, the priority is expressed as a percentage of the insurance premium and in most cases a copayment in excess of the priority is required.

### *Catastrophic excess of loss reinsurance*

There is a third class of non-proportional reinsurance form called catastrophic excess of loss reinsurance (Cat-XL). Here, in addition of the necessity to exceed the priority to have reinsurance protection also the

catastrophic event has to have taken place. Catastrophic events can be for instance an earthquake, an explosion that has a toll of at least 3 lives, and so forth. Catastrophic reinsurance does not cover every event. Typical standard exclusions in a Cat-XL agreement are the claims related to nuclear or radioactive incidents. Terrorism is also a common exclusion. For these risks as well as other political risks, government or national industry pools have been established.

## Annex B– Ceded Reinsurance Contract Review

### INSURANCE COMPANY LIMITED

*The following work paper should be completed in accordance with the review of the company's ceded reinsurance contracts. For those items that are not applicable, kindly indicate N/A:*

1. Affiliated Transaction (Y/N)	
2. Treaty/Certificate Number	
3. Form of agreement	
4. Type of Treaty	
5. Territory	
6. Effective date of contract	
7. Is the contract back dated <sup>6</sup> ?	
8. Expiration date	
9. Signed Cover notes	
10. Are the signatories authorized to bind the reinsurer <sup>7</sup> ?	
11. Name of Reinsurers, ratings and percentage held.	
12. Do all reinsurers meet the supervisor minimum acceptability standard? (Yes/No)	
13. Details of the Reinsurance Intermediary if any.	
14. Proof that the signatories allowed to bind the reinsurer	
15. Document has any termination provisions.	
16. Any portfolio entrance or exiting clauses <sup>8</sup> ?	

<sup>6</sup> Does the contract start at a date in the past? Usually you can allow that if less than a year, but must understand the reason for that = avoid taxed? Improve solvency or a valid reason.

<sup>7</sup> This may be difficult to ascertain if the reinsurers are overseas and the insurers use overseas brokers. At a minimum obtain a copy of their authority to bind the reinsurer

17. Document any exclusion provisions that differ from the underlying cover, including capacity and aggregation limits.	
18. Does the contract contain profit sharing provisions? <sup>9</sup>	
19. Are the following insurance clauses included in the contract?	
a) Insolvency Clause	
b) Arbitration Clause – (Territory?)	
c) Intermediary Clause	
d) Error and Omission Clause	
e) Sunset clause <sup>10</sup>	
f) Cash calls <sup>11</sup> /Cash Loss <sup>12</sup> ? If yes, what is the amount?	
20. Premium	
1) Annual reinsurance premium	
2) Minimum reinsurance premium	
3) Deposit Premiums	
4) Reinstatement premium <sup>13</sup>	
5) Does the contract contain a variable premium	

<sup>8</sup> same as the Portfolio Acceptance and Withdrawal clause

<sup>9</sup> If the results of the reinsurance treaty are positive, the cedant receives part of the reinsurance premium back. It can be abused to get Solvency improvement without risk transfer. But it can also be a valid and useful clause. Usually used for proportional reinsurance only

<sup>10</sup> A clause that stipulates that the reinsurer will not be liable for any loss that is not reported to the reinsurer, within a specified period of time after the expiration of the reinsurance contract;

<sup>11</sup> A reinsurance contract provision, common in proportional contracts, which allows a reinsured company to make claim and receive immediate payment for a large loss, without waiting for the usual periodic payment procedures to occur.

<sup>12</sup> Under proportional treaties claim recoveries are usually made in the accounts. However, in the event that a loss settled by the reinsured exceeds a predetermined amount the reinsured has the option to request from the reinsurer immediate settlement outside the regular accounts

<sup>13</sup> When a reinsured claim happens in catastrophic reinsurance the cedant can reinstate the full capacity paying a reinstatement premium.

depending on the losses affecting the contract?	
21. Commission:	
a) Commission Rate	
b) Special commissions	
22. Company's retention <sup>14</sup>	
23. Reinsurer's limit under the contract.	
24. Is there an aggregate limitation applicable to:	
a) a period of coverage	
b) geographic area, line of business, type of risk <sup>15</sup> ?	
c) a single loss event	
d) the total treaty? (cession limit)	
25. How often are reports for premiums /losses to be rendered?	
26. Are there any conditions that may impose additional cost in the future (e.g. retrospective ratings, commission to the insurance company that are adjusted downward should claims experience be worse than anticipated, Loss Participation Clauses, loss corridor, etc.)?	
27. Comments /Notes	

Prepared by:

Date:

Peer Review by:

Date:

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<sup>14</sup> Should be in line with declare reinsurance policy

<sup>15</sup> Here the focus is on the limitation by geographic area, etc. not where the risk is located or the line of business that is covered.

## Annex C – Glossary of Terms<sup>16</sup>

**Access to Records Clause.** A provision in a reinsurance agreement that allows the Reinsurer access to the Company's books, records and other documents and information pertaining to the reinsurance agreement. This includes related underwriting and claims information, for purposes of the Reinsurer obtaining information concerning the reinsurance agreement or its subject matter.

**Accident Year.** The date of the loss under the original policy rather than the effective date of the original policy that determines the basis of attachment. Any losses occurring during the reinsurance agreement period on policies in force (if any), written or renewed will be covered by that reinsurance agreement irrespective of the inception or the renewal date of the original policy. This mechanism is often used with "the losses occurring during" the contract period methodology.

**Accident Year Experience.** Underwriting experience calculated by matching the total value of all losses occurring during a given 12-month period (i.e., the dates of loss fall within the period) with the premiums earned for the same period. See also Calendar Year Experience and Policy Year Experience.

**Acquisition Costs.** All expenses directly related to acquiring insurance or reinsurance accounts, i.e., commissions paid to agents, brokerage fees paid to brokers, and expenses associated with marketing, underwriting, contract issuance and premium collection.

**Admitted Reinsurance (also known as Authorized Reinsurance).** A company is "admitted" when it has been licensed and accepted by appropriate insurance governmental authorities of a state or country. In determining its financial condition, a ceding insurer is allowed to take credit for the unearned premiums and unpaid claims on the risks reinsured if the reinsurance is placed in an admitted reinsurance company.

