The institute of finance management

Business, Risk Management

THE INSTITUTE OF FINANCE MANAGEMENT FACULTY OF INSURANCE AND SOCIAL SECURITY POSTGRADUATE DIPLOMA IN INSURANCE AND RISK MANAGEMENT (PART TIME) CC 400 D; RESEARCH METHODOLOGY GROUP ASSIGNMENT The Role of Insurance, co — insurance and reinsurance to the society PARTICIPANTS 1. ALICE NEEMA J SARIA IRM- PT/11/49901 2. SUSAN MASOY IRM- PT/11/49915 3. FLORENCE SEBUYOYA IRM- PT/11/49885 4. MGHOSI ERICK SHAO IRM- PT/11/59903 5. EVELYNE R MUHETO IRM- PT/11/48379 1) A. INTRODUCTION This assignment is presented to address the role of insurance, re-insurance and co-insurance in a society. It is organized in a topical format so as to exploit and appreciate in detail the role that each of the three concept plays in a social and economic development of the society. We will start by exploring the role of the insurance in general, followed by reinsurance and finally we will analyze the role of coinsurance. We will give concluding remarks in each on each of the subsection. B. INSURANCE C. RE - INSURANCE: Re — Insurance: The Concept Reinsurance is a financial transaction by which risk is transferred (ceded) from an insurance company (cedant) to a reinsurance company (reinsurer) in exchange of a payment (reinsurance premium). Providers of reinsurance are professional reinsurers which are entities exclusively dedicated to the activity of reinsurance. Also in most jurisdictions insurance companies are allowed to participate in reinsurance. The terms of a reinsurance transaction are defined in a reinsurance treaty. Due to the complexity of reinsurance treaties it is not uncommon that the definitive treaties are only signed months after the risk transfer took place. To document the acceptance of the risk, a short version of a treaty call a slip containing the most important terms of the

agreement is used instead. Slips are signed before the risk is transferred and accepted by the reinsurer. Some jurisdictions are requiring signed treaties before the risk is transferred. Reinsurance transactions or agreements arise when an original Insurer decides that it has more Insurance risks than it wishes to retain in its portfolio and then transfers a portfolio of its risks to other Insurance Companies. Reinsurance is one of the tools used to manage risk by insurance companies. Unlike insurance which protects individuals and non insurance corporate firm from financial loss, reinsurance protects the insurance company from financial loss. It offers an insurance company protection by spreading risk among several insurance companies in a pool that agrees to back the policies sold by the company. This enables an insurance company to cover more individuals without fear of incurring significant financial loss should a disaster occur, resulting in multiple policyholders filing claims at one time. Reinsurers can also transfer risks to other entities called retrocessionaires, by means of a financial transaction similar to reinsurance called retrocession. Professional retrocessionaires are expected to keep and not to transfer the assumed risk to other entities. In this manner reinsurers and insurers that do accept risks not individually identified can be sure that they will never assume part of the risk they had already transferred. Types of Reinsurance Agreements Reinsurance contracts can either take a form of automatic treaty or facultative. Below is a brief description of each: 1. Treaty reinsurance 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. Treaty reinsurance allows the cedant to act in an independent

and fast reacting way when accepting risks that fall under the object of the reinsurance agreement. In treaty reinsurance the acceptance of the risk by the reinsurer together with all financial conditions has already been negotiated and agreed upon. This characteristic of treaty reinsurance to offer " blind acceptance" of the risks to the cedant requires that the reinsurer know and trust the cedant. Treaty reinsurance is therefore only offered after the reinsurer has done proper due diligence on the insurance company to determine the quality of the business that would expect to reinsure. The important aspects that a reinsurer will pay attention includes, the expertise of the company, its risk attitude, its track record, the expected amount of business to be reinsured and administrative processes to name a few. Further, on a regular basis the reinsurer will audit the cedant to ensure that the terms of the treaty are being followed. 2. Facultative reinsurance 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. Insurance companies are offered from time to time the opportunity to insure risks that are very large or complex or simply unusual. In these situations facultative reinsurance is the best suited in managing risk. Here the reinsurer participates in the underwriting and assessment of the risk. Depending on the risk the reinsurer might or might not accept the reinsurance. In case of acceptance the reinsurer will provide the particular terms, like premium, exclusions, and so forth. The already negotiated facultative treaty will govern all other general terms of the agreement. The Need for Reinsurance in Insurance Market Managing of risks for insurance underwriters forms a very important role in ensuring prosperity of the

