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See table of contents

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Article abstract

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Reinsurance as a determining factor in the present insurance market for major risks[1]

by

MICHEL PARIZEAU

Notre collaborateur indique ici, en particulier, la réaction des marchés de réassurance aux sinistres croissants. On trouvera dans son texte l'explication de la hausse du prix de l'assurance, de quelques problèmes importants et de la difficulté d'obtenir les montants de plus en plus élevés que demandent les grandes affaires. Nous avons pensé que le lecteur trouverait dans ce travail les raisons d'une situation nouvelle, qui sera peut-être le point de départ d'une évolution assez radicale des méthodes de travail. A.

Insurance managers for firms exposed to major risks are faced today with considerable problems, due to the state of the insurance market which, taken as a whole,[2] is going through a crisis of magnitude and which has had recently the following main consequences for many:

— Uprating

— Increase in deductibles

— Restriction in coverages

— Diminishing capacity

Surprisingly, this general tendency — granted, more acute in certain fields that in others — comes at a time when Canadian insurance business has been improving compared

[1] Texte d'une conférence donnée aux membres de la Montreal Risk and Insurance Management Association, le 20 décembre 1968.

[2] It is to be stressed that we are taking here a broad view of the situation in Canada for special risks and that, to be exact, many nuances should be made according to the type of risks and the type of insurers.

to past performances. It is therefore adequate to go deeper into the matter and try to distinguish the elements of this new attitude.

Up to a few years ago, the main cause of worry amongst insurers related to the frequency and average cost of ordinary claims, which were both increasing steadily. The principal restraining efforts were then oriented towards whatever reasonable increases in rates competition allowed, the greater use of low scale deductibles, cutting down as much as possible on administration and acquisition costs, and hoping that the overall results would level off with time. Even though larges losses had occurred, they were still considered as essentially "accidental" and not particularly probable in future, especially amongst those insurers who were not touched by these so-called freak occurrences. These were the times when competent, imaginative and astute brokers were able to negotiate rather extraordinary conditions for those accounts where material premium volumes were involved. It is amazing to see to what extent some insurers — and not necessarily the smaller ones — were ready to bend backwards in order to set their hands on prestige accounts. This was the period when a lot of insurance men still acted as if they believed that premium volume was the key to the whole problem of equilibrium.

But then hurricane Betsy came and the spectacular fire of Chicago's McCormick Place. Underwriters were shocked. They became even more so when it appeared that losses individually involving millions of dollars were occurring with an increasing frequency, both through natural elements like earthquakes and hurricanes and through human errors involving fire, explosions, machinery breakdowns, marine and air disasters, etc. They were now discovering that major and catastrophic losses were generating, in their overall operations, a tremendously disturbing factor, on which they could exercise very little control.

Another characteristic of what I shall call the post-Betsy era, compared with what is now happening, relates to the relations existing between the insurers — the ceding companies — and their reinsurers. Until recently, it was understood and implied that such relations relied upon the principle that the reinsurer followed the good or bad fortune of the ceding company. Insurance had always gone through a definite cycle of good and bad years and the two parties involved were brothers in arms, so to speak. Nowadays, it is not that the said principle has been done away with, but it has been discovered that with the advent of frequency in the field of high losses, the principle does not work anymore and that the reinsurers are taking a far greater part of the load.

In order to fully grasp this changing pattern, it is essential here to understand the basic workings of reinsurance. First, reinsurance can be made on a per case basis (facultative) or on a treaty basis. Secondly, as far as treaties are concerned, four main types of reinsurance arrangements exist:

— the quota-share by which the reinsurer takes a fixed percentage of risks subscribed by the ceding company.

— the surplus by which the reinsurer takes up to so many times the amount kept by the ceding company (these first two types are called proportionate arrangements, since the loss is apportioned between the two parties according to the percentage predetermined by the proportion of the amount of insurance taken by each of them; the only difference between the two arrangements being that in the first case there is a fixed percentage and in the second case, a percentage that can vary from one risk to the other according to the ceding company's decision. The premium is separated between the two parties pro rata of their interest and the reinsurers pay a commission which theoretically corresponds to the administration and acquisition costs of the ceding company).

— the excess of loss by which the reinsurer pays the excess of a predetermined sum *per loss*.

— the stop loss by which the reinsurer pays the excess of a predetermined percentage of overall losses for the year. (These last two types are called excess covers, since the reinsurer's obligations come into line only for losses which are in excess of a predetermined amount or overall percentage. Here, there is no distribution of the insurance premium between the parties, but the reinsurer charges to the ceding company a percentage of the ceding company's gross premium as a reinsurance premium).

