

Proportional Reinsurance

Some comments on the more usual clauses used in obligatory contracts (Fire and Allied Perils)

Eric A. Pearce

Volume 43, Number 3, 1975

URI: <https://id.erudit.org/iderudit/1103857ar>
DOI: <https://doi.org/10.7202/1103857ar>

[See table of contents](#)

Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

[Explore this journal](#)

Cite this document

Pearce, E. (1975). Proportional Reinsurance: Some comments on the more usual clauses used in obligatory contracts (Fire and Allied Perils). *Assurances*, 43(3), 195–218. <https://doi.org/10.7202/1103857ar>

Article abstract

It is generally agreed, I believe, that Proportional Reinsurance was the original form of reinsurance and has been in common use for a very much longer time than has Excess of Loss Reinsurance or Stop Loss Reinsurance. It would therefore have been logical to have considered first of all the proportional methods for my series of notes on reinsurance, but it was as a matter of deliberate choice that I dealt first with Excess of Loss Reinsurance and then with Stop Loss Reinsurance. I felt that I might have something more to offer when commenting on the latter two methods than when writing about Quota Share and Surplus reinsurances, which have been the subject of standard contracts for a great many years, the original wordings having been modified from time to time, to meet changing conditions, but remaining basically the same. It is now some years since two insurance companies, one French and one British, made it known to those, such as myself, who are interested in these things, that the reinsurance contracts between them had been in existence for one hundred years, without interruption. We all like to think of reinsurance as being a long term business, but this must truly be a record. I have dealt here only with obligatory treaties which form the overwhelming majority of the business, in terms of premium income. Nevertheless, Facultative reinsurance continues to have great importance, and has systems, methods and conventions essentially its own.

ASSURANCES

Revue trimestrielle consacrée à l'étude théorique et pratique
de l'assurance au Canada

Les articles signés n'engagent que leurs auteurs.

Prix au Canada :
L'abonnement : \$5.00
Le numéro : - \$1.50

Membres du comité :
Gérard Parizeau, Robert Parizeau,
Gérald Laberge, Jacques Caya
Mme Aurette P. Gervais

Administration :
410, rue Saint-Nicolas
Montréal

Courrier de la deuxième classe — Enregistrement N° 1638

195

43^e année

Montréal, Octobre 1975

N° 3

Proportional Reinsurance

Some comments on the more usual clauses
used in obligatory contracts

(Fire and Allied Perils)

by

ERIC A. PEARCE, F.C.I.I.¹

It is generally agreed, I believe, that Proportional Reinsurance was the original form of reinsurance and has been in common use for a very much longer time than has Excess of Loss Reinsurance or Stop Loss Reinsurance.

It would therefore have been logical to have considered first of all the proportional methods for my series of notes on reinsurance, but it was as a matter of deliberate choice that I dealt first with Excess of Loss Reinsurance and then with Stop Loss Reinsurance.

¹ Nous remercions notre collaborateur, M. Eric A. Pearce d'avoir écrit pour nous cet article sur un aspect de la réassurance à la fois très répandu et dont les règles méritent d'être précisées. A.

I felt that I might have something more to offer when commenting on the latter two methods than when writing about Quota Share and Surplus reinsurances, which have been the subject of standard contracts for a great many years, the original wordings having been modified from time to time, to meet changing conditions, but remaining basically the same.

196 *It is now some years since two insurance companies, one French and one British, made it known to those, such as myself, who are interested in these things, that the reinsurance contracts between them had been in existence for one hundred years, without interruption. We all like to think of reinsurance as being a long term business, but this must truly be a record.*

I have dealt here only with obligatory treaties which form the overwhelming majority of the business, in terms of premium income. Nevertheless, Facultative reinsurance continues to have great importance, and has systems, methods and conventions essentially its own.



Article 1. Scope of Cover

There are two main methods of obligatory proportional reinsurance, Quota Share and Surplus.