insurance market. As highlighted earlier, reinsurance is a tool for managing risks for insurance company. However several benefits are derived from this process. Below we discuss some of the basic ones. a) Increasing Underwriting Capacity - Insurance companies are often offered risks that may surpass their financial strength. Ceding part of the risk may allow them to accept the full risk thus satisfying client’s needs. For this purpose insurance companies may also use coinsurance. However in this case the insurance company will have to contact competitors to share part of the risk which might not be to its best interest, especially in a competitive market. Another disadvantage to the use of coinsurance is the burden put on the insured that will need to deal with a number of the participating insurance companies with regard to premium payments and claim settlements. b) Risk Capital Improvement And Diversification - Insurance companies having a more diversified portfolio of risks will tend to have more stable financial results. Using reinsurance will allow insurance companies to participate in a diversity of risks using the same working capital by ceding part of the risk and keeping a smaller portion of each risk. c) Surplus Relief - The use of reinsurance allows insurance companies to partially transfer risks off their balance sheet. While the ultimate responsibility to the policy holders still remains with the insurance company, most jurisdictions recognize reinsurance as a risk managing tool that allows a reduction of statutory surplus requirements. The guarantee implicit on a reinsurance contract to pay the reinsured claims is recognized in the capital requirements for the cedant. Hence it is not uncommon to base the prudential requirements on the insured premium net of reinsurance. Reinsurance thus removes a

technical risk but it introduces a counterparty risk since, as mentioned above, the ultimate responsibility to the policy holders still remains with the insurance company. To offset the counterparty risk additional surplus is usually required. This additional capital will vary depending on the solvency rating of the reinsurer. Also the amount of surplus relief granted will depend on that rating. d) Catastrophic Protection - Well run insurance companies accept risk exposure according to their financial strength. However, the risks may also be exposed to extreme infrequent events, like earthquakes, floods, plane crashes and other major catastrophic events. Holding enough capital for those extreme events would make the insurance operation economically unviable or at least very expensive. Transferring this exposure to catastrophic events to the reinsurers is a more effective way to address very infrequent events. Reinsures offer catastrophic protection in a more economic feasible way than insurance companies by participating in catastrophic exposures throughout the world and thus geographically better diversifying the risk. Usually reinsurers are also more capitalized than insurance companies. They also operate dedicated departments that have gained substantial knowledge of the physical characteristics and history of catastrophic events thus allowing them to price and underwrite properly the exposure and accept those risks. e) Expertise transfer - Through the reinsurance activity reinsurers acting in several markets with different insurance companies have the ability to acquire significant knowledge of the different products, markets and insurance techniques like underwriting, administration of the policies and claims assessment. This is particularly important when entering a new market, a new line of business or simply

launching a new product. Transferring the risk through reinsurance may also include the shift of the underwriting, administration, or other activity related to the risk transferred to the reinsurer. Such a reinsurance agreement allows insurers to focus in their core business outsourcing to experts the non core activities. f) Financing New Business — A fast growing insurance activity can require upfront financing. This is particularly true in the case of Life Insurance business. Here the insurance company has to finance the agents or broker’s commissions that can be as high as the full first year’s premium as well as the underwriting costs that may include medical examinations and financial assessments. Reinsuring part of the business can provide a source of financing especially if the reinsurer agrees to advance the future expected profits of the business in the form of reinsurance commission. This source of financing of insurance business can be attractive compared to other sources such as bank loans or equity. g) Community Benefit - Financing New Business — Depending on country’s jurisdiction, reinsurance sent outside the country is often subject to excise tax, usually from 1% to 3% of reinsurance premiums. Tax treaties between countries sometimes address the issue of excise tax and in some cases exemptions are granted. For example there is no US excise tax on reinsurance treaties with the UK. Though the tax might deter the growth of re-insurance business (if set to high), if appropriately set it may encourage flourishing and growth of insurance industry in a country, whilst at the same time becomes a source of revenue that will be used for country’s economic development. On the same note, treatments of withholding tax on dividends paid by reinsurance companies to their parents may work for against insurance industry growth whilst creating revenue for