**Aggregate Excess of Loss Reinsurance (also known as Excess of Loss Ratio Reinsurance, Stop Loss Reinsurance).** A form of excess of loss reinsurance which, subject to a specified limit, indemnifies the ceding company for the amount by which all of the ceding company's losses (either incurred or paid) during a specific period (usually 12 months) exceed either 1) a predetermined dollar amount or 2) a percentage of the company's subject premiums (loss ratio) for the specific period.

**Arbitration Clause.** Language providing a means of resolving differences between the reinsurer and the reinsured without litigation. Usually, each party appoints an arbiter. The two thus appointed select a third arbiter, or umpire, and a majority decision of the three becomes binding on the parties to the arbitration proceedings.

**Association (also known as Pool, Syndicate).** An organization of insurers or reinsurers through which pool members underwrite particular types of risks with premiums, losses, and expenses shared in agreed amounts.

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<sup>16</sup> The Reinsurance Association of America (RAA), 1445 New York Avenue, 7th Floor, Washington, DC 20005, [www.reinsurance.org](http://www.reinsurance.org) and [www.captive.com](http://www.captive.com)

**Assume.** To accept an obligation to indemnify all or part of a ceding company's insurance or reinsurance on a risk or exposure subject to the contract terms and conditions.

**Assumption.** A procedure under which one insurance (ore reinsurance) company takes over or assumes contractual obligations of another insurer or reinsurer.

**Base Premium (also known as Premium Base, Subject Premium, Underlying Premium).** The ceding company's premiums (written or earned) to which the reinsurance premium rate is applied to produce the reinsurance premium. This term is usually defined in the reinsurance contract.

**Basis of Attachment.** A methodology that determines which original policy losses will be covered under a given reinsurance agreement. There are two types of methodologies: policies attaching and losses occurring. The determination may be based on 1) the effective or renewal date of the original policy; or 2) on the date of the loss; or 3) on the date when the reinsured company recorded premium or loss transaction.

**Binder.** An interim short form contract evidencing coverage, pending replacement by a formal reinsurance contract. See Placement Slip and Cover Note.

**Bordereau (plural Bordereaux).** A report provided periodically by the reinsured detailing the reinsurance premiums and/or reinsurance losses and other pertinent information with respect to specific risks ceded under the reinsurance agreement.

**Broker.** An intermediary who negotiates reinsurance contracts between the ceding company and the reinsurer(s). The broker generally represents the ceding company and receives compensation in the form of commission, and/or other fees, for placing the business and performing other necessary services.

**Bulk Reinsurance.** A transaction sometimes defined by statute through which, of itself or in combination with other similar agreements, an insurer assumes all or a substantial portion of the liability of the reinsured company.

**Burning Cost (also known as Pure Loss Cost). Burning Cost** - A term most frequently used in spread loss property reinsurance to express pure loss cost or more specifically the ratio of the reinsurance losses incurred to the ceding company's subject premium.

**Calendar Year Experience.** The evaluation of underwriting experience whereby the total value of all losses incurred during a given twelve-month period (regardless of the dates of loss or the inception date of the policy) is matched with the premiums earned for the same period. As the name implies, Calendar Year Experience is usually calculated for a twelve-month period beginning January 1st. See also Accident Year Experience and Policy Year Experience.

**Capacity.** The largest amount of insurance or reinsurance available from a company or the market in general. Capacity may apply to a single risk, a program, a line of business, or an entire book of business. Also refers to the maximum amount of business (premium volume) that a company or the total market could write based on financial strength.

**Cancellation** - (a) Run-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall continue until the expiration date

of each policy; (b) Cut-off basis means that the liability of the reinsurer under policies, which became effective under the treaty prior to the cancellation date of such treaty, shall cease with respect to losses resulting from accidents taking place on and after said cancellation date. Usually the reinsurer will return to the company the unearned premium portfolio, unless the treaty is written on an earned premium basis.

**Catastrophe Reinsurance.** A form of excess of loss reinsurance which, subject to a specific limit, indemnifies the ceding company in excess of a specified retention with respect to an accumulation of losses resulting from an occurrence or series of occurrences arising from one or more disasters. Catastrophe contracts can also be written on an annual aggregate deductible basis under which protection is afforded for losses over a certain amount for each loss (the attachment point) in excess of a second amount in the aggregate for all losses (otherwise recoverable but for the aggregate deductible) in all catastrophes occurring during a period of time (usually one year).

**Cede.** The action of an insurer of reinsuring with another insurer or reinsurer the liability assumed through the issuance of one or more insurance policies by purchasing a contract that indemnifies the insurer within certain parameters for certain described losses under that policy or policies. This action is described as transferring the risk or a part of the risk from the insurer to the reinsurer. The insurer (the buyer) is called the cedant and the assuming company (the seller) is called the reinsurer.

**Cedant (also known as Ceding Company, Reassured, Reinsured).** The issuer of an insurance contract that contractually obtains an indemnification for all or a designated portion of the risk from one or more reinsurers.

**Ceding Commission.** An amount deducted from the reinsurance premium to compensate a ceding company for its acquisition and other overhead costs, including premium taxes. It may also include a profit factor. See Overriding Commission and Sliding Scale Commission.

**Cession.** The portion of insurance ceded by the ceding company to the reinsurer.

**Cessions Basis (also known as Cessions Made, Cessions Schedule).** A reinsurance pricing mechanism used on casualty reinsurance contracts where a premium for each reinsured policy is ceded to Reinsurer individually based on the exposure of the policy limits to the reinsurance limits (usually based on Increased Limit Factors).

**Claims Made Basis (Re)Insurance Agreements.** The provision in a policy of (re)insurance that affords coverage only for claims that are made during the term of the policy for losses that occur on or after the retroactive date specified in the policy. A claims-made policy is said to “cut-off the tail” on liability business by not covering claims reported after the term of the insurance policy unless extended by special agreement.

**Clash Cover.** A casualty excess of loss reinsurance agreement with a retention level equal to or higher than the maximum limits written under any one reinsured policy or contract reinsured under the reinsurance agreement. Usually applicable to casualty lines of business, the clash cover is intended to protect the ceding company against accumulations of loss arising from multiple insureds and/or multiple lines of business for one insured involved in one loss occurrence.

**Common Account Reinsurance.** Reinsurance which is purchased by the ceding insurer to protect both the itself and its reinsurer (usually quota share reinsurer) and which applies to net and treaty losses combined. This may also be referred to as Joint Account Excess of Loss Reinsurance.

**Commutation Agreement.** An agreement between the ceding insurer and the reinsurer that provides for the valuation, payment and complete discharge of some or all current and future obligations between the parties under particular reinsurance contract(s).