The former provides for the Reinsurer to accept a fixed share of each and every insurance within stated limits as to class of business and maximum sum insured, whereas under the latter method the Reinsurer accepts a part (or indeed the whole) of the share remaining after the Company has decided the amount it will retain on each insurance separately.

The following are typical clauses:

(a) Quota Share.

1. The Company binds itself to cede and the Reinsurer

agrees to accept and reinsure a fixed share of 20% (twenty percent) of each and every insurance and/or facultative reinsurance underwritten by the Company in its Fire Department, on risks situate in Canada (hereinafter called the "insurances") but not exceeding twice the retention of the Company.

2. The Company agrees to retain net for its own account a fixed share of 10% (ten percent) of each and every insurance.

197

(b) Surplus.

1. The Company binds itself to cede and the Reinsurer agrees to accept and reinsure 50% (fifty percent) of the First Surplus amounts above the retention of the Company on insurances and/or facultative reinsurances underwritten by the Company in its Fire Department on risks situate in Canada (hereinafter called the "insurances").

2. The amount of the First Surplus shall not exceed fifteen times the retention of the Company on the identical subject matter and risk.

Very frequently provision is made in this Article, whether for Quota Share or Surplus, permitting the Company to arrange excess of loss reinsurance for its own protection and stating that such excess of loss reinsurance will not be taken into account when determining the retention of the Company for the purpose of calculating the cession. Nevertheless, it is usual to stipulate that the deductible shall be fixed at such a level that the excess of loss reinsurance would not have the effect of reducing the retention on any particular risk by itself, unless the cession is correspondingly modified.

This condition is based on the accepted principle that the Reinsurer depends entirely on the skill of the Company

and bases its own acceptance on the amount which the Company is able and willing to carry for its own account on various classes of risk. The amounts are determined in accordance with the Table of Retentions as agreed between the parties, so that it would entirely falsify the Reinsurer's calculation of relative liability if it were found that the Company had arranged excess of loss reinsurance at a level which would reduce its retention in certain circumstances, leaving the Reinsurer, nevertheless, with the original cession.

198

The intention is that the Company should arrange its excess of loss reinsurance as protection against any serious multiple loss, whether it results from conflagration or any extraneous peril such as earthquake, windstorm or other cataclysm of nature.

So as to avoid any misunderstanding, it should perhaps be mentioned that there are many Physical Damage treaties which are based on a programme comprising basic Quota Share protected by excess of loss reinsurance with a deductible fixed at a relatively low level, which is taken out for common account of the Company and Quota Share Reinsurers. This method has been found effective in reducing the cost of operating the reinsurance. As the basis is fully understood by both parties and they run identical risk and exposure, there cannot be any objection to this method — quite the contrary.

Article 2. Exclusions

There is no standard clause with regard to exclusions and it is only comparatively recently that it has become the practice to set out a list of exclusions as part of a proportional treaty.

It is probable that such lists came into being because of the Atomic Pools Agreement and similar measures, which

made it essential for the Reinsurer to ensure that he did not receive some clearly defined classes of business under treaty.

Subsequently the practice was extended and at the present time it is quite usual to find that the treaty document excludes a number of the more hazardous risks, the type of list, in fact, which is seemingly more appropriate to an excess of loss reinsurance.

In earlier days, as already mentioned above, the Reinsurer left it to the Company to underwrite a balanced account, bearing in mind the joint interests of the parties. This was reflected in the Table of Retentions, headed with the maximum amount on risks considered to be the most acceptable and scaling down to quite small amounts on the more hazardous or very hazardous. This enabled the Company to accept a reasonable line on almost any proposal offered to it, and so to encourage agents and brokers to give a full showing of business, and for the Company to provide, in co-operation with other similar companies, a flourishing market for risks of every category.

199

Article 3. Retention

This is an important Article because the amount retained by the Company will govern the amount ceded, the premium payable and the amount recoverable in the event of loss.

