

## Stop Loss Reinsurance Some General Comments

Eric A. Pearce

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# Stop Loss Reinsurance

## Some General Comments <sup>1</sup>

*by*

ERIC A. PEARCE, F.C.I.I.

### Foreword

Readers may remember that some months ago, I prepared a review of the standard clauses used in Excess of Loss Reinsurance contracts. The very kind reception given to my notes, in Canada and elsewhere, emboldens me to write some general comments regarding the other main method of non-proportional reinsurance, namely Stop Loss. 209

The original name for this general form of reinsurance was "Aggregate Excess of Loss Reinsurance" and indeed that name is still used, as is "Excess of Loss Ratio Reinsurance".

There is no objection to the use of those names but throughout these notes I have used the shorter and more expressive "Stop Loss" which I have found to be gaining favour with reinsurance men.

Among other advantages, the name "Stop Loss" avoids any possibility of being confused with Excess of Loss Reinsurance, to which it is in no way similar.

In various forms, Stop Loss can be adapted to a great number of reinsurance needs and at some future time may become the most widely used of any form of reinsurance.

It is probably the old enemy "inflation" which has had the effect of retarding development, because an experienced reinsurer may expect that increased claims cost is likely to

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<sup>1</sup> A nouveau M. Pearce nous a rendu le service d'étudier pour nous une autre formule de réassurance. Nous l'en remercions. A.

run ahead of increased premiums and so upset the calculations of his risk, based on past statistics.

Stop Loss is sometimes used for the protection of a Life account against an unexpectedly high death strain. It is an interesting form of reinsurance, but I have not referred to it in the following notes because it is a rather different concept from the forms used for non-Life, and as such is worthy of study as a separate matter.

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**Article 1. Scope of cover**

Probably the most usual single classes of insurance protected by Stop Loss reinsurance at the present time are Hail, Fire (and other Physical Damage) and Workmen's Compensation, although Stop Loss reinsurance is frequently used to protect a whole portfolio of, for example, Marine or Non-Marine business.

In view of this, the article expressing the scope of cover is likely to vary greatly from one reinsurance to another, but a general basis will probably be along the following lines:

This Agreement subject to the exclusions hereinafter appearing shall apply to all policies or contracts of insurance or reinsurance in respect of Fire and Allied Perils, as original, (hereinafter called "policies") underwritten by the Company in Canada.

It is essential that this clause should be absolutely accurate in detail, so as to ensure that both parties agree exactly on the range of the policies and the classes of business included in the reinsurance. In those instances where the Company uses computer or mechanised accounting procedures, it may facilitate exact understanding if the code numbers or other machine references are used.

Further, if reinsurances are included it may be as well to state in this article any agreed limitations, such as the limitation to proportional facultative reinsurances, instead of the very broad description, "reinsurances".

**Article 2. Exclusions**

This article will almost certainly deal with standard exclusions, such as:

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War and Civil War  
Nuclear Incident

There will be more specific exclusions also, possibly specifying sections of the original policies which by agreement are not included within the scope of the reinsurance, such as Earthquake or Windstorm.

If the contract includes reinsurances, unless this has been strictly qualified in article 1, it will probably be necessary to set out in full the types of reinsurance not included, such as all non-proportional policies and proportional treaty business.

Further, there may be the exclusion of contracts applying to certain territories or to some classes of contract which are dealt with outside the scope of the Stop Loss reinsurance.

It is evident that the possible exclusions are endless and so should be dealt with in detail during the negotiations, before the terms are finally agreed upon by the parties.

**Article 3. Net Retained Lines**

It is an essential feature of Stop Loss reinsurance that the net retention of the Company must be determined in advance. The following is a simple and effective clause:

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This Agreement applies only to the net retention of the Company. Such net retention shall be deemed not to exceed C. \$10,000 in respect of any one risk.

There are a great number of variations and elaborations to this clause and attention is drawn to the following:

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- (a) When dealing with a class of business such as Fire where a Table of Net Retentions is applicable, it is quite usual to include such Table in the contract, in place of a single monetary amount, such as the C. \$10,000 mentioned above.
  - (b) In similar manner, for Hail or Earthquake there may be detailed stipulations of the maximum permitted sum insured in each area or zone.
  - (c) Some contracts state in full the Excess of Loss reinsurance protections which the Company has in force, but this may become very complicated particularly as it is essential to set out any limitations applicable to reinsurances, such as the number of full reinstatements or any possible aggregate limit or deductible. Certainly, if the Company does not have unlimited reinstatements on one or more of its Excess of Loss reinsurances there must be clear understanding between the parties as to the procedure to be adopted if the Company cannot recover the whole or part of a claim which would otherwise have been recoverable from Excess of Loss reinsurers.
  - (d) There is also the possibility that the Company may find itself without more specific reinsurance protection because the relevant reinsurer is unable or unwilling to pay its share of the claim, whether because of the insolvency of the reinsurer or because the reinsurance was invalid for any reason whatever, or merely because the Company failed to arrange the necessary facultative reinsurance.

