2023 CARe Reinsurance Seminar
C-22: Structured Risk: *How Many Levers Can We Pull*

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Gallagher Re
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Structured Quota Share

Managing Capitalization
Quota Share Reinsurance as Capital Management Tool

Finance growth

- Generate **capital relief**, improve capitalization scores (i.e., BCAR)
- Competitive pricing, when compared to other forms of capital, plus the flexibility of reinsurance
- Reduces premium required capital

Available reinsurance options run the continuum of cost/benefit

- **Traditional** / Unlimited
  - Costly under favorable scenarios
- **Structured** / Limited
  - Cost effective

Available reinsurance capacity from highly rated reinsurers mitigates execution risk

- Well-understood contract and terms
- Deep structured reinsurance market

Capital issues faced by Insurance Companies

- Statutory accounting and regulatory capital models have conservative biases
  - Accelerate capital requirements
  - Accelerate expense and defer income recognition
- Significant upfront capital contributions required
  - Depresses ROE’s during the start-up phase
- **A Quota Share will lower otherwise required capital by sharing economics with reinsurer**
Capital Benefit of Structured QS Reinsurance

• Quota Share reinsurance acts as a form of capital
  – Reduces and/or delays capital contributions otherwise required
  – Reduces premium capital charges in AM Best BCAR capital model
• Structured Quota Shares are most often compared to debt financing whereas Traditional Quota Shares are more comparable to equity
  – Structured – fixed cost in upside scenarios, limit on downside protection
  – Traditional – proportional sharing of economics both upside and downside
• Cost of “capital” is the reinsurer’s margin relative to capital benefit in AM Best’s BCAR

\[
\text{Ceded cost of capital} = \frac{\text{Impact on Net Income (ceded margin)}}{\text{Implied Capital Benefit based on BCAR improvement}}
\]
Structured quota share vs. debt financing
Structured QS Typical Coverage Terms

- Common contract features used to lower cost and limit risk include:
  - Experience Accounts – returns excess profit to cedant
    - Similar to 100% profit commission at ELR or better
  - Sliding scale ceding commission or loss corridors – losses in a specified range are retained by cedant
    - 60% - 70% corridor used in the example on the next slide
    - Limits reinsurers downside to balance upside retained by cedant
  - Loss ratio caps – losses in excess of the cap are retained by the cedant e.g., the reinsurer will not be responsible for losses in excess of a specified amount
    - 100% LR used in the example on the next slide
- Structured Quota Shares are subject to the same accounting and risk transfer rules as Traditional Quota Shares and all other reinsurance contracts:
  - Any limitations on recoveries (loss ratio or occurrence) must be reflected
  - Any experience related features must be currently accrued (profit commissions, loss corridors)
- Structured deals exceed accounting risk transfer guidelines and fully qualify for reinsurance accounting and capital relief
Margin Comparison: Structured vs. Traditional QS

Structured QS has a lower cost under favorable results...

6% margin same at ELR of 58% LR, Structured QS margin flat through 6-point Corridor to 64% LR

-24% at 40% LR

0% at 64% LR

-36% at 106% LR Capped beyond

-42% at 106% LR

but less downside protection if results are unfavorable

Traditional QS (36% Fixed CC)

Structured QS (6% Margin, 6-point Corridor, 100% LR Cap, FWA w 100% PC)
Multi-Year Excess of Loss

Managing XOL Retentions
## Structured Multi-Year XOL with Profit Commission

**Improving Cost Benefit on High Activity Working Layers**

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
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<tbody>
<tr>
<td>Best for High ROL layers with poor cost-benefit relationship</td>
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<tr>
<td>Takes advantage of diversification over time – most effective in high loss activity areas</td>
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<td>Reinsurers often have dedicated teams for this product</td>
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<td>Typically written with single or limited reinsurer</td>
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<tr>
<td>Can help bridge view of loss cost between cedent and reinsurer</td>
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Multi-Year Excess of Loss
Potential Solution to Increasing CAT XOL Costs

How it works:
- 2-to-3-year period
- Upfront Premium same or marginally higher than Traditional
- Cumulative notional Experience Account
- Margin 30-50% / PC 50-70%
- Annual Limits matching Traditional with additional Term Limits share across years
- Early cancellation option if profitable