The following is a quite usual form:

1. The retention of the Company in respect of any insurance shall not exceed the amount shown in the attached Table of Retentions as applicable to such an insurance.
2. Subject to the terms of paragraph 1 above, the Company shall have absolute discretion in fixing the amount

of its retention on any insurance and in determining what constitutes one risk.

3. Subject to the terms of paragraph 1 above, the Company shall have the right to modify its retention on any insurance at any time (provided it has no knowledge that any loss or damage has happened thereto) and to cede a corresponding share to the Reinsurer, as stated in Article 1.

200

4. If a loss occurs between the time of the acceptance of an insurance and the entry of the retention and cession in the reinsurance register the Company shall retain not less than the amount usually retained in accordance with its rules and practice for insurances in that category.

It will be noted that paragraphs 3 and 4 of the above are likely to apply more particularly to a Surplus treaty rather than to Quota Share. In respect of the latter it is quite usual merely to include in Article 1 a brief reference to the fact that the retention, and so the cession, is governed by the Table of Retentions. However, the longer form, as set out above, is to be preferred as expressing more fully the rights and duties of the Company.

Article 4. *Original Conditions and Premium*

A standard clause is as follows:

Cessions hereunder shall be subject to all the general, particular and special conditions and clauses of the original insurances and the premium payable by the Company to the Reinsurer shall be a proportionate share of the original gross premium paid for the original insurances, after deduction of cancellations and return premiums (hereinafter referred to as "net premium").

Such net premium shall be credited to the Reinsurer in the quarterly accounts referred to in Article 8.

Although the above may be considered as standard there are many variations according to local practice or to the terms negotiated in respect of particular treaties. For example, the gross premium may be subject to deduction of original charges such as taxes, fire brigade charges, license fees and stamp duty or other costs not recoverable from the insured as separate items.

In some instances the applicable premium may not be gross, but net after deduction of agents' commission or allocations to Government or tariff funds, established for many and varied reasons.

201

It is quite usual to include in this Article, or as a separate Article, a clause along the following lines:

An insurance granted by the Company in which the Company either solely or jointly with another party is named as the Insured, shall be deemed to be an insurance falling within the scope of this Agreement, notwithstanding that there may be no legal liability under such insurance by reason of the fact that the Company is named as an Insured.

This is particularly important when the Company has a part of its assets in buildings, mortgages and the like.

Although such risks are usually recognised as being of high quality within the relative category, Reinsurers sometimes seek an assurance from the Company that the rates applied will be the same as those charged for a similar construction not owned or controlled by the Company.

Article 5. Ceding Commission

The ceding commission is an allowance made by the Reinsurer to the Company to enable the latter to meet acquisition costs, such as agents' commission, brokerages, survey fees, departmental expenses and the like.

The commission terms vary greatly from one treaty to another. A simple form of this Article is as follows:

The Reinsurer agrees to pay to the Company a commission of 35% of the net premium ceded hereunder as defined in Article 4, such commission is to be calculated and credited to the Company in the quarterly accounts referred to in Article 8.

202 Because of the sharp variation in results likely to be experienced on any particular treaty over the years and also because of the competition between reinsurers for business (sometimes of doubtful quality), the practice has grown up of calculating commission according to a sliding scale.

The following is a typical clause:

1. The Reinsurer agrees to pay to the Company a provisional commission of 25% of the net premium ceded hereunder as defined in Article 4.
2. In the fourth quarterly account for each year the provisional commission shall be adjusted according to the incurred loss ratio, on a sliding scale of one half of one percent increase in commission for each one percent improvement in incurred loss ratio below 70%, as set out in paragraph 3 below.
3. For an incurred loss ratio of

70% and over	— commission 25%
which shall be the minimum commission.	
For an incurred loss ratio over 69%	— commission 25%
For an incurred loss ratio over 68% up to and including 69%	— commission 25½%
For an incurred loss ratio over 67% up to and including 68%	— commission 26%

the scale continues in similar manner to

- For an incurred loss ratio over
56% up to and including 57% — commission 31½%
For an incurred loss ratio over
55% up to and including 56% — commission 32%
For an incurred loss ratio of
55% and below — commission 32½%
which shall be the maximum commission.

