

**The American Bar Association
Standing Committee on Lawyers' Professional Liability
and the
ABA Center for Continuing Legal Education**

Present

Controlling Legal Malpractice Insurance Cost and Availability in a Changing Marketplace

**Reinsurance 101
By Michael Elliott**

© 2002 American Bar Association. All rights reserved.

American Bar Association
Center for Continuing Legal Education
321 N. Clark St.
Chicago, IL 60610

For more information about the American Bar Association and ABA-CLE..

ABA Member Services: 800.285.2221

Web Site: <http://www.abanet.org/cle>

**UNIFORM CERTIFICATE OF COMPLETION
ABA SELF-STUDY COURSES**

To acquire a Uniform Certificate of Completion for ABA self-study courses:

- visit the ABA-CLE Online Catalog at www.abanet.org/cle/catalog, or
- call our FaxInfo! service at 1.800.995.1253 and enter number 4004 when queried. A Certificate will be faxed directly to you.

The ABA has requested accreditation from those states approving self-study. Within 30 days of this activity, the attorney **must file this Certificate with his/her MCLE state agency if licensed in CO, FL, GA, IN, KS, KY, MS, NM, NV, VA, or WV. *Do not file this Certificate with your MCLE state agency if licensed in AZ, CA, ID, MN, MO, MT, NH, NY, OK, OR, UT, VT or WA.*** Filing of Certificates is optional in all remaining states with MCLE requirements. Attorneys should keep the original or a copy of this Certificate for your files. The ABA pays applicable fees in other states where the sponsor is required to do so, and in states where a late fee may become applicable. Please be aware that each state has its own rules and regulations, including its definition of "CLE"; therefore, certain programs may not receive credit in some states. Check with your state for confirmation of a program's approval.

NEW YORK LICENSED ATTORNEYS

Do not use this Certificate. Please complete the ABA Self-Study Confirmation Form for New York Attorneys. Fill out and return to the ABA as indicated on the Form.

- On the Web: www.abanet.org/cle/mclevew.html#newyork .
- On ABA FaxInfo service: 1.800.995.1253, select document number 4005.

The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the American Bar Association.

The information contained herein is based upon sources believed to be accurate and reliable. We have exercised reasonable care to assure the accuracy of the information. However, no representation or warranty is made as to such accuracy. Readers should check primary sources where appropriate and use the traditional legal research techniques to make sure that the information has not been affected or changed by recent developments.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

This publication was produced by the American Bar Association Center for Continuing Legal Education.

Michael Elliott.... EWI Re, Inc.

I. What is Reinsurance?

What is reinsurance, what does it do, why is it important to me? These are questions that many of you have asked at one time or another. Today I am going to remove the mystery and mystique surrounding reinsurance. It is simple, really! Reinsurance is insurance for insurance companies. Let me explain.

Everyone knows what insurance is. Indeed, everyone buys insurance in some form or another to protect their possessions and their loved-ones in case of accident, harm, or disaster. Take your home for example. All of you purchase homeowner's insurance to protect yourself if your house catches fire or is destroyed or damaged by windstorm, hurricane, or other similar peril. You are the insured, a company such as Safeco or Hartford is your insurer.

For some of the very same reasons you buy homeowner's coverage to insure your possessions, nearly every insurance company in the world buys coverage to reinsure its portfolio of business from accident, harm, or disaster. In this case a mythical XYZ Insurance Company is the reinsured, and companies such as Converium Re or St Paul Re are its reinsurers.

II. Definition of Reinsurance.

Many definitions of reinsurance exist. A typical definition would refer to reinsurance as: *AA form of insurance, being the insurance of one insurer (the reinsured) by another insurer (the reinsurer) by means of which the reinsured is indemnified for loss under insurance policies issued by the reinsured to the public.*

Public policy and common law have established the following about reinsurance:

Reinsurance is a form of insurance. As such, a contract of reinsurance is an insurance contract.

Only a entity empowered to write insurance may reinsure its policies.

The insurable interest of the reinsured is its insurance policy obligations.

The reinsurance provider must also be empowered to insure.

A contract of reinsurance is a contract under which one insurer agrees to indemnify another with respect to actual loss sustained under the latter's policy or policies of insurance.

III. What is the Purpose of Reinsurance?

The single most important problem for insurance companies today is no different than it was 400 years ago when it all started. That problem is to make the law of large numbers work within a portfolio of insurance risks assumed. Reinsurance helps make the law of large numbers succeed. Put another way, reinsurance allows the original insurer to assume risks in such a way that its book of business is no longer a series of blind bets or wagers.

