Proportional Reinsurance

As many of you know, pro rata is Latin for "give me your profits in return for a commission that might cover half of your expenses." At least it sometimes feels that way during reinsurance negotiations. Actually, it refers to dividing premiums, expenses and losses between participants in a predetermined percentage or proportion. While just what actually constitutes premium, expense and loss is often subject to spirited debate, for our purposes we will use basic definitions. In proportional reinsurance, a company cedes (reinsures) a specified portion of a risk less a commission and recovers the same portion of loss from the reinsurer. Two basic forms of proportional reinsurance are called "quota share" and "surplus share."

In quota share reinsurance, the ceding company and the reinsurer agree on what type(s) of insurance is to be ceded. The contract may cover a specific line of business, a particular geographic area, any part of or even all of a company's business. The transaction may be a one time cession (for example, a transfer of loss reserves) or may continue for several years. While a significant amount of catastrophe protection can be provided in certain cases, the traditional function of quota share reinsurance is financing.

Rapid growth and/or adverse experience can negatively impact an insurance company's surplus, reducing its ability to write new business. However, by placing a percentage of its business with reinsurers in return for a commission which reflects its expenses, a company can increase its surplus by the amount of the commission received. For example, should a company cede $10.00 of unearned premium minus a 25% ceding commission, it will cede a net premium of $7.50. On the other hand (or side of the ledger), its liabilities are reduced by the full $10.00 ceded and the difference of $2.50 is added to surplus. In the bad old days of reinsurance (which periodically repeat – those who ignore their history lessons are doomed to repeat them), a company might receive a commission which exceeded its actual expense, thereby making a profit on the transaction. Currently, the opposite is sometimes true, particularly for new ventures with limited experience.

One of the attractions of quota share reinsurance is that it can provide some measure of each of the four basic reinsurance functions – financing, stabilization, capacity and catastrophe protection. In the above example, the company financed its additional surplus needs which also contributed to its ability to offer additional capacity. If it cedes only business in an area or line perceived to represent a higher potential for loss, while retaining less hazardous business, it may be able to stabilize its loss ratio at a lower desired level. Finally, by placing reinsurance on an each risk basis, the company may realize significant catastrophe protection in selected areas.

Surplus share reinsurance (which shares its name, but not its meaning with policyholder's surplus) is similar in concept, except that (a) it only applies to first party (property) business, (b) only risks larger than (surplus of) a specified dollar amount or policy limit are ceded and (c) the capacity is usually expressed in terms of “lines,” with each line referring to the ceding company’s net retention or agreed upon dollar amount.

For example, if a company keeps all risks with a value up to $50,000, it might purchase a surplus treaty providing nine lines of capacity or $500,000 in total ($50,000 retained plus 9 times $50,000 ceded). It is not uncommon to find surplus treaties stacked one on top of another to provide the desired capacity – 1st surplus treaty, 2nd surplus treaty, 3rd surplus treaty, etc. While a company only cedes risks above a certain size, it receives from the reinsurer a proportional recovery of losses on all accounts ceded. Surplus reinsurance is usually purchased for capacity and stabilization reasons although, as proportional reinsurance, it also provides some catastrophe protection and financing.

Ceding commission arrangements are also similar for both quota share and surplus share treaties. In principle, there are three basic types: fixed, fixed plus contingent and sliding scale. In actual practice there are as many variations are there are reinsurers. Which is to say – nowhere near as many as there once were. While the practice of contingent commissions has been nearly beaten to death by regulators, Attorneys General and the media, the principal is benign when applied to arrangements between carriers and reinsurers since both parties know the terms and the terms do not unfairly discriminate against any third parties.

A fixed or “flat” commission is simply a percentage of written premium negotiated at the beginning of a reinsurance period. Contingent commissions are based on the profitability of the business reinsured and, theoretically at least, provide an incentive for a ceding company (or MGA) to produce and underwrite lower risk (or at least lower loss ratio) business.

As implied by their name, sliding scale commissions have a provisional, a maximum and a minimum commission. Depending upon loss ratio, the commission allowance can “slide” up or down to the maximum or minimum commission, respectively. The commission slide ratio (change in commission divided by change in loss ratio) can be different for different ranges of loss ratio. Other mechanism such as “caps” and / or “corridors” may be used depending upon the expertise, imagination, or lack thereof, of the underwriter.

In summary, proportional or pro rata reinsurance takes two forms: quota share and surplus share. Each refers to the division of premiums, expenses and losses according to a predetermined percentage or amount between carrier and reinsurer.

Quota share applies to the entirety of a company’s book of business in a specified territory, class, line or type of business. It can be a one time transaction or may be continuous until cancelled. The traditional and principal purpose of quota share reinsurance is financing, however significant stabilization, capacity and catastrophe protection can be provided depending on the structure.

Surplus share reinsurance applies only to those accounts which are “surplus” of a certain size and recoveries are proportional for losses on all accounts ceded. Surplus share contracts can be stacked to provide higher limits. It principally provides capacity and stabilization, but also provides some catastrophe protection and financing. Commission arrangements for both forms of proportional reinsurance can be fixed, contingent or sliding scale.

The author, James A. Warters, is Vice President and Northeast Regional Manager for Preferred Reinsurance Intermediaries of Columbia, South Carolina. When visiting the home office, he can be reached through the receptionist at 803-790-4800. His office is in Rockaway, New Jersey, 973-586-3105.