**Contingency Cover.** Reinsurance providing protection for an unusual combination of losses. See Clash Cover.

**Contingent Commissions (or Profit Commission).** An allowance payable to the ceding company in addition to the normal ceding commission allowance. It is a pre-determined percentage of the reinsurer's net profits after a charge for the reinsurer's overhead, derived from the subject treaty.

**Contributing Excess -** Where there is more than one reinsurer sharing a line of insurance on a risk in excess of a specified retention, each such reinsurer shall contribute towards any excess loss in proportion to his original participation in such risk. Example: Retention \$100,000, Reinsurer A accepts one-half contributing share part of \$1,000,000 in excess of said \$100,000. Reinsurer B accepts remaining one-half contribution share part of \$1,000,000.

**Cover Note.** A written statement issued by an intermediary, broker or direct writer indicating that the coverage has been effected and summarizing the terms. See also Binder and Placement Slip.

**Credit for Reinsurance.** The right of a ceding company under statutory accounting and regulatory provisions permitting a ceding company to treat amounts due from reinsurers as assets or reductions from liability based on the status of the reinsurer.

**Credit Carry Forward (CCF).** The transfer of credit or profit from one accounting period, as defined within the reinsurance agreement, to the succeeding accounting period under the existing contract or the replacing contract.

**Cut-Off Clause.** The termination provision of a reinsurance contract stipulating that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination.

**Cut-Through Endorsement.** An endorsement to an insurance policy or reinsurance contract which provides that, in the event of the insolvency of the insurance company, the amount of any loss which would have been recovered from the reinsurer by the insurance company (or its statutory receiver) will be paid instead directly to the policyholder, claimant, or other payee, as specified by the endorsement, by the reinsurer. The term is distinguished from an assumption. See Assumption of Liability Endorsement.

**Deficit Carry Forward (DCF).** The transfer of deficit or loss from one accounting period, as defined within the reinsurance agreement, to the succeeding accounting period under the existing contract or the replacing contract.

**Deficit and Credit Carry Forward (DCCF).** See Deficit Carry Forward and Credit Carry Forward.

**Deposit Premium.** The amount of premium (usually for an excess of loss reinsurance contract), which the ceding company pays to the reinsurer on a periodic basis during the term of the contract. This amount is

generally determined as a percentage of the estimated amount of premium that the contract will produce based on the rate and estimated subject premium. It is often the same as the minimum premium but may be higher or lower. The deposit premium will be adjusted to the higher of the actual developed premium or the minimum premium after the actual subject premium has been determined.

**Earned Reinsurance Premium.** A reinsurance term that refers to either 1) that part of the reinsurance premium applicable to the expired portion of the policies reinsured, or 2) that portion of the reinsurance premium which is deemed earned under the reinsurance contract.

**Entire Agreement Clause.** A clause in some reinsurance agreements providing that the reinsurance agreement constitutes the entire agreement between the parties with respect to its subject matter, superseding all previous contracts, written or oral; and that any prior statements, negotiations or representations between the parties are merged into the final, written agreement. The clause may also provide that any modifications or changes in the agreement must be in writing and executed by both parties.

**Errors and Omissions Clause.** A provision in reinsurance agreements which is intended to neutralize any change in liability or benefits as a result of an inadvertent error by either party.

**Estoppel (also known as Non-Waiver Clause).** A provision in a reinsurance agreement which reserves to the reinsurer every right under the reinsurance agreement not previously waived, and to the ceding company every right which had not been forfeited.

**Evergreen Clause.** A term in a Letter of Credit providing for automatic renewal of the credit.

**Excess of Loss Reinsurance (also known as Non-Proportional Reinsurance).** A form of reinsurance, which, subject to a specified limit, indemnifies the ceding company for the amount of loss in excess of a specified retention. It includes various types of reinsurance, such as catastrophe reinsurance, per risk reinsurance, per occurrence reinsurance and aggregate excess of loss reinsurance.

**Excess Per Risk Reinsurance.** A form of excess of loss reinsurance which, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

**Expense Ratio.** The percentage of premium used to pay all the costs of acquiring, writing and servicing insurance and reinsurance.

**Experience.** (1) The loss record of an insured or of a class of coverage. (2) Classified statistics of events connected with insurance, of outgo, or of income, actual or estimated. (3) What figures show to have happened in the past.

Experience may be compiled on different bases to provide various means of appraisal, viz. Accident Year, Calendar Year, or Policy Year, but, for underwriting purposes, should always compare earned premium with incurred losses after the latter have been modified by an allowance for loss development and incurred but not reported losses (I.B.N.R.).

**Experience Rating (also known as Loss Rating.)** An approach by which the rate is determined based on the ceding company's historical loss experience, actual and reconstructed.

**Exposure Rating.** An approach by which the rate is determined based on analysis of the exposure inherent in the business being covered by the contract based on industry experience for the same type of business (rather than on the actual historical loss experience of the company).

**Extended Reporting Period.** An additional period of time affording coverage after termination of a claims-made policy during which a claim first made after such termination for injury or damage that occurs on or after the retroactive date, if any, but before the policy termination date is covered. Also see Retroactive Date.

**Extra-Contractual Obligations (ECO).** In reinsurance, monetary awards or settlements against an insurer for its alleged wrongful conduct to its insured. Such payments required of an insurer to its insured are extra-contractual in that they are not covered in the underlying contract.

**Ex Gratia Payment Latin: “by favor”.** A voluntary payment made by the reinsurer in response to a loss for which it is not technically liable under the terms of its contract.

**Facultative Certificate of Reinsurance.** A contract formalizing a reinsurance cession on a specific risk.

**Facultative Treaty.** A reinsurance contract under which the ceding company has the option to cede and the reinsurer has the option to accept or decline individual risks. The contract merely reflects how individual facultative reinsurances shall be handled.

**Facultative Obligatory Treaty (also known as Facultative Semi-Automatic Treaty, Facultative Semi-Obligatory Treaty).** 1) A reinsurance contract under which the ceding company can select, and the reinsurer is obligated to accept cessions of risks of a defined class, provided the risks fall within the contract guidelines. 2) A reinsurance contract under which the ceding company must cede exposures of risks of a defined class that the reinsurer may accept, if ceded.