To meet such possibilities, there is sometimes included in the Net Retained Lines clause, a phrase to the effect that

“This Agreement shall only protect that portion of any insurance which the Company *acting in accordance with its established practices*, retains net . . .”

No very vivid imagination is required to visualise the unending arguments which could arise between the parties as to what is or is not the Company's “established practices”.

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Indeed, one does occasionally come across contracts which seem to have been drafted for the express purpose of establishing grounds for disagreement and misunderstanding by the use of such nebulous phrases as “any error or omission which results in an increase in the Company's normal retention” or “the Company's failure to reinsure in accordance with its normal practice”.

It would seem that the use of a monetary amount as set out in the clause suggested in the first paragraph above, or the inclusion as a warranty of the Table of Net Retentions, would meet the Reinsurer's requirements, particularly as such monetary amount or Table was probably part of the information on the basis of which the rate was fixed and the risk accepted.

The Reinsurer is, of course, entitled to the protection which this clause gives him. When fixing the rate or accepting a share of the reinsurance, he must be greatly influenced by the maximum any one loss to be included in the aggregation of claims. Thus, if a stated maximum amount represents 1% of the premium income, a reinsurance applying excess of 100% loss ratio may be an acceptable one to the Reinsurer but would probably become much less acceptable if the maximum represented 20% or even 10% of the premium income.

214 There is a point of considerable importance which arises when the Stop Loss applies to a Company's portfolio of business which contains a large number of Quota Share or Surplus treaties. In such a case if many of the treaties apply to a particular territory the Company, which to this extent is a ceding reinsurer or retrocessionnaire, is almost certain to have considerable accumulation on target risks, as each treaty is likely to cede a full line. For the protection of the Company, the Net Retained Lines clause should be drafted to take care of this aspect. The following is a typical clause which could be used for this purpose:

The Company may have several net retentions on the same risk, ceded to the Company under various original treaties. Each such net retention shall be deemed not to exceed 5% of 100% of the original treaty or C. \$10,000 (whichever is the less) in respect of any one risk any one cession.

#### **Article 4. Laws in Force**

Each class of business has its own distinct problems, which must be resolved between the parties during the negotiations. One such problem is that which arises with regard to a class of insurance, the operation of which is based on legislation or established local regulations. Such legislation may impose a scale of benefits payable in the event of injury or death or provide stated policy limits. These are all matters having a direct relationship with the cost of claims which arise under such policies. Typical examples are Workmen's Compensation or Employer's Liability Laws or Road Traffic Regulations.

Although in many countries such Laws or Regulations have now been replaced by Social Security legislation, so that all indemnification is dealt with by the State, in other

countries Insurance Companies still provide protection for the employer or motorist in respect of his liability.

In the latter countries, from time to time, the Governments revise the benefits payable, so as to bring them into line with present day values or to meet the requirements demanded by the electorate. Although such increased benefits are likely to throw a heavy burden onto the Insurer, the latter can be expected to recuperate any loss in future years as premiums are increased.

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The Stop Loss Reinsurer is however, likely to suffer a very severe set back in such cases, as the new risk may be vastly different to that contemplated when the reinsurance was negotiated.

As a protection against this, it is usual for the contract to contain a clause as follows:

1. This Agreement is based on the Workmen's Compensation Law of 1st January 1970 and any alterations thereto or Regulations promulgated thereunder up to the inception date of this Agreement.
2. If any alteration to such Law or Regulations is made on or after such inception date, which has the effect of increasing the Reinsurer's risk of loss, the reinsurance will be held covered from the date of such alteration, pending a re-negotiation of the terms and conditions of this Agreement.
3. If the parties cannot agree upon the terms of such re-negotiation, the claims subject to the new legislation will be dealt with (purely for the purposes of this Agreement) on the basis of the legislation referred to in the first paragraph of this Article.

Such a condition may at first sight appear to be rather harsh in its application against the Company, but there is a



feeling among some Reinsurers that unless provision is made in advance to deal with the situation, in the event of a change in the law, the reinsurance would cease to be valid, following one of the basic principles of insurance and reinsurance, namely the doctrine of "change of risk".