4. The "incurred loss ratio" for the year shall be the percentage that

203

- (a) losses paid and loss expenses plus the outstanding losses for the current year less the outstanding losses for the previous year;

bears to

- (b) the earned premiums, being net premium for the year after allowing for the adjustment of premium reserves on the basis of 40% in and out.

The foregoing is fairly simple in application, but other formulae have been developed of almost unbelievable complication, so that exceptionally good or exceptionally bad results provide a figure to be deducted from or added to the item of losses paid in the following year's calculation, and so taken into account again in such following year or years.

Article 6. Profit Commission

The profit commission is an additional allowance made by the Reinsurer to the Company when the results of any year show an overall profit to the Reinsurer.

In theory the intention is to encourage the Company through the expertise of its officials, to underwrite the business with all possible care and diligence, so as to provide a satisfactory result for both parties.

A S S U R A N C E S

Furthermore, this additional payment goes some way in recognition of the fact that the ceding commission may not fully reimburse the Company for the expense involved in running its affairs.

The following is a simple clause setting out the method of calculating the profit commission:

204 In respect of each year during which this Agreement is in force the Reinsurer agrees to pay to the Company, profit commission at the rate of 15% of the profit for such year, calculated in accordance with the following Profit Commission Statement.

Income

1. Reserve for losses outstanding as at the 31st December of the previous year.
2. Reserve for unearned premiums as at the 31st December of the previous year.
3. Net premium for the year, calculated in accordance with Article 4.

(in respect of the first year during which this Agreement is in force, Item 1 above will not appear, and Item 2 above will be replaced by the incoming premium portfolio, if any.)

Outgo

1. Ceding commission calculated in accordance with Article 5.
2. Losses and loss expenses paid during the year.
3. Reserve for losses outstanding as at the 31st December of the year.

4. Reserve for unearned premiums as at the 31st December of the year.
5. Reinsurer's expenses, calculated at 5% of the amount of Item 3 Income.
6. Deficit, if any, from the previous year or years.

(In the event of termination of this Agreement, with the withdrawal of the portfolio of unearned premiums, Item 4 above will be replaced by the amount of such outgoing premium portfolio.)

205

The excess, if any, of Income over Outgo represents the profit for the year.

The excess, if any, of Outgo over Income represents the deficit for the year.

In the event of termination of this Agreement, a provisional Profit Commission Statement shall be drawn up as at the date of termination and provisional profit commission, if any, shall be payable forthwith. A final Profit Commission Statement shall be drawn up when all liability has been run-off and the final accounts have been established and agreed between the parties, whereupon the profit commission payable, if any, shall be finally determined and adjusted.



It will be noted that this very simple form of Statement, provides for the deficit if any, to be carried forward until final extinction, but a more usual form is to carry forward a deficit for a maximum of three years.

This calls for special care in the preparation of the Statement, so as to avoid any misunderstanding as to what exactly is meant by "deficit".

A S S U R A N C E S

In the first year (Year 1) this is quite clear,

Total Income	100,000
Outgo Items 1 to 5	<u>102,000</u>
Deficit Year 1	<u>2,000</u>

In the next year (Year 2) the figures might be:

206

Total Income	101,000
Outgo Items 1 to 5	<u>100,000</u>
Profit for Year 2	<u>1,000</u>
Deficit from Year 1	2,000
Deficit remaining from Year 1	1,000

In the next year (Year 3), suppose the figures are,

Total Income	102,000
Outgo Items 1 to 5	<u>101,000</u>
Profit for Year 3	<u>1,000</u>
Deficit from Year 1	<u>1,000</u>

The deficit has been extinguished.