Usually an insurance company will buy reinsurance for one or more of the following reasons:

1. Market Capacity.
2. Stabilization of Result.
3. Catastrophe Protection.
4. Strengthening of its Financial Structure.

Let's examine **Market Capacity** first. There is a highly respected rule of thumb in the insurance industry. Never expose more than 5% of a company's Capital and Surplus on any one risk. But, what if, that company is being pressured to offer larger policy limits to its customers in order to stay in business. What then? Reinsurance of course! Reinsurance is a means by which an insurer can write more business at higher limits than its own resources would otherwise permit.

A second reason for reinsurance is for **Stabilization of Results**. To put it another way, giving your investment people a level playing field in order to maximize investment results. After all, investment income is a significant source of revenue for an insurance company. In order to gain a maximum yield from its investments, a company's management team must have assurance that there will be no drastic calls for cash to pay unexpected or abnormal losses. Reinsurance while it is not a banking transaction, does fulfill a financing function. In this case by providing for the amortization of insurance losses over time. A few examples of how stabilization can be achieved include:

1. Control of the exposure-to-loss factors on each individual risk.
2. Control of the total of all accumulated losses arising during the year.
3. Adjusting the mix of business.

One of reinsurance's main and customary roles has always been that of providing **Catastrophe Protection**. If your's is a company writing homeowners coverage in Florida, you would need protection from hurricanes. A property insurer in California is concerned with earthquakes. A writer of professional liability is concerned with large shock losses from unfavorable jury awards or from a change in the legal climate which could leave it vulnerable to unexpected legislative or court imposed exposures or coverage not originally intended.

Lastly reinsurance can be used to **Strengthen the Financial Structure** of a company by providing such things as:

1. Surplus relief.
2. Improvement to the company's financial statement.
3. Improvement of Best's and S & P ratings.
4. Meeting the requirements of regulatory authorities.
5. Modification of the company's tax obligations.

I will elaborate on how to strengthen an insurance company's financial situation using reinsurance in greater detail later in this discussion.

IV. The Two Types of Reinsurance.

When all is said and done, there are really only two types of reinsurance:

1. Facultative Reinsurance.
2. Treaty Reinsurance.

Facultative is the oldest form of reinsurance there is. Essentially facultative is reinsurance purchased on a "case by case" basis. In the case of our XYZ Insurance Company, specific reinsurance for a very large law firm would make an excellent example of a possible facultative placement.

Treaty reinsurance on the other hand covers an entire portfolio or class of business underwritten by an insurance company. By class of business I mean for example, XYZ insurance Company might reinsure its Lawyers Professional Liability, but keep for its own account a small book of "Office Business Owners" package policies because it views the exposure from those policies to be much less.

What is the difference between facultative and treaty? The main difference is one of obligation. In the case of facultative reinsurance, XYZ is under no obligation to place individual risks with anyone. By the same token the reinsurers are under no obligation to accept any business from XYZ either. Both parties have the facility to act as they deem in their individual best interest without having to consider any prior contract.

A reinsurance treaty on the other hand is an obligatory reinsurance agreement whereby the ceding company (in this case XYZ) is required to cede and the reinsurers are required to accept a specified share of all risks to be reinsured. These requirements and obligations are fully spelled out in the treaty wording which has been agreed upon ahead of time.

V. Methods of Reinsurance.

When you get right down to it, there are really only two methods of reinsurance:

1. Proportional Reinsurance - usually referred to as Pro Rata or Quota Share.
2. Non-Proportional Reinsurance - usually referred to as Excess of Loss.

Quota Share reinsurance is reinsurance in its most simplistic form. A quota share treaty allows a reinsured such as XYZ to cede a fixed percentage of every risk that is written to a group of reinsurers who are a party to such a quota share agreement.

Quota Share Example:

- # 80% Quota Share
- # Reinsurer receives 80% of the premium less a commission which is retained by the Reinsured to pay for its operating expenses.
- # Reinsurer pays 80% of each and every loss no matter how big or small
- # Often used for surplus relief or where an excess of loss program is inappropriate.
- # Usually has some form of a profit contingent arrangement to reward the reinsured for doing a good job.
- # Variations of this are called surplus treaties.