**Finite Reinsurance (also known as Financial Reinsurance, Limited Risk Reinsurance, Nontraditional Reinsurance, Structured Reinsurance).** A broad spectrum of treaty reinsurance arrangements which provide reinsurance coverage at lower margins than traditional reinsurance, in return for a lower probability of loss to the reinsurer. This reinsurance is often multi-year and often provides a means of sharing positive or negative claims experience with the cedant beyond that usually provided by traditional reinsurance.

**Flat Rate.** 1) A fixed insurance premium rate not subject to any subsequent adjustment. 2) A reinsurance premium rate applicable to the entire premium income derived by the ceding company from the business ceded to the reinsurer as distinguished from a rate applicable to excess limits.

**Follow the Fortunes.** Follow the fortunes generally provides that a reinsurer must follow the underwriting fortunes of its reinsured and, therefore, is bound by the decisions of its reinsured in the absence of fraud, collusion or bad faith. It requires a reinsurer to accept a reinsured’s good faith, business-like reasonable decision that a particular risk is covered by the terms of the underlying policy. The term is often used interchangeably with follow the settlements, and there may be overlap between the effect of follow the fortunes and follow the settlements when the “risk” is what generated the loss. Follow the fortunes is focused on “risk” determination, not necessarily tied to a loss settlement.

**Follow the Settlements.** Follow the settlements generally provides that a reinsurer must cover settlements made by the reinsured in a business-like manner, provided the settlement is arguably within the terms of

the reinsured's policy and the reinsurance agreement and the settlement is not affected by fraud, collusion or bad faith. It is an expectation that the reinsurer will abide by the reinsured's good faith determination to settle, rather than litigate. The term is often used interchangeably with follow the fortunes, and there may be overlap between the effect of follow the settlements and follow the fortunes when the "risk" is what generated the loss. Follow the settlements is focused on "loss settlement", not necessarily tied to a "risk determination" arising out of follow the fortunes.

**Fronting.** Arrangements by which an insurer, for a specified fee or premium, issues its policies to cover certain risks underwritten or otherwise managed by another insurer or reinsurer. The insurer then transfers all, or substantially all, of the liabilities thereunder to such insurers by means of reinsurance.

**Funded Cover.** A type of excess of loss reinsurance agreement under which the reinsured company pays an agreed upon premium to build a fund (which is held by the insurer or reinsurer pursuant to the terms of the agreement) from which to pay covered losses. Since that fund reduces the reinsurer's risk that losses will exceed the fund, the Reinsurer agrees to accept a reduced reinsurance margin. Any excess monies in the fund will be returned to the appropriate party pursuant to the terms of the contract.

**Funds Withheld.** A provision with respect to credit for reinsurance in a reinsurance treaty under which the premium due the reinsurer is withheld and not paid by the ceding company to enable the ceding company to reduce its liability for unauthorized reinsurance in its statutory statement. The reinsurer's asset, in lieu of cash, is "funds held by or deposited with reinsured companies."

**Gross Line.** The total limit of liability accepted by an insurer on an individual risk (net line plus all reinsurance ceded).

**Gross Net Earned Premium Income (GNEPI).** Generally, the usual rating base for excess of loss reinsurance. It represents the earned premiums of the primary company for the lines of business covered net, meaning after cancellation, refunds and premiums paid for any reinsurance protecting the cover being rated, but gross, meaning before deducting the premium for the cover being rated.

**Gross Net Written Premium Income (GNWPI).** Generally, gross written premium less only returned premiums and less premiums paid for reinsurance that inure to the benefit of the cover in question. Its purpose is to create a base to which the reinsurance rate is applied.

**Ground Up Loss.** The total amount of loss sustained by the ceding company before taking into account the credit(s) due from reinsurance recoverable(s).

**Incurred But Not Reported (IBNR).** Refers to losses that have occurred but have not yet been reported to the insurer or reinsurer. IBNR has two components: (1) a provision for loss and loss adjustment expense ("LAE") reserves in excess of the reserves on claims reported during the accounting period (IBNER); (2) a provision for loss and LAE reserves on claims that have occurred but not yet been reported during the accounting period (IBNYR).

**Incurred But Not Enough Reported (IBNER).** Is a provision in claims and losses already reported for claims reserve increases; decreases can occur although infrequently. It is created because reported claims reserves tend to increase from the time a claims-occurs until the claim is settled. Changes in insurance

company case reserves, during the accounting period and established by judgment and/or formula, often result from a lag in information on liability and damages.

**Incurred But Not Yet Reported (IBNYR).** Is a provision for loss reserves and LAE on losses and claims that have occurred but have not been made known to the insurer.

**Incurred Loss (also known as Loss Incurred).** Incurred loss is calculated as outstanding loss at the beginning of a reinsurance period plus paid and/or outstanding loss reported during that period minus the outstanding loss at the end of the period irrespective of when the loss actually occurred, or the original policy attached.

**Insolvency Clause.** A provision now appearing in most reinsurance contracts stating that in the event the reinsured is insolvent the reinsurance is payable directly to the company or its liquidator without reduction because of its insolvency or because the company or its liquidator has failed to pay all or a portion of any claim.

**Interlocking Clause.** A provision in a reinsurance agreement designed to allocate loss from a single occurrence between two or more reinsurance agreements. The provision is intended to be used when the company purchases its excess of loss reinsurance on an “underwriting year” or “risks attaching” basis. The provision allows the reinsured to prorate its retention between two or more reinsurance agreement periods, i.e., when one loss affects policies assigned to different reinsurance periods, so that the company will have one retention and one recovery for the loss involving the two reinsurance periods.

**Intermediary Clause.** A contractual provision in which the parties agree to effect all transactions through an intermediary and the credit risk of the intermediary, as distinct from other risks, is imposed on the reinsurer.

**Inuring Reinsurance.** A designation of other reinsurances which are first applied pursuant to the terms of the reinsurance agreement to reduce the loss subject to a particular reinsurance agreement. If the other reinsurances are to be disregarded as respects loss to that particular agreement, they are said to inure only to the benefit of the reinsured. Example: A ceding insurer has a 50% quota share agreement and a per occurrence excess of loss contract (i.e., catastrophe reinsurance) for \$80 million excess of \$20 million. A catastrophe loss of \$100 million occurs. If the quota share contract inures to the benefit of the catastrophe reinsurer, of the gross loss of \$100 million, the quota share reinsurer pays \$50 million, the ceding insurer bears the \$20 million catastrophe retention, and the catastrophe reinsurer indemnifies the ceding insurer to the extent of \$30 million.

