The role of Reinsurance in Building Resilience of the Rwandan Insurance Industry

RIBA Annual Conference

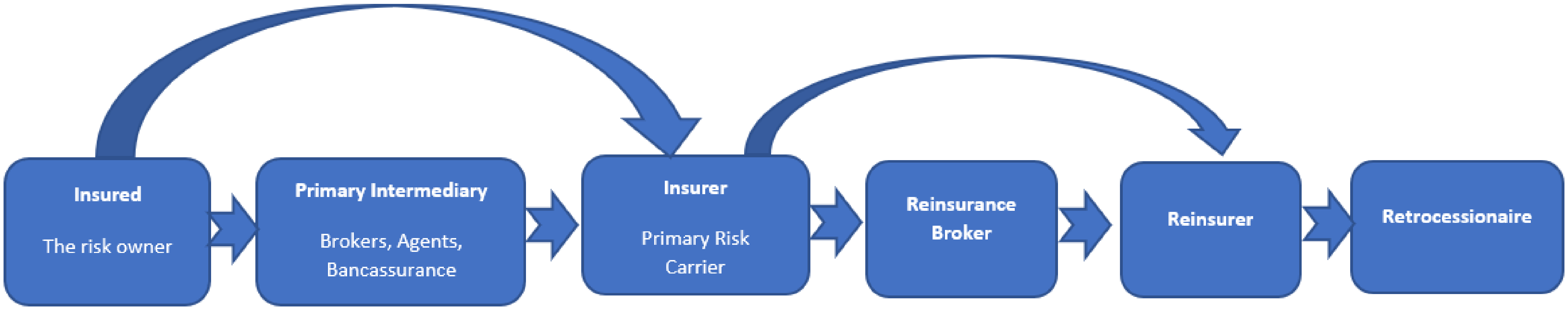
Reinsurance Defined

A legal definition of reinsurance was given by Lord Mansfield in the case of Delver v. Barnes (1807), that reinsurance -"consists of a new assurance, effected by a new policy, on the same risk which was before insured in order to indemnify the underwriters from their previous subscription; and both policies are in existence at the same time".

This definition relates to facultative reinsurance, which was the earliest form of reinsurance. It cannot be said that all forms of reinsurance satisfy Lord Mansfield's requirement that 'both policies are in existence at the same time', because with the development of treaty contracts, ceding companies have a blanket authority, within certain agreed criteria, to cede future risks underwritten. A simple definition of reinsurance therefore is that it is the acceptance by an insurer, known as a reinsurer, of all or part of the risk of loss of another insurer, called the ceding company.

In simple terms, reinsurance is insurance of insurance, where one or more insurance companies agree to indemnify the risk, partially or altogether, for the policy issued by another one or more insurance companies.

Risk Placement Channel



Why Reinsure

To secure a large number of similar risks to permitting the prediction of losses with a reasonable degree of certainty, insurance companies have devised the practice of reinsurance.

Reinsurance is the transfer of insurance business from one insurer to another. Its purpose is to shift risks from an insurer, whose financial security may be threatened by retaining too large an amount of risk, to other reinsurers who will share in the risk of large losses.

Reinsurance tends to stabilize profits and losses and permits more rapid growth.

The entire area of reinsurance and retrocession is an example of the essential need for a spread of risk among many risk bearers. Much of the process goes on without the policy-holder being aware of its existence since he is not a party to the reinsurance arrangement.

Reinsurance enables a risk to be scattered over a much wider area, which is the primary concept of the whole business of insurance.