Excess of loss reinsurance on the other hand grew primarily out of the requirement of the original insurer (the Reinsured) for protection from a catastrophe or the need to issue high limits of liability. Excess of loss reinsurance may be best described as an agreement whereby the reinsurer agrees to reimburse the reinsured for all losses over a set dollar amount. For example this year XYZ's reinsurance program protecting its book of lawyers E & O policies begins to respond when losses exceed \$500,000. Think of that \$500,000 if you will as XYZ's reinsurance deductible.

Excess of Loss Example:

- # \$500,000 excess \$500,000
- # The reinsurance premium is expressed as a percentage of the original premium. In other words a rate.
- # Can be written in layers in order to facilitate the limits of liability required by the Reinsured.
- # Lower layers may be written with a profit contingency.
- # Can be written on a per risk or per occurrence basis.
- # Can be written with an aggregate deductible.

VI. The Reinsurance Market Place.

Just who are these reinsurers that I keep talking about. They are either professional reinsurance companies whose sole enterprise is reinsurance or they are reinsurance divisions of conventional insurance companies which also accept reinsurance to diversify their book of business. There are insurance and reinsurance companies all over the world, but for practical purposes there are four markets:

1. London (where it started):
 - i. Lloyds of London
 - ii. London based insurance companies.
 - iii. Other companies with London offices such as and Swiss Re U.K..
2. United States:
 - i. Reinsurance divisions of insurance companies.
 - a. ACE Tempest Re
 - b. Hartford Re
 - c. St Paul Re
 - d. CNA Re U.S.
 - ii. Professional Reinsurers
 - a. Everest Re
 - b. Folksamerica Re
 - c. Odyssey Re
3. Europe:
 - i. Hannover Re
 - ii. Munich Re
 - iii. Cologne Re
 - iv. Conventium Re
4. Bermuda:
 - i. XL Insurance Company
 - ii. Stockton Re
 - iii. Chubb Atlantic

VII. The Reinsurance Intermediary.

Reinsurance is a dollar intensive business. Because most risks which require reinsurance are too big for one insurance company to write alone, so to is the need for more than one reinsurance company to cover such risks. A reinsurance program such as that placed for XYZ must have the support of the world wide reinsurance marketplace. The reinsurance intermediary is an indispensable link in forging a successful reinsurance program. A truly good reinsurance intermediary such as ourselves has the market knowledge and experience necessary to handle all negotiations between the parties. It is our job to reduce the time, effort, and expense of the ceding company in securing superior reinsurance. The mandate of the reinsurance intermediary is to provide its client with impartial, experienced counsel and to negotiate on its behalf the best reinsurance program available at the best possible price.

VIII. The Reinsurance Process.

What kind of Reinsurance does an insurance company need and why? Reinsurance is purchased for many reasons. Some of the key considerations include:

1. The size of the company.
2. The financial strength of the company.
3. The lines of business written.
4. The Experience of the company.
5. The ownership of the company. Stock or mutual.
6. The state or states of domicile
7. The agenda of management or the stockholders.
8. The need to grow or diversify with new product lines.
9. The need for higher limits.

IX. Conclusion

Reinsurance then, as stated in the beginning, is little more than the “an insurance company’s insurance protection. It is a necessary yet often misunderstood product, which has a great deal of influence over all that the insurance consumer has available to him or her when they seek to protect their business and families.

The Insurance/Reinsurance Players

Agent – Insurance is often sold to the public through an Insurance Agent. This agent may represent many insurance companies or only one or two. An agent representing many companies is generally referred to as being part of the Independent Insurance Network. An agent representing only one or two companies is generally referred to as a “Captive Agent”. Often the latter is an employee of the insurance company he or she represents. An Agent will be appointed by the insurance companies he represents and is considered the representative of those insurance companies.

Broker – Technically a Broker represents the policy Holder who are their clients. A broker will select an insurance company, or several insurance companies and present his clients needs and exposures to them for quotations and ultimately binding of coverage. Like agents, brokers are paid on a commission basis by the insurance company.

Direct Writer – Some insurance companies sell coverage on a “direct” basis. In other words, employees of the insurance company deal directly with the prospective insured,. The application and other necessary underwriting details are submitted directly to the insurance company which provides a quotation and will accept the order to bind coverage if acceptable.

Reinsurance Company – a insurance company that accepts the transfer of coverage and risk from another insurance company. The original insurance company is commonly referred to as the reinsured or ceding company. The company accepting the reinsurance is referred to as the reinsurer. The transfer of such reinsurance is often called a cession.

Reinsurance Intermediary – A professional broker licensed to negotiate and transact reinsurance contracts, cessions, and claims as necessary on behalf of a reinsured and a reinsure or group of reinsurers.