216 It is evident that it is in the best interests of both parties that the possibility of change should be foreseen and the principle of renegotiation established. This is particularly so in the case of Stop Loss reinsurance, because the period of the contract is usually one year, and to cut off a contract in mid term, might completely distort the results.

**Article 5. Basis of Reinsurance**

Stop Loss reinsurance may take many forms, but the following is quite usual for Fire insurance:

1. If in respect of the period of this Agreement the Incurred Losses exceed an amount equal to 100% of the Net Premium or C. \$1,000,000 whichever is the greater, the Reinsurer agrees to pay to the Company the amount by which the Incurred Losses exceed 100% of the Net Premium or C. \$1,000,000 whichever is the greater.
2. The liability of the Reinsurer for the period of this Agreement shall be limited to an amount equal to 20% of the Net Premium for such period or C. \$200,000 whichever is the less.

Attention is drawn to the monetary limit, both as regards the excess point and the limit of liability of the Reinsurer.

This is a necessary protection for the Reinsurer. The reinsurance is based on the past experience of the Company and/or a forecast or estimate of its future development. Any serious error in such forecast could result in the Reinsurer

being bound to a reinsurance very different to that which was contemplated at the time of the negotiations.

For example, suppose that the Net Premium which had been estimated at C. \$1,000,000 was not achieved during the year and reached only C. \$100,000, possibly on account of competition or for any other reason. In spite of the obvious implication that there would be a smaller number of policies in force, the risk of the Incurred Losses exceeding C. \$100,000 is probably vastly greater than if the excess point were C. \$1,000,000, assuming that the permitted net retention or Table of Limits remained unaltered.

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Similarly as regards the liability. If the Net Premium were greatly increased, to C. \$2,000,000 for example, the Reinsurer might find that his maximum liability, if expressed only as a percentage of Net Premium, was far greater than he had intended or, indeed, could prudently retain for his own account on that particular type of reinsurance.

In the early days of Stop Loss, when probably a much higher proportion of contracts were on a continuous basis rather than a fixed period basis, many Companies were of the opinion that if a Reinsurer had agreed to a stated monetary limit for one year, such limit was cumulative over the period of the contract, so that if the contract were free of claim for one year the monetary limit would be increased accordingly for the following year, although the limit of liability expressed as a percentage of the premium income would remain operative.

Indeed, unless the intention is clearly stated there might still be considerable doubt in the case of a contract for an indeterminate period, as to whether the monetary limit should apply to each year separately should accumulate year by year or should be a limit for the period of the contract, even if the contract should continue for a number of years.

One can visualise the position which could arise, particularly in the case of a new Company or a Company commencing to underwrite a new class of business. The premium would be expected to increase rapidly during the first few years and unless the monetary limit of liability was fixed at a very substantial amount at the outset, or revised each year, it would quickly become quite inadequate.

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Suppose that for a new class of business, a Stop Loss reinsurance was arranged to provide protection for 20% loss ratio excess of 100% loss ratio. In the first year a premium income of C. \$500,000 is envisaged and the monetary limit is fixed at C. \$100,000.

The premium income might be marginally larger or smaller but the reinsurance might continue into the next year without alteration. If at the end of that year the premium income has increased to C.\$1,000,000, the limit of C. \$100,000 has now become 10% not the 20% which the Company had in mind.

Assuming that the business continues to develop, it is not at all unreasonable to suppose that at the end of the fifth year the premium income will be C. \$3,000,000 so that the monetary limit of C. \$100,000, left unchanged because of an oversight, has become 3.3%, possibly less than the reinsurance premium for the year. If a claim now occurs, the Company, possibly quite inexperienced in the small details and practice of Stop Loss reinsurance, might feel that it has good reason to believe that the annual limit had accumulated so that it had cover up to five times C. \$100,000 being C. \$500,000; more closely approximating to the monetary limit appropriate to a premium income of C. \$3,000,000.

Although these figures may seem to be exaggerated, they are not necessarily so in those instances where a Com-

pany has recently ventured into a new class of business or in respect of insurances for which the sum insured is based on the price of farm produce or other commodities where the values at risk can vary very greatly over a relatively short period with little or no change in the actual quantity of the material at risk.

The remedy lies with the Company, who is in close touch with the development of the original sums insured and the premium income, and should be able to foresee with reasonable accuracy the likely turn of events. By making realistic estimates of premium income and prices, the Company can fix the monetary limits at satisfactory levels, so as to enable the Reinsurer to fix with prudence his capacity of acceptance. The Company can then bring in other Reinsurers to accept shares, if necessary.