**Layer.** A horizontal segment of the liability insured, e.g., the second \$100,000 of a \$500,000 liability is the first layer if the *cedant* retains \$100,000 but a higher layer if it retains a lesser amount.

**Lead Reinsurer.** The *reinsurer* who negotiates the terms, conditions, and premium *rates* and first signs on to the *slip*; *reinsurers* who subsequently sign on to the *slip* under those terms and conditions are considered following *reinsurers*.

**Loss Adjustment Expense (LAE).** The expense incurred by the ceding insurer in the defense, cost containment and settlement of claims under its policies. They are normally broken down into two categories: Allocated (ALAE) and Unallocated (ULAE). ALAE are often considered part of the loss to the

ceding insurer and may be recovered as part of the reinsurance payments from the reinsurer. By contrast, ULAE are considered part of the ceding insurer's overhead and cost of doing business and should not be subject to reinsurance recovery. The elements of loss adjustment expenses that are covered by reinsurance are specified in the terms of the reinsurance agreement.

**Loss Conversion Factor (also known as Loss Loading or Multiplier).** A factor applied to the anticipated losses (or loss cost) for an excess of loss reinsurance agreement in order to develop the reinsurance premium (or rate). This factor provides for the reinsurer's loss adjustment expense, overhead expense, and profit margin. See also Rating.

**Loss Corridor.** A mechanism contained in a proportional or an excess of loss agreement that requires the ceding insurer to be responsible for a certain amount of the ultimate net loss that is above the company's designated retention and below the designated limit, and which would otherwise be reimbursed under the reinsurance agreement. A loss corridor is usually expressed as a loss ratio percentage of the reinsurer's earned premium, or a combined ratio if the reinsurance agreement provides for a ceding commission to the company. Loss corridors are employed to mitigate the volatility of reinsurance agreements.

**Loss Development.** The process of change in amount of losses as a policy or accident year matures, as measured by the difference between paid losses and estimated outstanding losses at some subsequent point in time (usually 12-month periods), and paid losses and estimated outstanding losses at some previous point in time. In common usage it might refer to development on reported cases only, whereas a broader definition also would take into account the IBNR claims. **Loss Excess of Policy Limits** An amount of loss which exceeds the policy limits but is otherwise under the coverage terms of the policy, for which the insurer is potentially responsible by reason of its action or omissions in defending the insured under the policy. **Loss Incurred** See Incurred Loss.

**Loss Loaded Rating (also known as Expense Loaded).** A type of retrospective rate adjustment using the same period losses multiplied by a loss load and/or expense load

**Loss Portfolio Transfer.** A financial reinsurance transaction in which loss obligations that are already incurred, and which are expected to ultimately be paid are ceded to a reinsurer. In determining the premium paid to the reinsurer, the time value of money is considered, and the premium is therefore less than the ultimate amount expected to be paid. The difference between the premium paid for the transaction and the amount reserved by the cedant is the amount by which the cedant's statutory surplus increases. Other terms used in context with Lloyd's contracts are loss portfolio-rollover and reinsurance to close.

**Losses Occurring.** A specific time delineated in a reinsurance agreement when a loss is deemed to have occurred for purposes of determining whether the loss is within the period that reinsurance coverage applies, usually based on the definition of loss occurrence provided for in the agreement.

**Management Fee Expense (also known as Reinsurance Home Office Expense [RHOE], Reinsurer's Expense).** A deduction usually expressed as a percentage of ceded premium, in a calculation of profit or contingent commission. The amount is intended to account for the reinsurer's internal expenses.

**Margin Plus Rating.** A type of retrospective rate adjustment using the same period losses expressed as a ratio of earned premium for the same period plus a fixed margin.

**Maximum Foreseeable Loss / Probable Maximum Loss (PML).** The worst loss that is foreseeable or probable to occur because of a single event.

**Maximum Possible Loss.** The worst loss that could possibly occur because of a single event.

**Mediation.** A form of alternative dispute resolution in which the parties agree to submit any dispute to a neutral mediator, whose purpose and goal is to achieve a mutually acceptable settlement and compromise of the dispute, rather than issue a formal ruling and decision on the merits as occurs in arbitration. Depending upon the parties' agreement, the results of mediation can be binding, or non-binding.

**Minimum Premium.** An amount of premium which will be charged (usually for an excess of loss reinsurance contract), notwithstanding that the actual premium developed by applying the rate to the subject premium could produce a lower figure. See Deposit Premium.

**NBCR.** An acronym referring to nuclear, biological, chemical and radiological exposures, which may be defined in the reinsurance agreement, for purposes of excluding, limiting or providing reinsurance coverage.

**Net Retained Liability.** The amount of insurance that a ceding company keeps for its own account and does not reinsure in any way (except in some instances for catastrophe reinsurance).

**Net Loss.** The amount of loss sustained by an insurer after making deductions for all recoveries, salvage and all claims upon reinsurers – with specifics of the definition derived from the reinsurance agreement.

**Nine-Months Rule.** A contract signature rule adopted by the National Association of Insurance Commissioners generally imposing a nine-month time limit from the effective date of the treaty reinsurance agreement to the time when the treaty reinsurance agreement must be actually executed by the ceding company and the reinsurer or, in the case of multiple reinsurers, the lead designated reinsurer. The rule enables the ceding company to comply with statutory and/or regulatory requirements and receive accounting treatment as prospective, as opposed to retroactive, reinsurance.

**Ninety-Day Rule.** The National Association of Insurance Commissioners annual statement requirement which provides that an insurer or reinsurer must account for certain balances on Schedule F of the annual statement when it has reinsurance recoverables over ninety days past due for which the company may incur penalties. Non-Admitted Reinsurance Reinsurance placed with a reinsurer that does not have authorized or equivalent status in the jurisdiction in question.

**Novation.** The substitution of a new contract, debt or obligation for an existing one, between the same or different parties. A novation may substitute a new party and discharge one of the original parties to a contract by agreement of all parties. The requisites of a novation are 1) a previously valid obligation; 2) an agreement of all the parties to a new contract; 3) the extinguishment of the old obligation; and 4) the validity of the new obligation.

**Obligatory Treaty.** A reinsurance contract under which the subject business must be ceded by the insurer in accordance with contract terms and must be accepted by the reinsurer.