But suppose that in Year 2, instead of a profit there had been a deficit applicable to the year, of say 1,000. Then the accumulated deficit would be increased to 3,000. But this amount is not necessarily carried forward to future years, and it can readily be seen how important it is to identify on each Statement the year of origin of any deficit or remainder of deficit. In this example the deficit from Year 1 will appear in the Statement for Year 3, but any remainder will not appear in the Statement of Year 4. As the deficit from Year 2 would already have appeared in Year 3, unless it has been extinguished, it will be carried forward into Years 4 and 5, but not into any later Statement.

A S S U R A N C E S

Another system of calculating the profit commission is the three years average method. In this instance Item 6 shown in the formula above will be omitted and each separate profit or deficit is applied in the year for which it is calculated and the two years following. Thus:

Year A	Profit	10,000
Year B	Deficit	5,000
Year C	Profit	<u>6,000</u>
Profit for three years		11,000

207

The average is 3,666 on which the profit commission is calculated.

For the next year, Year A is dropped from the calculation and Year D is added. Thus:

Year B	Deficit	5,000
Year C	Profit	6,000
Year D	Profit	<u>2,000</u>
Profit for three years		3,000

The average is 1,000 on which the profit commission is calculated.

In the first two years of a treaty subject to this form of profit commission calculation, that is, before a true three year average exists, it is usual to calculate the profit commission for the first year on one-third of the profit, if any, for the year; and for the second year to calculate the profit commission on half the combined result for the first and second years, provided, naturally, that such result is an overall profit.

Item 5, Reinsurer's Expenses is worthy of comment. It does not always appear in the Statement and, no doubt, as a result of pressure from Companies, has tended either to be

greatly reduced, possibly to one percent or two percent, or to be entirely omitted.

208 Much will depend on the other terms being negotiated and the percentage of profit commission payable. The latter can, of course, vary very considerably and at one stage in Europe when the results of certain classes of business were consistently very favourable to Reinsurers, some Reinsurers were willing to allow one hundred percent profit commission, in consideration of having a five percent allowance for expenses, presumably feeling that it was an acceptable business proposition to have the virtual certainty of a five percent profit (subject to the deduction of the Reinsurer's true expenses) plus interest earned on the reserves.

Article 7. Settlement of Losses

At one time it was usual for companies to provide the Reinsurer with detailed information with regard to each loss paid, but this has long since ceased to be the rule.

The following are typical clauses regulating the advice and settlement of losses:

1. The Company alone shall have the right to settle losses, whether strictly in accordance with the policy terms, by way of compromise, by ex-gratia payments or otherwise. All settlements shall be unconditionally binding on the Reinsurer. The Company may contest any claim and the Reinsurer shall be liable for its share of the loss as finally determined including all costs and expenses in connection therewith. Such expenses shall, however, exclude items covering salaried employees and office expenses of the Company. The Reinsurer shall be entitled to receive its share of any salvages and recoveries relating to any loss or losses in which the Reinsurer is financially interested.

2. Immediate notice shall be given by the Company to the Reinsurer of any loss of which the total amount to be borne by the Reinsurer is estimated to attain or exceed C\$ 10,000. If required to do so the Company shall thereafter provide the Reinsurer with further information regarding the loss and the amount of the Reinsurer's share when the loss has been finally settled.

3. Whenever the Reinsurer's share of a loss attains or exceeds C\$ 10,000, the Reinsurer agrees to remit to the Company its share of such loss within fifteen days, if requested by the Company to do so.

209

4. All other losses and all salvages and recoveries shall be dealt with in the quarterly accounts referred to in Article 8.

5. The Company agrees to provide the Reinsurer with an estimate of the Reinsurer's share of all losses falling under this Agreement which are outstanding as at the 31st December of each year during which this Agreement is in force or there is any liability outstanding thereunder.

