



Southwestern Insurance Information Service

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Fact Sheet

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Reinsurance-A Stalwart Partner for Insurers and Consumers

Simply stated, reinsurance is insurance for insurance companies. Many people are unfamiliar with this aspect of the insurance industry.

There are many reasons a primary insurance company would purchase reinsurance. One of the most common is to limit their liability beyond a certain dollar amount, at which point the reinsurer steps in and pays. Another reason is to help pay claims following catastrophes such as hurricanes and other weather and man-made disastrous events. Additionally, an insurer may wish to increase the financial capacity of their company, thereby allowing them to offer higher limits to their customers, considerably higher than they could provide otherwise.

Reinsurance helps protect the solvency of an insurer and frees capital which allows a company to write more business, compete actively in the marketplace and provide the protection consumers expect.

Some reinsurers offer insurance companies added services such as assistance in underwriting risks, financial reserving for future claims and investment strategies. These services will vary from reinsurer to reinsurer.

The fundamental principle of reinsurance is that a transfer of risk must take place. Under some reinsurance arrangements, a reinsurer may agree to participate financially in one or more of the risks to varying degrees.

Insurance companies purchase reinsurance from several different sources. There are reinsurers domiciled in the U. S. as well as foreign companies conducting business from the United Kingdom, Europe, Bermuda and a host of other countries around the world.

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There are a number of different reinsurance contracts available to help insurers meet their desired goal.

Reinsurers may also transfer a portion of the risk to another reinsurer in a transaction known as retrocession. In other words, retrocession is insurance for reinsurance companies. The reinsurance company that reinsures the risk by another reinsurance company through retrocession is known as a retrocessionaire.

The cost of reinsurance varies in direct relationship to the risk assumed by the reinsurer. The greater the potential for a financial loss, the more expensive reinsurance will be to the insurer. Reinsurers use numerous sophisticated tools to determine the probability of a loss. Among those tools are catastrophe models which predict potential losses of a primary insurer based on historical data and the financial condition of the primary insurer.

Catastrophe modeling is a computer-based technological tool insurers and reinsurers use to help them assess potential losses resulting from weather and man-made disasters. Most major disasters are modeled including hurricanes, earthquakes, tornadoes, hail storms, severe winter weather and flooding. CAT modeling, as it is commonly referred to, requires the expertise of many disciplines including meteorologists, seismologists, geologists, engineers, statisticians, mathematicians and actuaries.

These models include historical data as well as current demographic information such as rising building and material costs after a storm as well as financial information necessary to accurately predict the effect disasters will have on the monetary resources of insurers and reinsurers in meeting the financial obligation of claims associated with the event.

CAT modeling is only one of many tools the insurance industry uses as they prepared to meet the responsibilities they have to their customers when disaster strikes.

During the year 2005, the U. S. sustained record hurricane losses (Katrina, Wilma and Rita) and the global reinsurance market paid 61 percent of the \$72.7 billion in losses. In the aftermath of the unprecedented hurricane losses in 2005, there was an increase in the cost of reinsurance. Additionally, several factors external to the reinsurance market affected the cost. Demand increased in some peak zones at a greater rate than the supply increased due to: rating agencies requiring more capital of

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insurers and reinsurers to support catastrophe risk; catastrophe risk modeling firms increasing loss predictions; and insurance company managements desiring to purchase more protection.

The amounts paid by insurers for reinsurance increased significantly in areas exposed to hurricanes caused by the combination of the amount purchased and the ensuing demand-driven increase in the price of windstorm catastrophe reinsurance. The capital markets responded to this demand, supplying in excess of \$40 billion in new capital for catastrophe products, ending that cycle of demand-driven reinsurance pricing by mid-year 2007.

Some of the new reinsurance capital during 2005-2006 came in the form of catastrophe bonds. Cat bonds are designed to provide protection to an insurer or reinsurer when a loss occurs. Currently, there are a variety of cat bond products with various formulas to account for the severity and location of a catastrophe that permit investors to expose principal or expected interest earnings to a catastrophic loss.

Another new financial product is a Side-car arrangement. A Side-car is essentially a special purpose reinsurance company that characteristically only insures one insurance or reinsurance company. They are typically owned by capital market investors, such as a group of equity investors or a hedge fund. The agreement between the Side-car and the reinsurer tends to be short term and usually provides for a one or two year commitment, but may be renewed at the discretion of the parties.

By January 2008 renewals, brokers reported supply exceeded demand, competition was working and, on average, U.S. national rates went down by 10 percent and U.S. regional programs were down by 12 percent. Mid-year 2008 broker reports showed a continuation, and in some markets, acceleration of the 10 to 15 percent pricing decreases in catastrophe reinsurance.

The cumulative impact of the catastrophes in 2008 and asset losses due to the near collapse of the financial market, however, was substantial. (The total for 2008 U.S. catastrophe losses was \$25.2 billion compared with \$6.7 billion in 2007.)

Early reports indicate that reinsurance prices for catastrophe exposed property did increase for the January 2009 renewals as a result of the 2008 catastrophes and the onset of the economic crisis. Broker reports note the impact on reinsurers of the financial and credit crisis and the 2008 hurricanes means reinsurers entered 2009 with 15 to 20 percent less economic capital than in 2008.

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Broker reports also state that “despite the magnitude of catastrophes and financial losses, the 8 percent (global) increase in property pricing was substantially lower than the increases that followed disasters such as Hurricane Andrew in 1992, the terror attacks of September 11, 2001, and Hurricanes Katrina, Rita, and Wilma in 2005. For the United States, rates rose on average by 11 percent, but there were wide variations dependent upon loss experience and zone.”

Reinsurance plays a significant role in the U. S. insurance market and around the world. Reinsurers wrote about \$168.0 billion in premiums in 2007, according to the latest data available.

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