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Reinsurers are usually careful to ensure that the deductible under a Stop Loss reinsurance is fixed at a level which will not guarantee that the Company will make a profit. To explain this, let us suppose that in respect of a particular class of business the Company's expenses (including agent's commission) amount to 30%. If the Stop Loss is arranged to pay the excess of 50% loss ratio (retained losses to retained premium) this will automatically ensure that the Company will make a profit of 20% ( $100\% \text{ less } 30\% = 70\% \text{ less } 50\%$ ) less the amount of the reinsurance premium paid as consideration for the Stop Loss reinsurance.

It is perhaps unlikely that such a Stop Loss could be arranged to-day but they were a fairly common feature of the reinsurance market some years ago. This arose out of the fact that in some European countries the Simple Risks classes of insurance, such as Fire and Accident, were to a certain extent in the hands of small insurance companies which were thoroughly sound financially, which had usually been in

existence for a great many years and were run on most conservative lines, frequently operating within a rather restricted geographical area. The profit ratios, in terms of percentage were good and in most years the business provided reasonable dividends for the shareholders. Obviously the results of the business were vulnerable to year by year fluctuations and the "guaranteed profit" Stop Loss reinsurance was really a form of dividend equalisation fund.

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This is in some ways similar to the Stop Loss reinsurances taken out by Mutual companies to protect the members against being required to meet one or more "calls" of premium.

It is perhaps worth mentioning that Mutual companies may take many forms, but a widely used system is that by which the premiums are fixed in accordance with a rate book exactly as for a stock company, although at rather lower rates than those charged by the latter for the identical risks. The theory is that if, year by year, there is a profit, such profit is shared by the whole body of the members, whereas if there is a loss, such loss is made good by calling upon each member to contribute a further premium which is known as a "call", probably an agreed percentage of the original annual premium paid at inception. In some cases there may be two or even three calls, in a year when the claims are particularly heavy.

Although the members are fully aware of the obligation to meet such calls of premium if they are made, the sudden necessity to do so might fall heavily upon the members.

Thus, Mutual companies are likely to seek Stop Loss reinsurance which will pay the excess of a stated level of the premium first debited to the members. When such level is exceeded the Reinsurer will pay (up to the limit of his liability) and so avoid the necessity for the Mutual to make a call of premium, or will at least reduce the amount of the call.

Great care must be taken when negotiating such a Stop Loss reinsurance and when writing the relative contract to ensure that the basic premiums as determined at the commencement of the reinsurance are the amounts first payable by the members as consideration for the insurance and exclude any amounts which the Mutual may collect subsequently or have the right so to collect.

Similarly, the definition of "premiums" must expressly include amounts which the Mutual may decide to return, or have the right to return to members.

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It is obviously not the intention of the reinsurance that the Mutual should be required to make, say, a 50% call before the loss ratio is calculated, nor that there should be a claim against the Reinsurer because the Mutual had decided to reduce the general level of premiums or to make a return to the members of a substantial part of the premiums paid by the members.

**Article 6. Definitions**

For the purposes of Stop Loss reinsurance, the protection may be based on a great variety of criteria, such as total sum insured, market price of produce or commodities, annual average value of the same, gross premium income, net premium income — in fact any figure which can be readily determined without controversy, against which the aggregation of losses can be measured.

From this it will be immediately evident how vitally important it is to have clear and concise definitions of all the terms used in the general body of the contract.

For example, it is frequently the case that "premium" against which losses are measured is quite different from "premium" used for the calculation of reinsurance premium.

Similarly, "losses" may vary greatly according to the class of business involved. In some contracts claims will be run off until final settlement, in others there may be reserve adjustment in and out, whilst in yet another it may be convenient to make provision for actuarial valuation of claims, after a certain number of years.

222 Obviously, each technical term must be carefully defined according to its use in each particular contract. The following are, therefore, merely broad reminders, which may be helpful as a guide to the preparation of definitions for use in some simple reinsurances.

**Losses**

- (i) Applicable to Fire and Allied Perils. Incurred Losses in respect of the period of this Agreement shall mean:
  - (a) Reserve for outstanding losses at the end of the period, plus
  - (b) Losses paid during the period, less
  - (c) Reserve for outstanding losses at the beginning of the period.
- (ii) Applicable to Hail and other hazards of nature. Incurred Losses in respect of the period of this Agreement shall mean the cost as finally determined of all losses occurring during such period.
- (iii) Applicable to Workmen's Compensation, Employer's Liability and Personal Accident and Sickness.
  - (a) Incurred Losses in respect of the period of this Agreement shall mean the cost as finally determined, of all losses occurring during such period.
  - (b) Nevertheless, if 36 months after the end of such period there remain outstanding any loss or losses which have not been finally settled, the Company and the Reinsurer shall review each

such loss and to the extent that they can agree upon an amount which they consider to be a reasonable estimate of the final cost, such figure will be used, for the purposes of this Agreement, as if it were the cost as finally determined of such loss or losses.