The purpose of paragraph 2 above is to enable the Reinsurer to keep a record of claims likely to give rise to a cash settlement as provided for in paragraph 3, and also to enable the Reinsurer to decide whether the Reinsurer should made a claim against its own excess of loss reinsurers, if any. In fact, the figure inserted in these paragraphs is likely to bear a relationship to the deductible under such excess of loss reinsurance. If the Reinsurer is not so protected, then paragraph 2 is likely to be deleted. It may possibly be replaced by a clause which binds the Company to provide detailed information with regard to a particular loss or losses when requested to do so. This enables the Reinsurer to determine its liability in respect of a particular catastrophe which is likely to affect

various treaties in which the Reinsurer is involved throughout the world.

The information to be provided in accordance with paragraph 5 is, of course, essential to the Reinsurer for purposes of its own accounts and statistical records. The same figure will also be used when drawing up the Profit Commission Statement for the year in question.

210

Article 8. Accounts

Little comment is required with regard to this Article. It merely provides for the routine transmission of accounting information and the settlement of balances between the parties.

The following text outlines the normal procedure:

1. The accounts under this Agreement shall be drawn up quarterly as at 31st March, 30th June, 30th September and 31st December of each year, and shall be sent by the Company to the Reinsurer within three months of the end of each such quarter.
2. The accounts shall be in Canadian currency and payments made or received in any other currency shall be converted into Canadian Dollars at the same rate of exchange as that used when the amounts were remitted to or paid by the Company.
3. The Reinsurer shall have one month from the date of receipt of the accounts either to confirm agreement or to make any observations relative thereto.
4. In either case the balance shown in the accounts shall thereupon become payable by the debtor party and any corrections becoming necessary as a result of error on the part of the Company shall be adjusted in the next account.

Although the Article provides a procedure for the checking of accounts and for payment within a stated delay, it is in practice quite usual for the Company to attach a cheque to the accounts when the balance is due to the Reinsurer. Similarly many Reinsurers pay balances due by them within a few days of receipt of the accounts.

In any case, it is evident that as the Reinsurer receives no information regarding individual cessions, and a minimum of information regarding losses, the checking of the accounts must be perfunctory.

211

Article 9. Unearned Premium Reserve

This is quite simply the reserve set aside by insurers and reinsurers to meet the liability which will accrue on almost every policy issued or renewed during a year, in respect of the unexpired period of the policy which runs into the next financial year. It is frequently referred to as the Unexpired Risk Reserve.

There are instances, rare though they may be, where every policy expires on the 31st December, and is renewed the next day, that is 1st January. In such cases there is no unearned premium outstanding at the end of the financial year and so no reserve is required.

In all other instances the question must arise as to how the reserve is to be calculated. Obviously the most accurate method is to calculate the amount of the unearned premium for each policy separately at pro rata temporis, and to apply the agreed rate of ceding commission. It seems almost certain that in earlier days this was the method used. It was abandoned in favour of less cumbersome and more expedient methods, but has in many instances been re-introduced, because by the use of computers the calculations have become simple and rapid.

However, there are still a great number, probably the vast majority, of proportional treaties in which the Unearned Premium Reserve for a year, is expressed as a percentage of the net premium for that year.

212 There are many acceptable methods of calculating the reserve. There is the basis of "twenty-fourths", the formula by which the premiums are registered in half-monthly periods throughout the year. The premium relative to the number of half-monthly periods from inception or renewal to the end of the year is considered as earned premium, the remainder being unearned.

Another, slightly less accurate, method is the basis of "twelfths". The principle is the same as for "twenty-fourths" but earned and unearned portions are calculated according to monthly instead of half-monthly periods.