Overlying Layers

Underlying Layers (> 30% ROL)

Retention

Structured Solution
Multi-Year XOL with PC to leverage on diversification over time
Multi-Year Excess of Loss
Potential Solution to Increasing CAT XOL Costs

### Bottom Layers – Commensurate Protection for Cost?
- High ROL layers = poor cost-benefit
- Large component of loss activity self-funded via high upfront and reinstatement premium
- Time diversification lowers volatility charge, diversification most effective on high loss activity areas

### Efficient Solution
- Product with high Profit Commission on good experience
- Budget stability and security over time with strategic capacity provider
- Not exposed to market volatility or post-loss adjustment

### Identical to Traditional
- Same annual coverage
- Similar or marginally higher upfront ROL

### Cash flow Benefit
- Upfront payment of only RI margin instead of full Deposit Premium

### Significant Profit Commission
- Potentially substantial cost savings with PC up to 70%+

### Guaranteed Pricing & Capacity
- Regardless of loss experience
- No post-loss adjustment

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Attractive cost-benefit with profit commission on good experience, guaranteed terms and capacity on poor experience, all while providing identical annual coverage as Traditional.
Motivations & Adaptations
An approach not a product

“Vanilla” MY – Pure Efficiency

Leveraging on time diversification for better cedant economics without compromising on reinsurer’s. In turn can achieve similar premium with significant PC.

- The time element reduces volatility which in turn reduces margin requirement.
- Significant PC possible given modelled loss activity compounded by tightened distribution over time.

Reinsurers, however, are unlikely to openly acknowledge above – expect default position to include loading on upfront premium in their favour.

Risk-Reward Tradeoff

The flexible augmentation of risk-reward profile – to sit in between traditional and self-retention – should in itself be a valuable, differentiating option.

- Works well when there is discrepancy between client and reinsurer view of expected loss – leveraging the gap.
- Also when the client is already in some mindset for higher risk retention – voluntarily or otherwise.

Above aspects compound in a hardening market whereby clients have increasingly limited options outside of straightforward risk-adjusted loadings.
Transaction Statistics
Highly varied in application

(Paid) ROL
Average ~50%
Majority 30-70%

Profit Commission
Average ~50%
Majority 30-70%
R/I Margin = 1 - PC

Duration
Vast majority 3 years
Up to 5 years

Customization of Premium, Limits & Margin subject to goals and constraints

Transacted ROL vs R/I Margin

ROL  R/I Margin
"Cat 32" Illustration
2-Year CAT XOL with 3 Limits over Term

Illustrative Terms
- 2-year period
- Upfront Premium same or marginally higher than Traditional
- Margin 30-50% / Profit Commission 50-70%
- Annual Limits matching Traditional at 2 occurrence limits, Term Limits set at 3 occurrence limits

<table>
<thead>
<tr>
<th>- Premium -</th>
<th>- Coverage -</th>
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<tr>
<td>Funds Withheld / Potential PC</td>
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<tr>
<td>Margin</td>
<td>Margin</td>
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<tr>
<td>Year 1</td>
<td>Year 2</td>
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<table>
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<tr>
<th>Reinstated Limit (Shared)</th>
<th>First Limit</th>
<th>First Limit</th>
<th>Retention</th>
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Covered Business
- Subject Policies: TBD
- Geographic Scope: TBD
- Subject Premium: TBD
- Broker: Gallagher Re

Structured Terms
- Product: Multi-Year Excess of Loss
- Reinsurer: TBD
- Effective Term: 2 annual periods
- Premium: TBD per Annual Period
- Reinstatement Premium: TBD
- Margin, Funds Transferred: A percentage of the Premium, Settled on a Funds Transferred basis
- Funds Withheld Account: Premium less Margin, to be retained by Company on a cumulative Funds Withheld basis
- Interest Credit: X%, applied to Funds Withheld Account each year until Commutation

Coverage
- Attachment Point: TBD, each Occurrence
- Occurrence Limit: TBD
- Aggregate Limit: 3 Occurrence Limit per Term
- Annual Limit: 2 Occurrence Limit per Annual Period
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