- (c) However, if in respect of any loss or losses the Company and the Reinsurer cannot agree upon an estimate of the final cost, such loss or losses shall be submitted to an actuary who has been chosen jointly by both parties, and he shall determine the amount of the probable final cost of each. Such amount shall be binding on both parties and used, for the purposes of this Agreement, as if it were the cost as finally determined of such loss or losses.

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(All "loss" definitions may be expected to make reference to the inclusion of costs of settlement and litigation, and the deduction of amounts recoverable under other reinsurances).

### **Premium**

- (iv) General definition of Gross Premium Income. Gross Premium Income shall mean the gross original premiums resulting from all policies described in Article 1, encashed by the Company in respect of the period of this Agreement, after deduction of cancellations and return premiums and gross original premiums paid or payable by the Company for reinsurances which inure to the benefit of the Reinsurer.
- (v) Applicable to Fire and Allied Perils insurance. Gross Net Premium Income in respect of the period of this Agreement shall mean:



- (a) Incoming premium reserve at the beginning of the period, plus
  - (b) Gross premium income of the Company for the period, less
  - (c) Outgoing premium reserve at the end of the period.
- (vi) Applicable to Hail insurance and insurance against any other seasonal hazard where the risk is completely run-off during the period of the Stop Loss reinsurance. Gross Premium Income in respect of the period of this Agreement shall mean the gross original premiums accounted for by the Company relative to the policies described in Article 1, which commence or take effect during the said period, after deduction of cancellations and return premiums and gross original premiums paid or payable by the Company for reinsurance which inure to the benefit of the Reinsurer.

The next definition, is that applicable to Workmen's Compensation insurance or Group Personal Accident insurance and similar, where an initial premium is paid and then adjusted at the end of the policy period on the basis of the annual wage roll or the turnover of the commercial undertaking in question, or other criteria of the number of persons who have been at risk during the period of the insurance. On every occasion before writing this definition into a contract, it may be helpful to consider the definition of "Losses" which is to be used in the same contract.

The true comparison for the purposes of a Stop Loss reinsurance, is to take on the one hand:

- (a) all losses arising under policies having their inception or renewal dates during the period of the reinsurance, from such inception or renewal date until the termination

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or renewal date next following after the end of the period of the reinsurance; and on the other hand:

- (b) the gross original premiums payable for such policies including any additional premium payable at the termination date or next renewal date of each of the policies which additional premiums are applicable to the period then expired.

In fact, this is the basis colloquially known as “policies issued and/or renewed during the period”.

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However, this is not a very practical approach, because it is necessary to wait until all liability under one year's policies has run-off, i.e., twelve months after the end of the year, and similarly to wait for all the premium adjustments to be rendered by the Insureds and agreed by the Company, which is certain to be at least eighteen months after the end of the year and likely to be much longer.

Therefore, as a matter of expediency, it is usual to apply on the one hand:

- (a) losses occurring during the period of the reinsurance irrespective of the inception or renewal dates of the policies; and on the other hand:
- (b) premiums encashed during the period of the reinsurance.

This is usually referred to as “accidents happening during the period”, and it is on this basis that the following definition is drafted:

- (vii) Gross Premium Income in respect of the period of this Agreement shall mean the gross original premiums resulting from all policies described in Article 1, encashed by the Company during the period of this Agreement, including any additional or return premiums payable on adjustment under such policies

irrespective of the period or year to which such adjustments apply, but nevertheless after deduction of gross original premium paid during the period of this Agreement for reinsurances which inure to the benefit of the Reinsurer.

226 It is evident that the Gross Premium Income established in accordance with definition (vii) will not be exactly commensurate with the risk covered by the Reinsurer. There would be adjustments from the preceding year and possibly from more than one earlier year, whereas many adjustments arising in respect of policies renewed or terminated during the period of reinsurance would not be included. However, if the reinsurance continues in force with the same Reinsurer for several years, there is not likely to be any great loss of premium over the whole period. The advantage is that the figures will be available very shortly after the end of the period of reinsurance, and can probably be tied in accurately with the Company's balance sheet figures.