Over the years many companies have developed a practical, possibly rule-of-thumb, method which consists of carrying forward a fixed percentage of net premium, free of ceding commission. The percentage is usually 40%, frequently 35% and can be any other percentage. The reason for choosing 40% is obscure, but may be based on two theoretical points:

- (a) That the premium is received regularly throughout the year, so that the carry-forward should be 50% (subject to ceding commission).
- (b) That the Agents' commission plus general expenses amount to 20% of the net premium.

On these assumptions, the carry-forward should be half of the net premium less commission and expenses, namely $100\% \text{ less } 20\% = 80\%$ of which half is 40%. By this method, if the commission and expenses are a larger or smaller percentage, the carry-forward would alter accordingly.

Naturally the Company and the Reinsurer will agree what is a reasonable carry-forward. This has significance only to the extent that the net premium income varies from one year to the next. If there is no variation, in theory there is no reason to have incoming and outgoing reserve, because the former and the latter would be identical. It must be borne in mind, however, that if the treaty remains in force for many years, even a modest annual variation might show a quite considerable difference during a ten or twenty year period.

213

The following are standard clauses:

- (a) When the treaty commences without incoming portfolio premium.

The Company shall be entitled to retain as a premium reserve out of monies due to the Reinsurer a sum equal to 40% of the annual net premium, as defined in Article 4. The calculation of the premium reserve shall be made in each quarterly account and during the first four quarters that the Agreement is in force, shall be accumulated quarter by quarter. Thereafter the premium reserve shall be based upon the net premium of the relative quarter and the three preceding quarters, thus releasing the premium reserve for the corresponding quarter in the previous year.

- (b) When the treaty commences with incoming portfolio premium.

1. The Company shall be entitled to retain out of monies due to the Reinsurer, a premium reserve which shall be constituted at 40% of the annual net premium as defined in Article 4. The calculation is to be made as at 31st December of each year.

2. As at the inception date of this Agreement a premium reserve will be constituted by debiting the Reinsurer with

40% of the net premium which would have been ceded to the Reinsurer had this Agreement been in force during the previous twelve months. This amount shall remain unaltered until the following 31st December when any necessary adjustments shall be made in the fourth quarterly account of the year in question. Thereafter adjustments shall be made annually in the fourth quarterly account.

214

Article 10. Portfolio Premium

Portfolio Premium is the expression generally accepted as meaning the premium required to meet the liability which is outstanding on insurances in force at the inception (incoming portfolio) and termination (outgoing portfolio) of the Agreement.

The following is a usual form of text:

1. The Reinsurer agrees to assume liability for its proportion of the First Surplus under all insurances commencing prior to and in force on the inception date of this Agreement, in consideration of which the Company will credit the Reinsurer in the first quarterly account with a sum equivalent to 40% of the net premium which, if this Agreement had been in force, would have been ceded to the Reinsurer in the accounts for the four quarters immediately preceding the inception date of this Agreement. The amount so credited shall not be subject to payment of ceding commission.
2. On the termination of this Agreement the Company will debit the Reinsurer with 40% of the net premium credited to the Reinsurer under this Agreement and appearing in the accounts for the four quarters immediately preceding the date of termination and the liability of the Reinsurer under existing cessions shall cease as

from the date of termination. No refund of commission shall be allowed on the amount so debited.

It will be noted that these clauses impose the duty on the Company to cede and withdraw the portfolio, but it is much more usual to leave it to the Company to decide at inception and termination whether it will involve the Reinsurer in the transfer of portfolio in or out as the case may be, or to run-off the unexpired risk.

215

Such freedom of action is an advantage to the Company, and indeed this could be a very valuable condition if the results of the business were such that the Company was unable to find suitable reinsurers to take over the share or shares terminated. There are, of course, many other reasons why it is desirable for the Company to have the right to decide the means, in detail, of running off the liability for risks in force at the end of any particular period of re-insurance.

Article 11. *Portfolio of Losses Outstanding*

Although it is very far from being the universal practice, some treaties do provide for the transfer from one Reinsurer to another of the portfolio of losses outstanding.