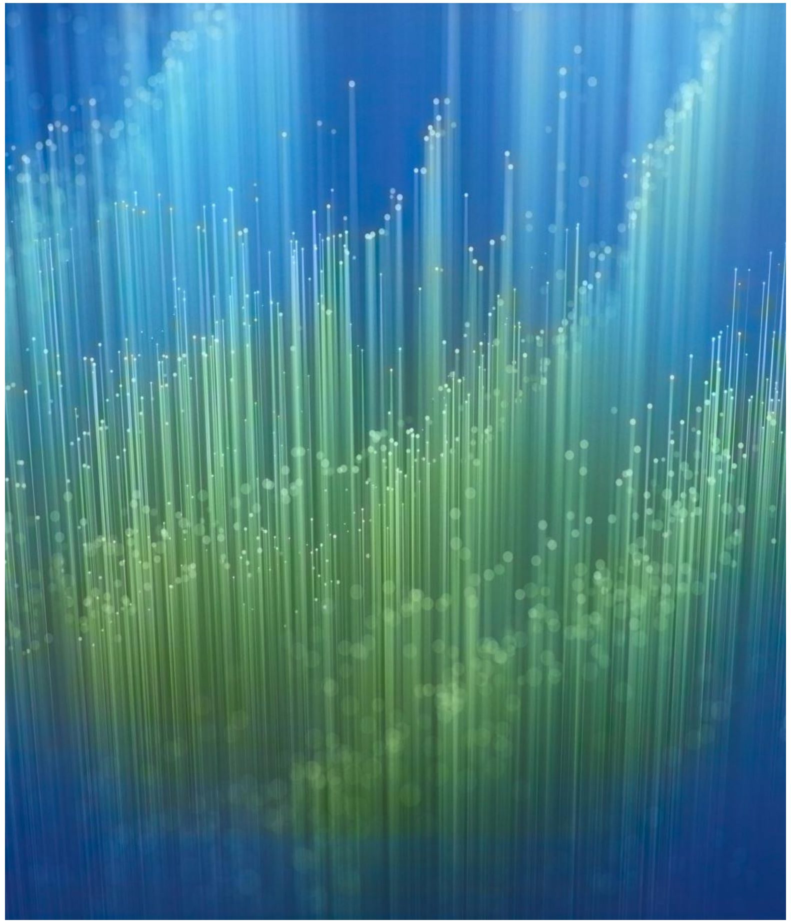
The need for reinsurance arises in the same way as an original insured needs insurance protection.

W-SAFE
RE-INSURANCE COMPANY

Types of Reinsurance

PARTICIPATING, PROPORTIONAL OR PRO-RATA: Where the proportion of amounts payable by the insurer and the reinsurers regarding a loss is determined and agreed beforehand, i.e., before a loss. Here, the insurer’s premium is also distributed between himself and the reinsurers in the same proportion. Examples are facultative, quota share, surplus, or pool.

NON-PROPORTIONAL: The reinsurance is on different terms, and the reinsurers do not stand to be proportionately liable for a loss. Therefore, the premium received by the insurer is also not required to be proportionately distributed to the reinsurers. Examples are an excess of loss treaty, stop loss treaty, etc.



The role of Reinsurance in Building Resilience of the Rwandan Market

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1. **Loss Limitation**

- There are two essential aspects to controlling claims – claims frequency and claims severity.
- Claims frequency arises when a ceding company experiences a greater NUMBER of losses than expected. This may occur in a random way – such as experiencing a much larger number of motor losses in a year than expected. – simply there have been a lot of losses; or this may occur due to a natural disaster – an area with several policyholders being affected by flood, or earthquake or windstorm. Each individual loss in terms of amount may be well within the acceptable size of loss but experiencing so many more small losses than expected results in a large deficit at the end of the year. To avoid this situation ceding companies purchase reinsurance.
- Claims severity results from losses where the AMOUNT is or could be, much higher than expected. One way to limit this exposure is by transferring out, by way of reinsurance, a part of the risk at the time of acceptance. Thus, if a ceding company writes motor cars with an average value of USD 40,000 and a maximum value of USD 55,000, and an important client wishes to insure a Ferrari worth USD 200,000, the ceding company limits its potential loss by ceding away that part of the risk which exceeds its average value of USD 40,000 and thereby avoids the possibility of having a loss above an acceptable amount. Severity can also result from an unexpected turn of events. An underwriter estimates a maximum probable loss for a property risk at 10% of the maximum sum insured, and the loss is, in fact, 30% of the maximum sum insured – three times higher than ever expected. Equally a ceding company may estimate, based on its capital free reserves that it cannot afford to pay more than USD 100,000 for any individual claim which could occur, nor USD 250,000 for all claims arising out of one event. Again, to avoid situations which could cause the ceding company to have losses exceeding these amounts, the ceding company will buy reinsurance.