economic development. As a concluding remark on reinsurance, we would like to note that, Insurance companies enter reinsurance agreements for one or more of the above mentioned reasons. There might be other special situations where reinsurance is used as a valid financial and operational tool, however if none of the above mentioned needs is present, special scrutiny of the transaction is required. The great flexibility of reinsurance treaties that allows effective tailor-made solutions to meet individual insurance company's needs has been abused in the past to design tax avoidance, money laundry and other illegal activities. A reinsurance agreement that does not transfer any type of risk is always questionable. D. CO-INSURANCE Coinsurance: The Concept Co-insurance refers to joint assumption of risk and the term is used in analogous forms depending on the environment in which it is being used at. There are two basic co insurance approaches, these are Risk Sharing between the insurer and the insured and the second approach is Joint Assumption of Risks Between Various Insurers. Reinsurance is to be differentiated from coinsurance, where the risk is shared and not transferred among several insurance companies, each one of them having a direct contractual relationship with the insured for the portion of the risk accepted by that company. Thus, reinsurance always involves legal entities and not individuals. In reinsurance, the contractual relationship is between the cedant and the reinsurer. Only in special situations does the reinsurance treaty have a provision called the cut through clause that allows the insured to have a direct legal claim to the reinsurer; for example in case the insurer becomes insolvent. The concept is understood differently in different insurance markets. For example in North America it is generally used to refer

to an agreement between the insured and the insurer to share in the settlements of any covered losses in proportion agreed upon in advance. On the other hand such internationally and especially for countries in Europe and Africa, co insurance is referred as a risk-spreading procedure whereby the insured risk is distributed among two or more insurance companies each bearing a proportional share of the risk on the insured. Below we highlight in detail these approaches of co-insurance with special emphasis in International market perspective. 1. Risk Sharing Between the Insurer and the insured This may take a number of forms as described below: * Health Insurance In Health insurance coinsurance refer to an assumption of risk between the insurer and the insured. It is sometimes used synonymously with copayment, in which risk share agreement between the insurer and insured is kept in place. It might be necessary to differentiate the copayment with coinsurance in order to eliminate any confusion that may arise thereto. The copayment is a payment defined in the insurance policy and paid by the insured each time a medical service is utilized. Copayment is a form of coinsurance but It must be paid before any policy benefit is payable by an insurance company. On the other hand, coinsurance as referred in health insurance is a percentage payment after the deductible reach a certain limit. It is normally instituted for expensive non clinical procedures such as dental care and/or optometrists' procedures. Insurance companies use coinsurance to share health care costs to prevent moral hazard. Though the coinsurances are often a small portion of the actual cost of the medical service, it is meant to prevent people from seeking medical care that may not be necessary (e. g. an infection by the common cold). The underlying philosophy is that with

no coinsurance payments, the insured will consume more on unnecessary health service than they would necessary need. However, coinsurance and copayments in health insurance may also discourage people from seeking necessary medical care. Higher proportions of these payments may result in non-use of essential medical services, thus rendering someone who is insured effectively uninsured due to inability to pay. Thus there is a balance to be achieved, a high enough to deter unneeded expenses but low enough not to render the insurance useless. * Property Insurance In Property insurance coinsurance refers to the penalty imposed on the insured by the insurance company for under-reporting/declaring/insuring the value of tangible property. The penalty is based on a percentage stated within the policy and the amount under reported. This shall be better explained by use of an example: * A building actually valued at TZS 100 Million has an 80% coinsurance clause but is insured for only TZS 75 Million. Since its insured value is less than 80% of its actual value, when it suffers a loss, the insurance payout will be subject to the underreporting penalty. * For example: if it suffers a TZS 20 Million loss. The insured would recover only $75, 000 Ã· (80% Ã— 100 Million Ã— 20, 000 = $18, 750 (less any deductible as per policy). The underlying motivation for this clause is to deter the insured from underinsuring and hence a share of the loss once a peril happens. One of the benefits of this approach is increased transparency in insuring assets as well as growth of the insurance sector in as far as pooling of risks is concerned. * In other form of insurances In some cases, including employer's liability insurance, motor and title insurances coinsurance percent denotes a function analogous to the copayment function that it has

in health insurance, where the insured covers a certain percentage of the losses up to a certain level. 2. Joint Assumption of Risks Between Various Insurers In this context, a joint assumption of risk is undertaken by two or more insurers based on the number of criteria such as: * Magnitude of the risk covered. Too large complex projects are associated with a number of risk that may limit a single insurer assuming all the risk based on their capital adequacy * Country regulation in as far as the magnitude of risk that a single insurer can underwrite * Customer preference and perception to risk and hence request to spread risk in order to avoid overconcentration. * Perceived risk of the cover in the eyes of the underwriting insurance firm * Risk appetite of the participating insurance companies based on their existing portfolio * Potential for spreading loss in eventuality that an actual loss occurs a potential of a loss that it may incur in the eventuality that any actual loss. The joint assumption of risk may take either of the following forms: a) Syndication Only one insurer issues the policy to the insured and calls upon all other coinsurers to subscribe to that policy with their respective share or the policy is endorsed by coinsurance clause listing all participating coinsurers and their respective shares depending on their market practice. The issuing insurer is appointed as a lead insurer or lead underwriter. The leading insurance company will be responsible for administering various aspects of the insurance policy, such as premium, any claims and the insurance documents. The lead insurer will thus charge a levy for arrangement termed as Lead Office commission. To take advantage of this type of arrangement the lead insurer has to be authorized by the other coinsurers to act on their behalf. This authority needs to be in legal form