Lawyers Professional Liability Insurance is written both through licensed insurance agents, insurance brokers, and on a direct basis. The following list of companies and underwriting managers write professional liability insurance for attorneys. Not all companies will be licensed in every state. Many of these companies, particularly the NABRICO companies only write in a single state or are limited in their geographic spread. There are exceptions to this within NABRICO, a visit to the individual companies web sites will find out for you if that company is licensed in your state of domicile.

**ALPHABETICAL INDEX OF NABRICO COMPANIES**

[Clicking the Company name will provide you with contact information. Those companies that are on the Web have their web addresses listed, and clicking on the web address will take you directly to the company Website.]

ALPS - Attorneys Liability Protection Society

Website: www.alpsnet.com

(Alaska, Arizona, Colorado, Delaware, Hawaii, Idaho, Indiana, Kansas, Maine, Montana, Northern Marianas Islands, Nevada, New Hampshire, New Mexico, North Dakota, Rhode Island, South Carolina, South Dakota, Vermont, Virgin Islands, Washington, West Virginia, Wyoming)

Attorneys Insurance Mutual of Alabama, Inc.

(Alabama)

CLIA - Canadian Lawyers' Insurance Association

Website: www.clia.ca

(Alberta, Manitoba, New Brunswick, Northwest Territories, Nova Scotia, Prince Edward Island, Saskatchewan, Yukon)

Florida Lawyers Mutual Insurance Company

Website: www.flmic.com

(Florida)

Illinois State Bar Association Mutual Insurance Company

Website: www.isbamutual.com

(Illinois)

Lawyers Insurance Fund Law Society of British Columbia

Website: www.lawsociety.bc.ca

(British Columbia)

Lawyers Mutual Insurance Company

(California)

Lawyers Mutual Insurance Company of Kentucky

Website: www.lmick.com

(Kentucky)

Lawyers Mutual Liability Insurance Company of North Carolina

Website: www.lmlnc.com

(North Carolina)

Lawyers Professional Indemnity Company

Website: www.lpic.ca

(Ontario, Newfoundland)

Michigan Lawyers Mutual Insurance Company

Website: www.mlmico.com

(Michigan)

Minnesota Lawyers Mutual Insurance Company

Website: www.mlmins.com

(Iowa, Indiana, Minnesota, Pennsylvania, Nebraska, North Dakota, South Dakota)

Ohio Bar Liability Insurance Company
Website: www.oblic.com
(Ohio)

Oklahoma Attorneys Mutual Insurance Company
Website: www.oamic.com
(Oklahoma)

Oregon State Bar Professional Liability Fund
Website: www.osbplf.org
(Oregon)

Professional Liability Insurance Fund of the Quebec Bar
Website: www.assurance-barreau.com
(Quebec)

Solicitors' Mutual Defense Fund, Ltd.
(Ireland)

Texas Lawyers' Insurance Exchange
Website: www.tlie.org
(Texas)

The Bar Plan Mutual Insurance Company
Website: www.thebarplan.com
(Kansas, Missouri)

The Legal Mutual Insurance Society of Maryland
Website: www.legalmutual.com
(Maryland)

Wisconsin Lawyers Mutual Insurance Company
Website: www.wilmic.com
(Wisconsin)



Non-NABRICO Insurance Companies

Admiral Insurance Company	American Safety Group
AIG, Philadelphia Insurance Co.	Atlantic Insurance Company
American National Lawyers Ins. Reciprocal	CNA
Chicago Insurance Company	Chubb Insurance Company
Carolina Casualty Ins. Co.	Clarendon Insurance Co.
Evanston Insurance Company	Executive Risk Indemnity
Gulf Insurance Company	Great American Insurance Company
General Star Ins. Co	Garden State Indemnity
Hartford Financial Products Twin City, Nutmeg Ins. Co	Kemper Insurance Co. Lumberman's Ins. Co.
.Hartford Insurance Co.	Jamison Special Risk, Inc
Lloyds of London	Legion Insurance Co.
Liberty International Ins. Co.	Lexington Insurance Co.
Medmarc Casualty Insurance Co.	Markel American Ins. Co.
Northland Ins. Co.	National Casualty Ins. Co.
North American Elite	Old republic Insurance Co.
Royal Surplus Lines	St Paul Insurance Co.
Shand Morhan	SAFECO
Scottsdale Insurance Co.	TIG Insurance Co.
United National Ins. Co.	Westport/GE Financial
Zurich Insurance Company/	