Ceding Company Considerations

CARE

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Key Considerations

- Maintain or Raise Rating
- Protect against Capital Impairment Events
- Smooth Losses to Protect Income Volatility
- Gain Key Knowledge on New Lines/Ventures
- Increase Capacity to Write Business
- Collectability of Reinsurance
- Advantageous Commutation

Rating

- BCAR = Adj. Capital/Best's Req. Capital
  - Reinsurance lowers the Best's Req. Capital by exchanging underwriting risk for credit risk. Since credit risk has a much lower charge, overall RBC decreases
    - Quota share cedes more premium and thus larger impact
  - Cat reinsurance lowers the 1:100 wind and 1:250 earthquake events, which are a direct subtraction from Adjusted Capital
    - 2nd event impact evaluated, especially if Gross/Net is large

BCAR Ratio Before Reins

	Umbrella	Auto	GL	Total
Premiums	50,000,000	200,000,000	100,000,000	350,000,000
Disc Reserves	150,000,000	400,000,000	250,000,000	800,000,000
Reins Prem	-	-	-	-
Disc Loss Ratio	40.0%	60.0%	55.0%	55.7%
Disc Comb Ratio	70.0%	90.0%	85.0%	85.7%
Expected Profit	15,000,000	20,000,000	15,000,000	50,000,000
Adjusted Surplus				500,000,000
ROE				**13.5%**
BCAR Factors				
Prem	40.0%	29.0%	37.0%	115,000,000
Reserves	50.0%	38.0%	45.0%	339,500,000
Recoverables	10.0%	10.0%	10.0%	-
Net Req Capital				454,500,000
BCAR				**110.0%**
Rating				**B+**

BCAR Ratio After 50% QS

	Umbrella	Auto	GL	Total
Premiums	50,000,000	200,000,000	100,000,000	350,000,000
Disc Reserves	150,000,000	400,000,000	250,000,000	800,000,000
Reins Prem	25,000,000	100,000,000	50,000,000	175,000,000
Disc Loss Ratio	40.0%	60.0%	55.0%	55.7%
Disc Comb Ratio	70.0%	90.0%	85.0%	85.7%
Expected Profit	7,500,000	10,000,000	7,500,000	25,000,000
Adjusted Surplus				**347,425,000**
ROE				**10.7%**
BCAR Factors				
Prem	40.0%	29.0%	37.0%	57,500,000
Reserves	50.0%	38.0%	45.0%	169,750,000
Recoverables	10.0%	10.0%	10.0%	40,000,000
Net Req Capital				267,250,000
BCAR				**130.0%**
Rating				**A-**

Rating

- BCAR = Adj. Capital/Best's Req. Capital
  - Reinsurance write-offs important since they can increase the charge % for other reinsurance recoverables
  - High reliance on reinsurance can also elevate the charge for credit risk
  - Date integrity of cat modeling key evaluation point
  - Basis risk on cat derivatives lowers reinsurance credit (indemnity bonds get full credit)

Capital Impairment

- Catastrophic Events
  - Cat Events that would impair capital
    - "Impairment" self-defined by insurer (ability to raise capital/issue debt, a ratings downgrade that would affect business, etc.)
  - Natural Cats – hurricane, earthquake, flood, tornado, winter storm
  - Man Made Cats – terrorism, CBRN
  - Not just property, e.g. Workers Compensation, D&O, E&O

Capital Impairment

- Models are crucial
  - Used for Property Catastrophe, Worker's Compensation, Terrorism
  - Brokers often provide modeling services
  - Advantage to modeling in-house for larger companies
    - Portfolio selection maximization
    - Real time modeling of exposure changes (e.g. acquisitions)
    - Incorporation into ERM modeling
    - Ongoing assessment of reinsurance protection

Capital Impairment

- Access to Capital
  - Direct and Broker Market Reinsurers
  - Capital Markets (equity, debt)
  - Cat Bonds, Sidecars, Swaps – provides hedge when Reinsurance Market capacity crunch
    - Reinsurance accounting not allowed for non-indemnity
    - Lower credit risk (recent default of credit swap counterparty challenges this belief)

Income Smoothing

- Generally excess of loss for large limits
  - Property (Property Cat and Per Risk)
  - Lead and Excess Umbrella books
  - Any business that offers very high limits (Energy, Aviation, Marine, etc.)
- Important for publicly traded companies
- Important for companies that issue debt
- SBU income smoothing - often done through internal reinsurance for larger companies

New Ventures

- Generally Quota Share evolving to Excess of Loss as book matures
  - Equal alignment at inception (same “skin” in the game)
  - When book is stable reinsurers comfortable with different alignment, cedent keeps more profit
- Reinsurer often provides knowledge of new business
  - E.G. Auto unit rates and GL layer factors for Umbrella books

Capacity to Write Business

- Small insurers need increased capacity via quota share
- Certain markets require large lines (e.g. large property, excess umbrella, aviation)
- Market penetration may require accumulation of aggregate risk
- Internal management restrictions for individual SBU line sizes or aggregates
  - May be handled through internal reinsurance

Collectability of Reinsurance

- Recoverable balance from a single reinsurer
- Disputed balances
  - Lack of clarity in reinsurance contracts
  - Obstructive reinsurers
- Credit rating
  - ERM, Rating Agencies
  - Probability of default increases over longer time horizon

Commutations

- To reduce amount of recoverables, particularly if overloaded on one reinsurer
- Recover some of the profit on longer tailed covers that appear to have low chance of being triggered
- Insolvencies – first to the table gets more on the dollar
- Schemes of Arrangement – resistant run-off managers
- Mandatory Commutations – specific formulas

Commutations - Language

- WC Mandatory Commutation Spells Out:
  - 2004 Life Table
  - Latest 20 year Medical CPI
  - Lastest 10 year COLA rate from NCCI
  - Discount rate from 15 year Treasury Bill
  - Arbitration provision using independent actuary
- Collateral Escalation for “Triggering Event”
- Relationship with Reinsurer **Matters!**
  - **Future reinsurance cessions biggest negotiation tool**
    - **commuting to reduce current recoverables**
    - **Returning some profit on treaties with positive results**