2. Provide Capacity to the Insurer

- In many countries the premium that an insurer can write is a factor of the capital and free reserves the insurance company has available. Based on the insurance company's capital and free reserves, the company can write a multiple of this amount in premium income. Thus, if country A allows insurers to write three times their capital and free reserves in premium, and the capital and free reserves are USD 3,500,000 then the company can write up to USD 10,500,000 of premiums. The "premiums" in such cases are often the premiums "net of reinsurance", thus if the company can find reinsurance capacity, it can write a multiple of the amount based purely on its capital and free reserves.
- For example, if the company can find reinsurers willing to reinsure 50% of all its risks, then the company can write up to USD 21,000,000 instead of USD 10,500,000. To this extent, reinsurance can be seen as "soft capital" for an insurance company. Rather than raising new capital to write more business, the insurance company can simply try to get more reinsurance capacity.
- In addition to its ability to simply write more premium income, an insurer may simply need more capacity on a particular risk. Perhaps the insurer is limited to a sum insured of USD 2,000,000 on office buildings, and an important client requires that the company write USD 4,000,000 if they want to have the business. By seeking reinsurance cover, the insurance company can increase its share in a particular piece of business, by seeking capacity in the reinsurance markets.

3. Create Financial Stability

- It is a fact of life that investors want stable results. They do not want surprises. When an insurance company makes predictions of its results to its shareholders, it must do all it can to produce results close to, or better than, those predictions. If the insurance company only produces 50% of the predicted profit, or worse, produces a loss, then the shareholders will often require the management to fully explain the situation.
- As noted in item 1 above, the main issues facing insurance companies are to control claims severity and claims frequency. There are reinsurance products for even the most volatile of portfolios, to enable an insurance company to stabilize its results over a period of years.
- The issue is one of cost. The more reinsurance a company buys, the more it reduces its risks. There is a true saying that “there is no profit without risk”, so it is the challenge of every insurance company management to balance profit and stability, to find the right combination of retention and reinsurance to provide the optimum result.

4. Protect Solvency Margins

- As noted in point 2 above many countries require insurance companies to maintain premiums at a certain ratio of their capital and free reserves. This is known as being within the solvency margin. Thus, in the example in item 2 above the insurance company could write USD 10,500,000 of premiums (net of reinsurance) based on its capital and free reserves. If the company wrote instead USD 12,000,000 of net premiums, then it is highly likely the government regulator in the country concerned would take disciplinary action against the insurance company for exceeding its allowed solvency margin.
- Motor business is a good example of a class of business where if an insurance company has an attractive product, it can produce large amounts of additional premium income very quickly. To avoid problems with the government regulator, the company can monitor its income closely, and as it gets close to its allowed solvency margin it can purchase additional reinsurance to ensure it stays within its permitted ratios.

5. Provide Value Added Services

- One guaranteed element of our daily lives is that there will be constant change and whether we like it or not there is no escape from the need to innovate and evolve. This may be something the insurance company initiates itself – for example, a decision to write engineering business, or it may be the result of extreme pressure from the market, for example to write some type of cyber cover. Where an insurance company has no knowledge of these classes of business it can often turn to a professional reinsurer for help in establishing the necessary know-how to write such classes profitably. Professional reinsurers have a broad experience over a number of markets and can often import good ideas and experience from other markets that have been faced with similar problems. While no market is ever exactly the same as another market, with the skill, capacity and experience of a good reinsurer, it may be possible to adapt wordings and pricing to begin a new class or a new account for a particular insurance company without threatening its stability.
- A number of reinsurers can also provide useful market information for existing lines of business and training to an insurance company using their reinsurance capacity. This is a win-win situation for both sides as well-trained insurance company employees enhance the profitability of their employer and also contribute to the profitability of the reinsurer

6. Increased insurance Penetration

- Reinsurers invest heavily in research and development. As a result, they play a vital role in launching and rolling out new insurance products geared towards meeting the population needs. This is important to increase the very low insurance penetration in African countries like Rwanda where the penetration is still below 2% as per the 2017 statistics.
- Reinsurers can take shocks which are expected to come up from new and none tested insurance products. Volatile classes like Agriculture, bonds, cyber and other new and emerging risks need a lot of reinsurance support. Most of these classes tend to protect the uninsured population and therefore have a direct impact to insurance penetration.

7. Reciprocity

- This is a widely used term in the transaction of the reinsurance business, indicating a situation involving the desire for the satisfaction of mutual interest.
- Normally, the direct insurers do transact reinsurance business in addition to the insurance business at one time or the other.
- When they cede reinsurance business as such to another company, they also expect that at different times that company also would cede reinsurance business to them. This understanding of looking after each other’s interests is expressed by the term ’’Reciprocity”.