**O.C.A. (Outstanding Cash Advance).** A method of funding by the reinsurer by cash advance in connection with a securitization provision contained in a reinsurance agreement requiring the reinsurer to

secure its outstanding obligations under the agreement as of a particular point in time. The cash advance is held by the company in trust for the reinsurer in an interest-bearing account or invested by the company in acceptable securities. The amount of the cash advance is subject to adjustment at given intervals as the reinsurer's obligations change, as defined in the securitization provision. Generally, should the reinsurer fail to perform its payment obligations under the reinsurance agreement, the company may utilize the outstanding cash advance to meet such obligations. Also see Trust and Unauthorized Reinsurance.

**Occurrence.** A frequently used term in reinsurance referring to an incident, happening or event which triggers coverage under an occurrence-based agreement. The definition of an occurrence will vary, depending upon the intent and interests of the parties. Occurrence Coverage A policy covering claims that arise out of damage or injury that took place during the policy period regardless of when claims are made. Most commercial general liability insurance is written on an occurrence form. Contrast with claims-made coverage.

**Occurrence Limit.** A provision in most property per risk reinsurance contracts that limits the reinsurer's liability for all risks involved in one occurrence. See Occurrence.

**Offset (also known as Setoff.)** The netting of amounts due between two parties as provided for by common law, contract law, statutory law, regulatory law and/or judicial law. Some reinsurance contracts contain a mutual right of offset, while others may operate only for one party's benefit. Offset may be allowed under all contracts between the parties or only under that specific contract.

**Original Conditions Clause.** A provision in a reinsurance agreement which incorporates by reference all of the terms (as well as amendments, modifications, alterations and waivers) of the original policy written by the ceding company that are not otherwise addressed in the reinsurance agreement. See also Follow the Fortunes.

**Outstanding Loss Reserve (OLR, O/S).** For an individual loss, an estimate of the amount the insurer expects to pay for the reported claim. For total losses, estimates of expected payments for reported and unreported claims. May include amounts for loss adjustment expenses. See Incurred But Not Reported (IBNR), Incurred Losses and Loss Development.

**Over-Line.** The amount of insurance or reinsurance that exceeds the insurer's or reinsurer's normal capacity. This is inclusive of automatic reinsurance facilities.

**Overriding Commission** 1) An allowance paid to the ceding company over and above the acquisition cost to allow for overhead expenses and often including a margin for profit. 2) A fee or percentage of money that is paid to a party responsible for placing a retrocession of reinsurance. 3) In insurance, a fee or a percentage of money that is paid by the insurer to an agent or general agent for premium volume produced by other agents in a given geographic area.

**Participating Reinsurance (also known as Proportional, Pro Rata Reinsurance, Quota Share).** A generic term describing all forms of quota share and surplus reinsurance in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

**Payback.** A method of reinsurance rating under which the price is based on how frequently a limits loss might occur over a period of time based on historical or projection indications. Thus, if the indicated or

projected loss would occur only once in five years, the price would be set (without regard to expenses and profit margins) to be equal to the limit divided by five and the contract would thus be said to have a “five-year payback.” Inverse calculation with Rate on Line.

**Placement Slip.** A temporary agreement of reinsurance terms and conditions arrangements for which coverage has been effected, pending replacement by a formal reinsurance contract. Also known as a binder, confirmation, slip and in some circumstances, cover note.

**Peril.** This term refers to the causes of possible loss in the property field - for instance: Fire, Windstorm, Collision, Hail, etc. In the casualty field the term “Hazard” is more frequently used.

**Portfolio.** A reinsurance term that defines a body of: 1) insurance (policies) in force (premium portfolio), 2) outstanding losses (loss portfolio), or 3) company investments (investment portfolio). The reinsurance of all existing insurance, as well as new and renewal business, is therefore described as a running account reinsurance with portfolio transfer or assumption.

**Portfolio Reinsurance.** The transfer of portfolio via a cession of reinsurance; the reinsurance of a runoff. Only policies in force (or losses outstanding) are reinsured, and no new or renewal business is included. Premium or loss portfolios, or both, may be reinsured. The term is sometimes applied to the reinsurance by one insurer of all business in force of another insurer retiring from an agency from a territory or from the insurance business entirely.

**Portfolio Return.** If the reinsurer is relieved of liability (under a pro rata reinsurance) for losses happening after termination of the treaty or at a later date, the total unearned premium reserve on business less unreinsured (less ceding commissions thereon) is normally returned to the cedant. Also known as a return portfolio or return of unearned premium.

**Portfolio Run-Off.** Continuing the reinsurance of a portfolio until all ceded premium is earned, or all losses are settled, or both. While a loss runoff is usually unlimited as to time, a premium run-off can be for a specified duration.

**Priority.** The term used in some reinsurance markets outside the U.S. to mean the retention of the primary company in a reinsurance agreement.

**Profit Commission.** A commission feature whereby the cedant is allowed a commission based on the reinsurer’s profitability under the reinsurance contract.

**Provisional Rate, Premium, or Commission.** Tentative amounts applicable to either rate, premium or commission set at the start of the contract and subject to subsequent adjustment.

**Rate.** The percent or factor applied to the ceding company’s subject premium to produce the reinsurance premium.

**Rate On Line.** A percentage derived by dividing reinsurance premium by reinsurance limit; the inverse is known as the payback or amortization period. For example, a \$10 million catastrophe cover with a premium of \$2 million would have a rate on line of 20 percent and a payback period of 5 years.

**Rating.** There are two basic approaches for pricing of reinsurance contracts usually applied to excess of loss reinsurance contracts: exposure rating and experience rating. Both methods can be used as separate rating approaches or may be weighted together to calculate the price for the contract.

**Prospective Rating (also known as Flat Rating).** A formula for calculation of reinsurance premium for a specified period where a fixed rate is promulgated using the ceding company's historical loss experience, actual or constructed, and the premium for the current period is calculated by multiplying the fixed rate by the current period ceded earned (or occasionally written) premium.

**Reciprocity.** A mutual exchange of reinsurance between two or more companies.

**Reinstatement Clause.** When the amount of reinsurance coverage provided under a contract is reduced by the payment of loss as the result of one occurrence, the reinsurance cover is automatically reinstated, sometimes subject to the payment of a specified reinstatement premium. Reinsurance contracts may provide for an unlimited number of reinstatements or for a specific number of reinstatements. See Reinstatement Premium.

