Limiting loss at your doorstep

The role of reinsurance in the insurance industry and how it affects your business **Interviewed by Elizabeth Grace Saunders**

Insurance is all about risk management and limiting loss. So how do insurance companies limit the risk within their own businesses? The answer is reinsurance — insurance for insurance companies.

"Policyholders transfer their financial risk to their insurance company," says Tom Hudock, risk manager with Westfield Insurance. "The company retains some of that risk and transfers, or cedes, the remainder to other insurance companies called reinsurers. Reinsurance is primarily insurance for an insurance company. Large self-insured businesses can also purchase reinsurance to reduce their risk."

Smart Business discussed with Hudock the purpose and the impact of reinsurance in the insurance industry.

Tom Hudock, CPCU, ARM, ARe
Risk manager
Westfield Insurance

Why do insurance companies purchase reinsurance?

When an insurance company issues a policy, it promises to pay for future claims that may occur. In order to deliver on these promises, an insurer must remain financially sound. Reinsurance preserves policyholders' surplus (retained earnings).

There are three main reasons why insurance companies purchase reinsurance: capacity, stability and catastrophe protection.

- Periodically, an insurer will purchase reinsurance on a single large risk, e.g. a $50 million building. This is called facultative reinsurance. It provides the insurer with the capacity to insure a risk that might otherwise be declined.

- Treaty reinsurance is another type of reinsurance that insurance companies buy to stabilize their underwriting results for their portfolio of risks. Loss experience varies from year to year, and reinsurance helps smooth earnings.

- Insurance companies are exposed to very large losses from catastrophes, like hurricanes and earthquakes, which could result in bankruptcy. To protect its policyholders' surplus, an insurer will purchase catastrophe reinsurance that limits its loss from a single event to a predetermined amount.

How does reinsurance work?

The insurance company provides the reinsurer with loss exposure data, claims experience and the amount of risk that the insurer wishes to retain. The reinsurer then determines the reinsurance premium. A portion of the premium that is collected from the policyholder is ceded to the reinsurer in payment for the risk assumed by the reinsurer.

For example, the insurer may retain the first $1 million of loss and the reinsurer(s) may agree to pay the next $4 million. If a policyholder were to incur a $5 million loss, the insurer would pay its policyholder $5 million, and then be reimbursed $4 million by the reinsurer.

How does reinsurance affect business insurance policyholders?

Depending upon the size, location and type of risk to be insured, a business may have difficulty finding affordable insurance due to the availability and/or the cost of reinsurance. Smaller insurance companies depend more on reinsurance than the large national insurance companies. In some cases, even the largest insurer may not be willing to offer insurance due to the lack of reinsurance.

For example, a business occupying the Sears Tower in Chicago may not be able to buy terrorism insurance because reinsurance for a terrorist event is not available.

How is reinsurance related to industry cycles?

The reinsurance industry also goes through hard and soft markets. In the two years following the World Trade Center attacks in 2001, total losses — including from hurricanes and other long-tail liabilities — exceeded $50 billion, and capital losses from the global fall in equity values exceeded $180 billion. This created a hard market for reinsurance in which demand for reinsurance exceeded supply, causing premiums to rise. This contributed to the hardening of the primary insurance market.

Due to the increase in reinsurance rates, and because 2006 was a very profitable year for reinsurers due to a mild hurricane season, there are signs that the reinsurance market may be softening. This will ease pressure on primary insurers' pricing.

What else should businesses know about reinsurance and industry cycles?

Most reinsurers write business worldwide, while most U.S. insurers only write business in the United States. The U.S. insurance and reinsurance cycles are linked together but do not move perfectly in sync. Softness in reinsurance pricing contributes to the depth and length of the soft market for primary insurers. Usually, the market does not begin to harden until reinsurer pricing rises.

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