INSURANCE-6

RE-INSURANCE

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RE-INSURANCE

Reinsurance is a contract between two or more insurance companies by which a portion of risk of loss is transferred to another insurance company. This happen when an insurance company has undertaken more risk burden on its shoulders than its bearing capacity. Double insurance is thus a device to reduce the risk. Usually, an insurance company insure a profitable venture comes in its way, even if the risk involved is beyond the capacity. By transferring the risk to any other insurance company, the insurer reduces his liability.

Definition

1. According to the Federation of Insurance Institutes, Mumbai, "Reinsurance is an arrangement whereby an insurer who has accepted an insurance, transfers a part of the risk to another insurer so that his liability on any one risk is limited to a figure proportionate to his financial capacity."
2. In the words of Riegel and Miller, "Reinsurance is the transfer by an insurance company a portion of its risk to another company."
3. In the words of R.S. Sharma, "When an insurer transfers a part of his risk on a particular policy by insuring it with some other insurer, it is called re-insurance."

A reinsurance does not affect the contract between the original insurer and the assured. Reinsurance can be restored in all types of insurance contracts, which involves large risks. As the contract of reinsurance is a contract of good faith, the reinsurer is not liable to the assured and the contract is co-extensive with the original policy.

Under the reinsurance method, if an insurance company receives an insurance proposal worth Rs. 10 crore, where its risk bearing capacity is of Rs. 5 crore only, it has two options either to reject the proposal or to accept it. After accepting the proposal the insurer can limit his liability by getting reinsured for Rs. 5 crore with another insurer. In case of complete loss the original insurer makes the payment of claim to the insured for Rs. 10 crore and then claims Rs. 5 crore from the re-insurer(s).

Features

1. Reinsurance is a contract of indemnity.
2. It is an insurance contract between two insurance companies.
3. The relationship of the assured remains with the original insurer only. The re-insurer is not liable directly towards the assured.
4. In re-insurance the insurer transfers the risk beyond the risk beyond the limit of his capacity to another insurance company.
5. Re-insurance does not affects the right of insured.
6. The original insurer cannot do re-insurance more than the insured sum.
7. Re-insurance can be possible in all types of insurance.
8. The fundamental principles of insurance are applicable in re-insurance also.
9. Re-insurer is bound only those liability for which the original insurer is legally liable.

Merits of Re-insurance

Re-insurance is beneficial to the insurers and the insureds both.

1. Re-insurance is a security for the insurers. He can share his risk with other insurers.

2. It increases the capacity of the insurer of undertake insurance of larger sums without any hesitation. Many smaller companies can also undertake heavy risks.
3. It reduces the situation of uncertainty by distribution of risks among other insurers.
4. It encourages the new and smell insures to undertake more risk and remain in business.
5. It makes possible for the insurer to insure catastrophic risks like flood, earthquake, cyclone etc. Normally such risks are not insured.
6. It brings stability of earning the profits by distributing risks among many.
7. It brings stability in income by reducing liability.
8. It is device against becoming an insolvent. When a number of insurers become insolvent the business cannot be carried forward. In such a situation the remaining business can be reinsured and can find alternative for survival.
9. It reduces unhealthy competition since most of the insurers cooperate each other in this case.
10. Re-insurance is more useful to new insurers who bear loss capacity to undertake risks.
11. It increases the goodwill of insurance business as it undertakes different types of risks and issues policies against those risks.

Advantages to the insureds include the following

1. The insured gets the goodwill of two insurers and in the case where one insurer becomes insolvent he can claim indemnity from the other.

2. The insured is protected against bad effect of insuring with an insurer who undertakes more than his risk bearing capacity.
3. The insured also gets the advantages to insure with one insurer for a large sum. There is no need for him to insure with more than one insurer.
4. Advantage of insuring against catastrophic risks like cyclone, floods, earthquake etc. which are not insured normally by the insurance companies.

There are three methods of Re-insurance

1. Facultative method
2. Treaty method
3. Pooling method

1. Facultative Method : This is the very oldest method of reinsurance. Under this method both the parties are formed into a contract for any specific time. The reinsurer has the liberty to accept or reject a proposal received for re-insurance. The method is a flexible one, reinsurance can be affected according to the needs of circumstance. This method is more suitable for emergent situations.

In the words of Reigel and Miller, "Facultative reinsurance is an arrangement made with respect to a particular risk at a particular time."

Merits : Certain important merits are as follows :

(1) This method is flexible. The facility to make reinsurance is based on the circumstances of the case.

(2) There is no restriction on re-insurance.

(3) This method can be adopted even in emergency situations.

(4) This method is more useful where the risk is not standardised.

(5) This method makes the original insurer vigilant and makes arrangement for reinsurance before the insurance is made. In case no re-insurance is available, he may refuse to accept heavy losses due to involvement of heavy risk.

Demerits : The important demerits of this method are as follows :

(1) Many paper-work is involved in the process of reinsurance.

(2) This is an uncertain method.

(3) Unnecessary delays take place since the consent of the reinsurer is to be taken again and again.

(4) This sort of delay in getting the consent of the reinsurer leaves the chance of getting the insurance proposal.

(5) This method is more expensive.

(6) This method is impractical and non-beneficial to small and medium re-insures.

(7) In absence of getting prior consent of the re-insurer, if the proposals involving heavy risk are accepted, the insurer has to suffer heavy losses due to involvement of heavy risk.

Because of these and many other drawbacks of facultative reinsurance method, the Auto-Facultative reinsurance method has been developed. Under this new method a special category of risks ar re-insured. Re-insurance of this method has much importance in Engineering Insurance, Air Transport Insurance, Satellite Insurance, Crop Insurance, Disturbance Insurance etc.

(2) Treaty Method : It is an informal agreement between two insurers under which the re-insurer agrees to reinsure risks written by the other insurance company (propose) subject to the terms and conditions of the treaty and within the prescribed time limit. Treaty is a formal and legally binding agreement between the parties. The following types of treaty of agreements are made under this method ;

(1) Quota or fixed share treaty.

(2) Surplus treaty

(3) Excess of loss treaty

(4) Excess of loss ratio or stop-loss treaty.

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