**Reinstatement Cover.** A type of reinsurance that provides a ceding company all or a portion of the ceding company's contract or program limits that were eroded under a reinstatement clause in the original reinsurance agreement. The reinstatement cover is normally a separate agreement and the term usually incepts at the date of the last loss, running through the end of the original coverage period. Customarily, the reinstatement cover provides only a single limit and is not likely to include a reinstatement provision. For example, after the major windstorms of 2004 and 2005, ceding companies that sustained losses reinsured under their reinsurance contracts may have lacked sufficient reinsurance protection for the remainder of the year. In such an instance, those insurers might attempt to secure reinsurance to replace that no longer available under the original contracts.

**Reinstatement Premium.** An additional pro rata reinsurance premium that may be charged for reinstating the amount of reinsurance coverage reduced as the result of a reinsurance loss payment under a reinsurance contract. See Reinstatement Clause.

**Reinsurance.** The transaction whereby the assuming insurer in consideration of premium paid, agrees to indemnify the ceding company against all or part of the loss which the latter may sustain under the policy or policies which it has issued.

**Reinsurance Premium.** The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

**Reinsurer.** The insurer which assumes all or a part of the insurance or reinsurance risk written by another insurer.

**Reports and Remittances Clause.** The contract clause that specifies the types, timing and frequency of reports that are due to the reinsurer and usually outlines the format and content of the reports. Stipulates when adjustments and balances (if any) are due to either party.

**Reserve.** An amount which is established to provide for payment of a future obligation.

**Retention.** The amount of risk the ceding company keeps for its own account or the account of others.

**Retroactive Date.** The date on a claims-made policy or reinsurance contract which triggers the beginning period of coverage for occurrences commencing prior to the effective date of the policy. A retroactive date is not required. If one is shown on a claims-made policy, any claim made during the policy period on a loss that occurred before the retroactive date will not be covered. In reinsurance, losses occurring before the contract term are sometimes covered by the addition of “retroactive” coverage to the contract.

**Retrocede.** The action of a reinsurer of reinsuring with another reinsurer its liability assumed through the issuance of one or more reinsurance contracts to primary insurance companies or to other reinsurers. The reinsurer seeking protection may purchase a reinsurance contract or contracts that will indemnify it within certain parameters for certain described losses under that reinsurance contract or contracts. This action is described as transferring the risk or a part of the risk. The reinsurer seeking protection (the buyer) is called the retrocedent and the reinsurer providing the protection (the seller) is called the retrocessionaire.

**Retrospective Rating (also known as Self Rating, Swing Rating, and Loss Rating).** A formula for calculation of reinsurance premium for a specified period where a provisional rate is promulgated using the ceding company’s historical loss experience and is adjusted (subject to minimum and maximum) based on the current period actual loss experience. Premium for the current period is then calculated by multiplying the adjusted rate by the by the current period ceded earned premiums.

**Risk.** A term which defines uncertainty of loss, chance of loss, or the variance of actual from expected results as it relates to coverage provided under an insurance or reinsurance contract. Also, the term is used to identify the object of insurance protection, e.g., a building, an automobile, a human life, or exposure to liability. In reinsurance, each ceding company customarily makes its own rules for defining a risk.

**Risk Transfer.** A key element of reinsurance, whereby insurance risk is shifted from the reinsured to the reinsurer under a reinsurance agreement. In order for a reinsured to receive statutory and GAAP credit for reinsurance, a threshold of both underwriting risk and timing risk transfer must be achieved. See Risk.

**Run-Off.** A termination provision of a reinsurance contract that stipulates the reinsurer remains liable for loss as a result of occurrences taking place after the date of termination for reinsured policies in force at the date of termination until their expiration or for a specified time period.

**Salvage and Subrogation.** Those rights of the insured which, under the terms of the policy, automatically transfer to the insurer upon settlement of a loss. Salvage applies to any proceeds from the repaired, recovered, or scrapped property. Subrogation refers to the assignment of a contractual right of an insured or reinsured by terms of the policy or by law, after payment of a loss, of the rights of the insured to recover the amount of the loss from one legally liable for it. The ceding insurer and reinsurer can agree how subrogation rights and recoveries will be addressed and handled under the reinsurance agreement.

**Self-Insurance.** Setting aside of funds by an individual or organization to meet his or its losses, and to absorb fluctuations in the amount of loss, the losses being charged against the funds so set aside or accumulated.

**Service of Suit Clause.** A clause in reinsurance contracts whereby the reinsurer agrees to submit to any court of competent jurisdiction in the United States, which provides a legal basis for the enforcement of arbitration awards. The clause names a U.S. agent to accept service of process on behalf of the reinsurer for purposes of the ceding company gaining U.S. jurisdiction against the reinsurer. It is not intended to

supersede the contracting parties' obligation to arbitrate disputes, but to provide a mechanism to enforce awards.

**Severability Clause.** A clause in some reinsurance agreements, providing that should any part of the agreement be found illegal or otherwise unenforceable, the remainder of the agreement will continue in force while the illegal part will be severed from the agreement. Severability may apply to the entire agreement or be limited to a specific provision which may present enforceability issues.

For example, in jurisdictions where punitive damages are uninsurable, a severability clause in an Extra Contractual Obligations provision (or as a separate clause) will preserve the overall enforceability of the provision, even though a portion of the ECO provision has been invalidated.

**Sidecar.** A special purpose vehicle designed to allow investors to assume the risk and earn the profit on a group of insurance policies (a "book of business") written by a particular insurer or assumed by a particular reinsurer (collectively "re/insurer"). A re/insurer will usually only cede the premiums associated with a book of business to such an entity if the investors place sufficient funds in the vehicle to ensure that it can meet claims if they arise. Typically, the liability of investors is limited to these funds. The vehicle is often formed as an independent company and to provide additional capacity to the re/insurer to write property catastrophe business or other short tail lines. The original capacity is usually provided through a quota share or similar type arrangement. The re/insurer normally charges a fee (ceding commission) for originating and managing the sidecar business and may sometimes also receive a profit commission if the book of business is profitable. Because the investors' capital is usually intended to be invested in this vehicle for a short-term, the sidecar has a limited existence, often for only one year, after which investors may withdraw their investment. These structures have become quite prominent in the aftermath of Hurricane Katrina as a vehicle for re/insurers to add risk-bearing capacity, and for investors to participate in the potential profits resulting from sharp price increases in re/insurance.

**Sliding Scale Commission.** A commission adjustment on earned premiums whereby the actual commission varies inversely with the loss ratio, subject to a maximum and minimum.