It is to be noticed also:

— that treaties are usually applied by classes of insurance: fire, automobile, liability, etc. and that they normally include a list of prohibited risks.

— that ceding companies usually wish to protect their treaties whenever they feel that a risk is particularly hazardous, even when said treaties do not contain any exclusion relating to such risk, by buying facultative reinsurance.

— that proportionate reinsurance is mainly — not only, however — a means of financing increased volume because of the requirements relating to the reserve for unearned premiums, and that it is used therefore to a much greater extent by smaller companies.

— that excess of loss reinsurance is a much purer form of reinsurance, giving to the ceding company the levellingoff benefit which is essential to the basic principle of insurance relating to the law of average.

— and finally that because of this, excess of loss reinsurance is the only solution for ceding companies in the field of major or catastrophe risks.

Now, from these elements, one can better understand that frequency or high losses is touching reinsurers to a much greater extent than the ceding companies. As long as the latter are protected by reinsurance above a certain amount of loss which keeps their net loss in line with those happening under normal occurrences, the overall situation remains reasonable and within the grasp of the ceding companies possibility to adjust their results.

But reinsurers, who are alimented mainly by normal business premiums, are faced nowadays with tremendous outgo of money for losses which were never contemplated initially to such an extent.

Moreover, reinsurers are faced with the problem of accumulation of losses stemming from a single occurrence and emanating from different ceding companies. Let us take an example:

Suppose that a windstorm loss of $20 millions occurs like the one that happened on the east coast of the United States on November 11-12th of this year, and that this loss is spread amongst 100 companies in equal shares of $200,000. Let us suppose that each company was protected under an excess of loss treaty above $150,000 and that one reinsurer had subscribed to 10 of these treaties. He would than have to pay $50,000 $\times$ 10 = $500,000.[1]

[1] Nous renvoyons le lecteur au texte de M. Jean Sousselier, paru dans le numéro d'octobre 1968 de la Revue. Nous lui avons emprunté cet exemple en l'adaptant au marché nord-américain. M. P.

Let us now suppose that the overall loss is 10% higher or $22 millions. One then sees that each ceding company's loss remains at $150,000, but that the reinsurer's share goes up to $70,000 × 10 = 700,000 which means an increase of 40% over what he would have to pay under the previous example which took into account an overall loss of only 10% less.

276 This shows how, in reinsurance, there can be a progression in losses which surpasses the simple arithmetic progression, while the premiums received do not follow the same progression.

Now, you are all aware that many rather new factors have influenced results in the past few years:

— considerable increases in liability judgments given by the courts, with said judgments coming many years after the occurrences, therefore with a gap between the level of losses expected at the time the premiums were established and the true results.

— a steady increase in the cost of living, everywhere in the world, here again increasing considerably the gap between premiums received and losses paid, with, for the reinsurers, the non-arithmetic progression already noted.

— a regular trend towards currency devaluation which can affect in an important way, depending upon the circumstances, the results of reinsurers.

In view of all this, the world's reinsurance market, especially after the tremendous constriction at Lloyd's — which has always been the center of reinsurance operations — has recently awakened and has decided that it was time to do something about the situation which, if one reads the papers submitted to the last September Rendez-vous of reinsurers at

Monte Carlo, appears unanimously as the result not of a cyclic low, but of a crisis brought about by the lack of adaptation of an extraordinarily important industry to the drastic changes in the political, sociological and economic environment.

The first and most important move of this reaction was the definite decision of reinsurers to do away with the "follow the ceding company's attitude" in premium and form setting and to intervene directly in the establishment of the insurance conditions, whenever the reinsurers were taking the larger share of the risk. Of course, with the tremendously bad results in the field of major and catastroph risks, this is where the consequences were felt most, and this is why you gentlemen are now hearing so much about this mysterious and powerful man, the reinsurer.

I do not want to appear too alarming but I must warn you that you are not yet at the end of your headaches and that the situation, in your major league, is not yet ripe for scientific and rational approaches. You are faced with unusual and high risks and you will have to understand that in future you will have to pay much more for what you are asking.

Until the time when insurers and reinsurers have truly realised the necessity of establishing not only past statistics but prospective thinking for the future in terms of the modern age mammoths that you have become, I do not believe that general insurance will yet become the true science that it should be.

The crisis to which I have been referring should however have a positive consequence as far as you are concerned: you should now realize that insurance is only a means amongst others for the preservation of assets, that it is not a necessity in all circumstances, and that much more thought should be given to self-insurance, captive insurance companies, safety prevention and risk management.

Your firms are spending considerable sums of money for research. I hope that one day insurers and reinsurers will thoroughly realize that they must keep in pace with you not only to give the service which they are supposed to offer, but also to survive.