Classification of Reinsurers

1. National Reinsurers-Kenya Re, Uganda Re etc.
2. Regional Reinsurers-Zep Re, Africa Re
3. International Reinsurers-Munich Re, Swiss Re, W-Safe Re

Importance of a National Reinsurer in creating a vibrant country’s insurance industry

1. Capacity

- National reinsurance companies are started with the aim of provision of reinsurance capacities through the underwriting of reinsurance business and thereby retaining within the country part of the business which are hitherto reinsured outside the country. In every branch of insurance, there are risks which, because of their sizes or their nature, an insurance company cannot afford to keep for its own account. Such risks are numerous, the Commercial Passenger aircraft being an example. These risks would be beyond the limit which is prudent for one insurance company to carry, and it is necessary for that company to affect reinsurance.
- Local insurance companies depend on International markets for reinsurance of their risks as individually or even collectively, since they are not able to retain large portions of the risk especially in markets without National Reinsurers. Conducting business with international reinsurers mean that the individual local companies have to export money abroad. The amount of money thus exported forms a large portion of each country’s payment for international services. National reinsurance companies' formation, help in curbing this outflow of cash so that the reinsurance premiums are retained and invested in the country. The reinsurance companies therefore create reinsurance capacities which enable acceptance and retention of larger risks. This has its benefits in that our growing economies with their peculiar African characteristics have local grown support/solutions.

2. Stability

- Reinsurance companies have added stability to the insurance industry and to the local economies by evening out the results of the insurance companies as they continue to absorb the impact of large losses which would have led to very damaging results to the individual insurance companies. In the recent past, there has been an upsurge in the numbers (frequency) and size (magnitude) of the claims. The reinsurers have proved themselves by settling the claims and facilitating the return of production to the affected industries and other business concerns. Wide swings in results of an insurance company can be very damaging to its image with the public and will cause a lot of concern to the shareholders. One area of concern is that International Reinsurers being the fair whether friends they have proved to be usually pull out from the African markets during the tough times, when profits are low, profits being their major objective. They will however sneak back whenever the conditions become more favorable. This in and out movements leads to a very volatile and unstable situation which impairs economic growth , as the insurance sector plays the key role of protecting the economic activities. Their withdrawal means that the indigenous African insurance companies would have no reinsurer to turn to and would in turn be bullied into accepting terms that are inclined to exportation of more premiums outside the continent. The regional and local reinsurers have effectively given the capacity and stability needed whenever such withdrawals occur and will continue to do so as they are here to stay.
- *“No ones cooks better than one's mother”*

3. Financial aspects

- The other main role of reinsurance has been in its financing aspect. One of the yardsticks used by regulatory bodies in controlling insurance companies is the measure of their solvency. This is calculated by the percentage which the capital and free reserves of the company bears to its gross net premium income. These authorities have minimum solvency requirements below which they would not allow companies to operate. By ceding premiums to reinsurance company, the insurance company automatically enhances its solvency margin.

4. Closer cooperation

- National reinsurers have served to create forums for exchange of ideas by companies in the countries. Markets used to be so far apart depending on their colonial histories. The neighboring countries with different colonial histories knew virtually nothing or very little about each other.
- *“A man does not wander far from where his corn is roasting”*

5. Training and manpower development

- National Reinsurers are seriously engaged in the manpower development for the insurance sector by offering technical services as well as training opportunities in the region to enhance insurance and reinsurance knowledge. National reinsurance companies have also provided employment opportunities which have improved living standards and welfare. The National reinsurers have participated in the insurance and reinsurance activities, such as loss prevention exercises, creation and Management of insurance and Reinsurance pools, notably The COMESA Yellow Card Reinsurance Pool, The African Fire Pool, The Oil and Energy Pool , The RCTG Pool, among others. These pools in their own ways have contributed to the economic development of the region. As part of the global players, the reinsurers have been able to attract international funds through reinsuring of risks with international players. For the liabilities ceded out, the international reinsurers have responded whenever a claim situation arises, and this has brought in funds from overseas. In summary we can say that the national reinsurers have played their roles very well in enhancing Economic development.

6. Foreign currency earning/saving

- Local Reinsurer is a source of foreign exchange earnings through inward premium from other markets as a result of selling capacity and providing cover to insurers and reinsurers domiciled in foreign markets. This may also be achieved through reciprocity among developing countries reinsurance entities. Through providing local capacity, national reinsurers reduce the amount of foreign currency paid outside the country, hence protecting the local reserves.
- *“Uncontrolled generosity is the only noble deed which has never created a billionaire”*

Parting Shot

"Reinsurance is as important to the insurance industry as it is backbone to vertebrates. Operates at the backend but supports the entire system"

Its importance should never be tested by breaking it


Thank you

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