**Special Acceptance.** The specific agreement by the reinsurer to include under a reinsurance contract a risk not included within the terms of the contract.

**Special Termination Clause.** A clause found in reinsurance contracts providing that, upon the happening of some specified condition or event, such as the insolvency, merger, loss in credit rating or decline in policyholder surplus of one party, the other party can fully terminate the contract earlier than would otherwise be required, had such condition or event not happened. The clause should state which party may initiate the termination, the notice requirements, the triggering conditions or events necessary, the effective date of termination, and the method of terminating existing business (i.e., whether on a cut-off or run-off basis).

**Spread Loss.** A form of reinsurance under which premiums are paid during good years to build up a fund from which losses are recovered in bad years. This reinsurance has the effect of stabilizing a *cedant's loss ratio* over an extended period of time.

**Standard Premium.** The insurance premium determined on the basis of the insurer's authorized rates multiplied by the experience modification factor. The standard premium is usually not the final premium that

the insured pays. It excludes the effects of some pricing programs, such as premium discounts, schedule rating, deductible credits, retrospective rating, and expense constants that are reported in statistical classes.

**Stop Loss.** A form of reinsurance under which the *reinsurer* pays some or all of a *cedant's* aggregate retained losses in excess of a predetermined dollar amount or in excess of a percentage of premium.

**Structured Settlements.** The settlement of a casualty or workers' compensation claim involving periodic annuity payments over an extended period of time, rather than in one up-front, lump sum cash payment. There are certain advantages to a claimant under a structured settlement, including favorable tax treatment of interest under the Internal Revenue Code, that are not present under a lump sum cash settlement. Structured settlements are designed to guard against the early dissipation of settlement proceeds by recipients, who are often minors or those in need of lifetime care as a result of their injuries.

**Sunrise Clause.** A clause in casualty reinsurance contracts that provides coverage for losses reported to the reinsurer during the term of the current reinsurance contract but resulting from occurrences that took place during a prior period. Sunrise clauses are used to reactivate coverage that no longer exists due to the existence of a sunset clause. See Sunset Clause.

**Sunset Clause.** A clause in casualty reinsurance contracts that provides that the reinsurer will not be liable for any loss that is not reported to the reinsurer within a specified period of time after the expiration of the reinsurance contract. See Sunrise Clause.

**Surplus Reinsurance (also known as Surplus Share Reinsurance or Variable Quota Share Reinsurance).** A form of pro rata reinsurance under which the ceding company cedes that portion of its liability on a given risk which is greater than the portion of risk the cedant retains (i.e., net line), and the premiums and losses are shared in the same proportion as the ceded amount bears to the total limit insured on each risk.

**Target Risk.** In property reinsurance certain risks (for example, particular bridges, tunnels, fine arts collections, and property of similarly high value and exposure) that are excluded from coverage under reinsurance treaties. Such risks require individual acceptance under facultative contracts.

**Term Contract.** A form of reinsurance contract written for a stipulated term (usually one year). The contract automatically expires at the end of the term and renewal must be negotiated.

**Total Insurable Value (TIV).** The total values for insured perils and coverages for a particular risk, whether or not insurance limits have been purchased to that amount.

**Total Insured Value Clause.** An exclusion that prevents a reinsurer's over-lining on a single large risk (usually excess of \$250 million) caused by a potential accumulation of property limits from two or more ceding companies. The customary exception to the exclusion applies to risks insured 100 percent by one insurer or specifically listed classes (such as apartments, offices, hotels, hospitals, etc.).

**Treaty.** A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume risks of a particular class or classes of business.

**Trust Agreements.** An agreement establishing a trust arrangement, which may be utilized as a mechanism by the reinsurer for purposes of securing its obligations to the ceding company to satisfy securitization requirements that might apply to the reinsurer under the terms of a reinsurance agreement.

Under the trust arrangement, a legal entity is created by a grantor (usually the reinsurer) for the benefit of a designated beneficiary (usually the ceding company). The trustee (generally a financial institution) holds a fiduciary responsibility to handle the trust's corpus assets and income for the economic benefit of the beneficiary, in accordance with the terms of the trust. In the event that the reinsurer defaults in its payment obligations to the ceding company under the terms of the reinsurance agreement, the trustee may release funds from the corpus of the trust to satisfy such obligations to the ceding company, in accordance with the terms of the trust. In reinsurance, such an agreement is typically established to permit a licensed ceding company to take credit for non-admitted reinsurance up to the value of the assets in the trust.

**Ultimate Net Loss.** 1) In reinsurance, the measure of loss to which the reinsurance applies, as determined by the reinsurance agreement. 2) In liability insurance, the amount actually paid or payable for the settlement of claims for which the reinsured is liable (including or excluding defense costs) after deductions are made for recoveries and certain specified reinsurance.

**Unauthorized Reinsurance.** Reinsurance placed with a reinsurer that does not have authorized or equivalent status in the jurisdiction in question.

**Unearned Premium Portfolio.** The sum of all unearned premium for in force policies of insurance under the reinsurance agreement, often with respect to a particular block, book or class of business during a particular period.

**Unearned Premium Portfolio Rollover.** A term describing an accounting transaction in which an unearned premium portfolio is carried forward from one accounting period to the following accounting period under an existing contract or a renewal.

**Unearned Premium Reserve.** The reserve amount included in the company's financial statements for unearned premiums with respect to the insurance policies or reinsurance agreements as of a particular point in time. Unearned premiums are the sum of all the premiums representing the unexpired portions of the policies or reinsurance agreements which the insurer or reinsurer has on its books as of a certain date.

**Underlying.** The amount of insurance or reinsurance on a risk (or occurrence) which applies to a loss before the next higher excess layer of insurance or reinsurance attaches.

**Underwriting Capacity.** The maximum amount of money an insurer or reinsurer is willing to risk in a single loss event on a single risk or in a given period. The limit of capacity for an insurer or reinsurer that may also be imposed by law or regulatory authority.

**Underwriting Year.** The effective date of the original policy, rather than the date of loss, determines the basis of attachment. Any losses occurring on policies written or renewed with inception or renewal dates during the term of the given reinsurance agreement will be covered by that reinsurance agreement irrespective when the loss actually occurred. This mechanism is often used with "the policies attaching" methodology.

**Unearned Reinsurance Premium.** That part of the reinsurance premium applicable to the unexpired portion of the policies reinsured.

**Working Cover.** A contract covering an amount of excess reinsurance in which loss frequency is anticipated.