defining rights obligation and responsibility of all participating coinsurers. The main motivation and advantage for this approach is that the insured will deal only with the lead underwriter and hence reduce the arrangement time as well as well as reduced arrangement costs. b) Separate obligation between insurers Some customers may require two or more title companies to issue policies together, where each policy is issued to the Insured for a defined portion of sum insured. Each policy will contain a provision, by exception or by endorsement, that the policy liability is limited to the same percentage of any particular loss. Motivation for Customers to prefer this mode of coinsurance would include but not limited to: * An advantage of having insurance assessment of risk from different risk surveyors. However, it is usually more costly and usually results in more difficult underwriting due to inconsistent underwriting and exception forms. * Another advantage is sighted to be a hedge against the risk that its primary insurer may go into receivership before a claim is made on the policy. However this is invalidated by existence of Reinsurance Agreements. * An advantage to the participating insurance company is sighted to be an opportunity to limit their obligations in eventuality of a loss, since coinsuring companies do not have an obligation to pay any claim beyond the limited percentage. However since there is no legal relationship between the coinsurers, the insured may be faced with administrative burden as well as the need to proceed separately against each coinsurer in the event coinsurer in the event of loss or claim. Effects of Coinsurance in Insurance Market The spreading of risk by coinsurance has certain advantages and disadvantages for the market participants. Some of the benefits are considered to be cost on the other part and hence there is

no clear cut position to argue on advantageous state or non advantageous state. Below we consider some of them in very high level. * In syndication, lead insurers are in a position to decide upon the lead share, maintain the relationship and control the amount of information passed on the other coinsurers. This may result in unfair competition in the market and hence stagnate the market growth * Lead insurers stands a chance to win reciprocity of business and hence act as a barrier for follow coinsurer access to business * Coinsurance may allow competitors to access lead insurer business by which the lead insurer may lose a competitive advantage from sharing risk information and underwriting expertise * Lesser security of other coinsures dilutes the ability to sell financial strength and control of the relationship is surrender to the lead underwriter. This is a considered as a cost in growth of insurance industry in an economy. * Follow coinsurers have access to additional business with relatively little investment. In a period of time, acquisition costs are significantly reduced and facultative markets may be avoided. This might be an advantage to the follow coinsurer, but it may act against reinsurance companies due to loss of business * Lead insurers can also decide to offer capacity within its own risk appetite parameters and as such limit the gross exposure to avoid facultative market or to avoid the additional efforts to generate 100% of the capacity. This again is considers as a disadvantage as it limits the market from exploring 100% of the potential and hence loss of revenue to a number of stakeholders including the brokerages, other insurance and reinsurance companies as well as exposing the insured to a potential uncovered loss in the eventuality of risk or loss event. * Follow coinsurers usually have limited underwriting

information, thus exposed to the risk that the composition of their portfolio is adversely affected and might result in insolvency in the event that an actual loss transpires and needs to be settled * There is a danger that the follow role may lead to undesirable consequences such as deterioration of underwriting expertise and limited claims control * Over time a follow insurer may find it difficult to develop a market profile or area of specialization which is a necessary component for creating and sustain client relationships. * In a market where brokers undertake the underwriting roles, coinsurance agreements may give them significant advantage as they will be controlling the distribution channel. This gives them a considerable control on pricing, terms and conditions. * Coinsurance agreements increases competition in the market and hence push down the prices. In this regards insurers may conclude a coinsurance agreement at insufficient rate levels. This movement may be counterproductive to the economic recovery of the market and long term solvency of insurers. * In health Insurance, coinsurance for managing moral risk and thus considered as a useful tool in ensuring the insurance industry is not abused * In other forms of insurance such as property or motor, the aspect of coinsurance instill discipline on discloser and ensure the market potential is exploited to the highest levels. All these effects are necessary and need to be considered when assessing the impact of coinsurance in an economy. Prudent analysis and evaluation of the modality should be the basis for a decision for or against coinsurance and ruthless application of the basics should form an underlying foundation for flourishing insurance industry in an economy and hence economic development.