The following is a usual form:

1. The Company will provide the Reinsurer with an estimate of all losses outstanding and unpaid as at the inception date of this Agreement, and the Reinsurer agrees to accept liability for its share of all such losses, in consideration of which the Company will credit the Reinsurer with a sum equal to one hundred percent of its share of such estimate. Such sum will be credited in the first quarterly account. The Reinsurer further agrees to assume liability for its share of any loss which occurred

prior to the inception date of this Agreement but which, for any reason whatsoever, was not advised to the Company until after the inception date of the Agreement.

2. The Company undertakes to provide the Reinsurer with a detailed estimate of the Reinsurer's share of all losses outstanding and unpaid at the date of termination of this Agreement and the Reinsurer agrees to discharge its liability in respect of all such losses by means of a single payment equal to one hundred percent of the total amount of such estimate. The Reinsurer shall in this manner be relieved of any further liability in respect of such losses. The relative amount will appear in the quarterly account to be drawn up as at the date of termination of this Agreement.

3. Nevertheless, should there be any material discrepancy between the amount of the estimate of losses outstanding referred to in paragraphs 1 and 2 above, and the amounts of final settlement in respect of such losses, such discrepancy shall be adjusted between the parties, so as to ensure that so far as practicable one Reinsurer shall not be at a disadvantage compared with any other Reinsurer.

4. In such case the Profit Commission Statement drawn up as at the date of termination of this Agreement shall be considered as provisional and a final Profit Commission Statement shall be drawn up when the final adjustment has been made.

The method of the cession and withdrawal of the portfolio of losses outstanding is very convenient to both parties, as it reduces to a minimum the amount of work and correspondence with regard to the run-off.

In the case of a treaty where the adequacy of the reserves has been shown over a period of years, it is quite customary

to settle outstanding liability at 90% of the estimate put forward by the Company, an estimate, naturally, which has been prepared for all the reinsurers, not only the Reinsurer who has terminated its interest.

This method is still used to some degree, but has lost favour in many countries because of the incidence of inflation and the increasing difficulty of providing accurate estimates for unsettled claims.

217

It is because of this difficulty that one has seen the introduction of paragraphs 3 and 4, which must to a large extent nullify the value of this Article. Very serious anomalies can arise and there was found to be an increasing reluctance on the part of reinsurers to take over the liability for claims which had occurred prior to the inception date of the treaty.

Article 12. *Period of Reinsurance*

There may be Quota Share or Surplus treaties which are on an annual basis, but they are rare indeed. The great majority are drawn up for an indeterminate period subject to notice of termination which can be given by either party. There is no fixed rule with regard to the period of notice; it may be six months or a year or 90 days but is most likely to be three calendar months.

The clause may provide for the notice to become effective at any time, such as half-yearly or monthly but is usually stated to take effect as at one date in the year, probably to coincide with the end of the Company's financial year.

The following is a typical clause:

1. This Agreement shall take effect from and including the 1st January 19.... and shall continue in force until terminated as provided for in paragraph 2 below.

2. Either the Company or the Reinsurer may terminate this Agreement by giving to the other party three calendar months notice in writing by registered post, to the address stated in the preamble to this Agreement, such notice to take effect as at 31st December of any year.

218

It is quite usual to state in this Article that the Company shall have the option of deciding whether to run-off the current cessions or to withdraw the portfolio as at the date of termination. This has been referred to more fully under the heading of Article 10 Portfolio Premium. When there is an option, the Company must notify its decision to the Reinsurer on or before the date of termination.

Another article sometimes found in Surplus reinsurance contracts is that which requires the Company to prepare and send to the Reinsurer bordereaux showing details of every insurance ceded to the Reinsurer. This condition has now been very largely superceded and only in special cases is the information provided, as for example in respect of insurances where the Reinsurer may wish to control its own accumulations, or for large and/or hazardous risks.

The contract will almost certainly include other Articles 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.