In the final paragraphs of Article 5 Basis of Reinsurance, reference was made to the type of Stop Loss reinsurance which might be used by a Mutual company to protect its members against being required to meet the cost of one or more "calls" of premium.

The following is a definition of "premiums" suitable for such a reinsurance:

- (viii) (a) Gross Premium Income shall mean the gross original normal premiums resulting from all policies described in Article 1, accounted for by the Mutual in respect of the period of this Agreement, after deduction of cancellation and gross original normal premiums paid or payable by the Mutual for reinsurances which inure to the benefit of the Reinsurer.

- (b) "Normal premiums" shall mean the premium accounted for by the Mutual at the commencement of each policy period in accordance with its Rules and the conditions of the policies, but shall not take into account either the calls of premium which the Mutual may decide to collect from its members, or any return of premium which the Mutual may decide to make to its members.

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The above is based on the general definition of Gross Premium Income set out in (vi) above but, naturally, the definition must be adapted for each class of business whether or not the cedent is a Mutual company.

It is found from time to time that it is stated in the contract that the premium paid for the Stop Loss reinsurance shall not be deducted from the Gross Premium Income when establishing the amount of the "premium" upon which the Stop Loss reinsurance is based, whether as regards excess point or otherwise.

When there is a limitation of the permitted deductions to "premiums paid or payable for reinsurances which inure to the benefit of the Reinsurer" one might assume that this is sufficient for all practical purposes. However, Reinsurers do sometimes require the condition to be more explicitly stated.

This point has its importance because a premium paid for one or more layers of Stop Loss reinsurance, possibly as much as five percent or more of the premium, could quite easily make the difference between there being a claim against the Reinsurer, or not.

Further, some Stop Loss Reinsurers are quite firmly of the opinion that the "premium paid or payable for reinsurances which inure to the benefit of the Reinsurer" should not be deducted when arriving at the amount of the Gross

Premium Income (or similar) on which the Stop Loss premium is to be calculated.

228 The view expressed by Reinsurers is that when entering into a Stop Loss reinsurance, they expect to maintain continuity of cover exactly as for other forms of obligatory reinsurance and also expect to have a certain consistency in the premium which they receive. If the premium paid for Excess of Loss reinsurance is to be deducted from Gross Premium Income (or similar) any increase in such Excess of Loss premium has the effect of reducing the Stop Loss premium, without in any way reducing the Stop Loss Reinsurer's risk. Indeed, the fact that the Company is paying a sharply increased rate of premium for Excess of Loss reinsurance might indicate that there had been a general increase in claims cost and that accordingly the risk of claim under the Stop Loss reinsurance is also increased.

Similarly, when the Company's Excess of Loss reinsurance is subject to an adjustable rate of premium, not only could the situation arise where the Stop Loss Reinsurer would not be aware of the amount of his premium until the Excess of Loss premium had been finally determined (possibly years later), but also that the deteriorating experience on a few claims had increased the Excess of Loss premium and so had automatically reduced the amount of premium payable under the Stop Loss reinsurance.

Naturally, each reinsurance programme must be considered as a whole and details agreed in negotiation, but in many instances it does seem that the Stop Loss Reinsurer has a strong case for maintaining that the Gross Premium Income (or similar) should not be subject to any deduction in respect of the cost of other reinsurances in general.

(The attention of the reader is directed to the general discussion of "premium income" which appeared in Article 9

Rate of Premium and Deposit Premium, of A Review of Standard Clause for Excess of Loss Reinsurance.)

**Loss ratio**

When the basis of reinsurance is expressed in relation to Loss Ratio, it is necessary to include in the contract a definition of that term. The following is usual:

- (ix) Loss Ratio shall mean the amount of the Incurred Losses for the period of this Agreement expressed as a percentage of the amount of the Gross Premium Income for the same period. 229

**Article 7. Notification of claim and settlement of loss**

It should be borne in mind that as Stop Loss reinsurance applies to the aggregation of losses in respect of a stated period (usually one year) there can be only one claim against the Reinsurer in respect of each such period.

The amount of the claim, if any, cannot be determined until the amount of the Incurred Losses has been established, and this must of necessity entail a delay of months or years. Nevertheless the Company will, as soon as its annual figures are prepared, be able to form a realistic appreciation of the possibility of the Reinsurer being called upon to meet a claim. It is helpful for the Reinsurer to know this at an early date, so that he can make the necessary provisions and establish the necessary reserves in his own books.

The standard clause is as follows:

1. As soon as practicable after the end of the period of this Agreement, the Company shall advise the Reinsurer of the likelihood of the Reinsurer being called upon to meet a claim hereunder and shall inform the Reinsurer of the probable amount of such claim, if any. It is em-

phasized that this early notification of a possible claim is given in a spirit of helpful co-operation, but in the first instance is a matter of opinion on the part of the Company and such opinion is not in any way binding on the Company and does not impose any limitation as to the amount of the eventual claim, if any.

2. As soon as the Company is able to do so, the Company shall prepare and send to the Reinsurer, a statement showing the following:

- (i) Incurred Losses
- (ii) Net Premium

3. If the Company wishes to make a claim against the Reinsurer in accordance with Article 5, the calculation of such claim shall be submitted to the Reinsurer at the same time as the information required in accordance with paragraph 2 above.

4. The Reinsurer agrees to pay the amount of the claim within fifteen days of receipt of the statement of claim and proof of the loss submitted in accordance with paragraph 3 above.

Provision has been made in Article 6 Definitions, for Incurred Losses to include, in certain circumstances, the agreed estimates for outstanding claims or the actuarial valuation of claims. Such provision is intended to enable the Company and the Reinsurer to reach speedy settlement of a claim under the Stop Loss reinsurance without waiting for final run-off of all original losses.

There is not usually any difficulty in arriving at an amicable compromise settlement, bearing in mind that the Stop Loss applies to the great mass of claims, most of which are small and the larger of which are likely to be protected by Excess of Loss reinsurance, or be limited by the maximum amount warranty set out in Article 3 Net Retained Lines.

However, in exceptional circumstances it may be found impossible to fix an estimated amount of loss which is equitable to both parties, particularly in those instances where the question of whether there is or is not a claim under the original policy may depend on a Court action taking many years, or indeed depending on a decision to be taken by any official body or person who may be quite unconnected with the Company.

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Should such an unavoidable delay occur, one would expect the Company and the Reinsurer to make an interim settlement of the Stop Loss claim on some agreed basis, and to make a final adjustment, if necessary, when eventually the true figures can be determined.

In certain instances it may be necessary or desirable to arrange for the Company to have the right to make a provisional claim against the Reinsurer and to adjust such provisional claim year by year until the Company is able to formulate the definite claim.

This is very helpful in those cases where the Company is required by law or custom to show in its published accounts the equivalent in cash or securities of the amount of the Company's outstanding claims, including the amounts payable by all its reinsurers. A provisional settlement by the Reinsurer under the Stop Loss reinsurance would, in a year of serious losses, provide the Company with the necessary funds, without involving the Company's capital or free reserves.

The following is a basic clause for this purpose:

1. As soon as practicable after the 31st December 1970, the Company shall prepare and submit to the Reinsurer a statement in respect of the period of this Agreement as stated in Article 8, showing:
  - (a) Earned premium for such period.



- (b) Losses paid in respect of such period.
- (c) Losses outstanding as at the end of such period.
- 2. The sum produced by the addition of items (b) and (c) expressed as a percentage of the amount of item (a) shall be the first Provisional Loss Ratio for the period of this Agreement.
- 3. If the Provisional Loss Ratio shall exceed 100% (one hundred percent) the Reinsurer shall pay the amount of the loss as provided in Article 5, within 15 days of the said statement having been agreed between the parties.
- 4. As soon as practicable after the 31st December of each subsequent year, until all losses have been finally determined, the Company will submit to the Reinsurer a statement as required in paragraph 1 above showing the figures as at the 31st December in question. The Second, Third etc., Provisional Loss Ratios, shall be calculated as in paragraph 2 above, and the necessary adjustments shall be made between the parties, year by year.
- 5. When all losses have been finally determined, the Company will prepare and submit to the Reinsurer a statement in respect of the period of this Agreement as stated in Article 8, showing:
  - (i) Earned Premium for such period.
  - (ii) Incurred Losses for such period.

The Definite Loss Ratio shall then be calculated and a final adjustment and settlement shall be made between the parties.

**Article 8. Period of Reinsurance**

The following is a common form of this Article:

The period of this Agreement is from the

1st January 1970 to the 31st December 1970  
(both days inclusive).

Quite frequently the period is stated to commence on an agreed date (e.g. 1st January) and to continue in force until terminated by either party giving to the other not less than three months notice of termination to take effect as at the 31st December of any year.

There can be no real objection to this latter form which is used for many other non-proportional reinsurances and for the great majority of proportional reinsurances, nevertheless when applied to Stop Loss it is likely to introduce unnecessary complications.

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For example, in Article 5. Basis of Reinsurance, it may become necessary to specify not only that the losses and premiums are those relative to each year separately, but also that the profit or loss from any year is not to be carried forward into the next year (unless of course it is the intention of the parties that such should be the basis — which is possible but very rare.)

Similarly it becomes necessary to emphasize that the Company cannot carry forward into a subsequent year, any unused portion of the monetary limit.

Moreover, it might be necessary to amend Article 4. Laws in Force.

These complications are avoided by the use of a fixed period contract. The latter will almost certainly involve extra work in the preparation of fresh documents for each new period, but this is amply compensated for by the greater clarity of the expression of intention between the parties and the increased simplicity of the text.

One occasionally sees a Stop Loss contract which is expressed as applying “to losses occurring during the period

from 1st January 1970 to 31st December 1970". This is almost certainly a direct importation from the standard Excess of Loss reinsurance contract.

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However, it seems preferable to use this Article merely to state the period, using other Articles to describe in detail the basis of cover, such as that which gives the Definitions. Indeed, this reference would be definitely wrong when dealing with certain classes of business such as Fire or Physical Damage generally, where for convenience and speed of claim settlement, incoming and outgoing reserves are taken into account.

**Article 9. Rate of premium and deposit premium**

For Stop Loss reinsurance, as for Excess of Loss reinsurance, it is usual for the premium payable to the Reinsurer to be a fixed or adjustable percentage of the premium income (or similar) subject to a deposit premium payable wholly in advance, or by quarterly instalments.

The attention of the reader is drawn to the relative section of A Review of Standard Clauses for Excess of Loss Reinsurance (Article 9 of that publication) which deals fully with this aspect of the contract.

However, it may not come amiss to emphasize here that the parties should be quite sure that there is a clear understanding between them as to the basic figure on which the rate is to be calculated, and that such figure has been correctly defined in Article 6. Definitions.

There is one aspect of the calculation of Stop Loss reinsurance premium which is not common to other types of non-proportional reinsurance. It will be recalled that when considering Article 5. Basis of Reinsurance, attention was drawn to the necessity of reviewing each year, and if necessary

revising, the monetary limit of liability of the Reinsurer. Because of the apparently unfair manner in which such limit can operate, as then explained, the Company will sometimes propose that the reinsurance premium should be linked to the monetary limit.

In the above Article 5, the liability is stated to be 20% of the Net Premium or C. \$200,000 whichever is the less. This implies that the two parties when negotiating the reinsurance estimated that the Net Premium would be C. \$1,000,000.

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As has been seen, if the Net Premium as finally determined were considerably larger, the Company would be prejudiced because the protection granted is correspondingly reduced. There is also the possibility that the Company would in a similar way be prejudiced in the matter of the reinsurance premium payable.

Suppose that the Basis of Reinsurance is as stated in Article 5 and that the agreed reinsurance premium is 5% of the Net Premium i.e., 5% of C. \$1,000,000 = C. \$50,000 which is a quarter of the limit of liability of the Reinsurer. However, if the protection in terms of percentage of Net Premium is reduced (as explained in the notes regarding Article 5) the reinsurance premium becomes an increasingly large proportion of the monetary limit, until in an extreme case it could exceed the amount of such monetary limit.

Therefore the Company may feel that the reinsurance premium should be expressed as a percentage of the Net Premium or of the estimated amount of the Net Premium (C. \$1,000,000 in the example above) whichever is the less. In that way the reinsurance premium becomes more closely linked to the actual protection granted.

Although some Reinsurers have from time to time agreed to this as a matter of equity, others will not do so because

in their view the premium required for the risk is not exactly in proportion to the limit of liability.

236 Indeed, it does seem that this is a reasonable objection because it is obvious on the basis expressed in Article 5 paragraphs 1 and 2, the first half of the liability (10% of Net Premium excess of 100% of Net Premium) is more vulnerable and more likely to suffer loss, than the second half of the liability (10% of Net Premium excess of 110% of Net Premium).

As mentioned in Article 5, the remedy does lie with the Company, who must recognise the necessity of constantly ensuring that the monetary limit is sufficiently large to provide full protection.



The Stop Loss reinsurance contract will normally include other standard clauses such as:

Inspection of books  
Errors and Omissions  
Arbitration

Such clauses are similar to those found in Excess of Loss reinsurance contracts and having been dealt with fully in A Review of Standard Clauses for Excess of Loss Reinsurance, the comments have not been repeated here.<sup>1</sup>

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<sup>1</sup> « Assurances », October 1973 and January 1974 issues.