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What is an exclusion?

by

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In earlier articles presented in "Assurances", Mr. Eric Pearce addressed himself to clauses commonly found in reinsurance treaties. There was, however, one area which he did not touch upon and which I propose to look at in this article. It is the highly subjective topic of exclusions in Canadian treaty wordings, an area where standardization has become the norm.

Q. When is an exclusion not an exclusion?

A. When a loss occurs.

The answer seems somewhat facile, and yet the position is one in which most reinsurers find themselves under a normal wording. Typically an exclusion list ends along the following lines:

> "If a policy affords insurance in respect of a risk excluded by such (exclusion) list, the terms of this agreement shall nevertheless apply to such risk until its existence is discovered by a member of the underwriting department of the Cedant and for thirty days thereafter.
>
> During such period of thirty days after discovery the Cedant may forward to the Reinsurer full underwriting information with the request that the risk should continue to be included within the scope of this agreement.
>
> The Reinsurer shall have the right at its sole discretion to accept or refuse the risk and the Reinsurer shall inform the Cedant of the Reinsurer's decision as soon as practicable after receipt of the underwriting information."

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The probability is that discovery of the excluded risk would be when a loss occurred, rather than in any random audit, in which case 30 days' notice is not very useful. In fact the reinsurer is providing errors and omissions coverage for the insurance company's agents or employees in respect of their underwriting ability. I doubt that most reinsurers contemplate this in rating excess treaties, and I suspect that some are even unaware of its impact.

Turning now to another contentious area of exclusions, we reach the subjective area of definition of terms. Following are three examples taken from treaty wordings which show the lack of precision in deciding exactly what is excluded:

1. Any exclusion listed in Section X of this article shall be automatically waived with respect to a risk where the operation described in the exclusion is not the insured's principal operation.
2. The exclusions set forth above shall not apply to risks regularly engaged in other operations which involve only incidental operations in any of the above exclusions.
3. This agreement shall however apply to policies excluded above provided that the risks covered by such policies are part of general operations undertaken by the original Insured, which general operations are not themselves excluded.

A closer study of these clauses would be useful.

1. The key word here is "principal", which is defined in the Oxford Dictionary as "first in rank or importance, chief; main, leading." In today's world of corporate conglomerates, it is not impossible to find, under this definition, a company whose operations are technically within the scope of the treaty, but in reality should be excluded.
   Using the example of a general public liability excess treaty, we can create a conglomerate to fit the above scene.
   XYZ Inc.

Operations

a)	40%	Manufacturer of vehicle shock absorbers
b)	30%	Manufacturer of aircraft landing systems
c)	15%	Drilling for oil and natural gas
d)	10%	Distribution of natural gas
e)	5%	Land development
	100%	

138 Under the (fairly) standard exclusion list found in a general liability treaty, operations b), c) and d) would be excluded. However, since operation a) is the principal operation and is not excluded, the others are automatically covered under Clause 1. We have the paradoxical situation of 55% of the company's operations being on the exclusion list yet covered!

2. In Clause 2 the key word is "incidental", defined in the dictionary as "casual, not essential". Although the intention seems reasonably clear, who is the judge of essential? Is the operation of a small municipal airport essential to the running of a municipality? It could be argued that the main business of the municipality is running the town and the airport is incidental to it — but for an underwriter it is not difficult to see that a major exposure is the airport.
3. In clause 3 "minor part" is the phrase around which the intention revolves. "Minor" is defined as "comparatively unimportant, lesser". Again we have the problem raised in Clause 1, although the positive 'minor part' appears to be more restricting than the negative "not the insured's principal operation". As we saw in Clause 1, the aircraft landing gear manufacturing fell within the scope of cover; however, it could not be covered with Clause 3 since at 30% of the operations it is certainly not a 'minor part'.

But even if these clauses show a lack of precision in the wording, there is another area in which the current exclusion

wordings should concern reinsurance underwriters. The preamble to wordings generally reads, in part, along the following lines:

> "...covering automobile and general liability policies underwritten by the Cedant in Canada..."

First of all, the business should be 'and classified as Canadian but extending to cover incidental (that word again!) exposures elsewhere."

And here we come to a major problem facing reinsurers today, the judgment of exposure. There is no doubt that reinsurers are concerned (and rightly so) about the extent to which U.S. exposure affects Canadian covers.

To look at the problem in a little more depth, let's return to the XYZ company and look at its principal operation — manufacturing vehicle shock absorbers. It is agreed that the risk is covered under the treaty but let's look at the split of sales from this Canadian risk.

Sales:	$120,000,000	70%	Canada
		25%	U.S.A.
		5%	Elsewhere

In terms of sales, yes the U.S. and elsewhere are a minor part, but in terms of exposure? I suspect that many underwriters would agree that the exposure from 25% sales to the U.S.A. far outweighs the exposure from 70% Canadian sales, yet I know there are companies who deem even a 25% U.S. sales level "incidental" or "a minor part." It is true that the estimating of exposure is highly subjective and that ten underwriters would probably give ten different answers, but there is certainly room for some starting point of exclusion — possibly at a 25% U.S. sales level.

Another failing that can be seen in exclusion lists is that of keeping up to date with technological change and scientific

discoveries. Again it probably stems from the use of standardized exclusion lists which have served reasonably well in the past — so why change them?

There are probably many areas, especially in products liability, where the hazards posed by the product take it outside the ordinary run-of-the-mill business which a treaty can be expected to cover and into the realm of facultative placement. As an example of this, in today's energy-conscious world, we can
140 look at the problems of insulation, and in particular foam insulation. The pumped in urea formaldehyde foam (which eventually hardens in the walls to a protective barrier) is fairly new on the scene in Canada. However, problems have been reported with it in the U.S. and its application is now banned in at least one state. The concern of legislators has been continual leakage of noxious fumes into houses, causing breathing problems to occupants. Do the fumes have any permanent damaging effect? If they do, it is a problem which will surface in the future, but in the meantime there are numerous houses considered uninhabitable.

Still on the topic of insulation, I wonder if the effects of breathing fibreglass dust have been studied. Anyone whose skin has been touched by a fibreglass insulation batt knows the itching which follows. When the batts are cut, inevitably small particles of fibreglass are breathed in — unless the user is wearing a protective mask. But do the fibreglass insulation packages recommend using a mask? No. Again — given the widespread use of fibreglass insulation — the potential problem is enormous.

In this brief article I have tried to point out a few of the dangers in accepting so-called "standard" exclusion lists in reinsurance treaties. In recalling that the purpose of such a list is to take out the unusual, the highly hazardous risk and to leave a reasonably homogeneous portfolio which the reinsurer can assess, it can be seen that in suggesting changes I am not

merely trying to avoid the running of any risk. A prudent underwriter should foresee the problems presented by technological change, by increasing complexity and geographic scope of risk and not just react when a loss occurs by offering a plaintive "But I thought that was excluded!"

L'accès du Québec au marché financier. Gouvernement du Canada, Ottawa. Centre d'Information sur l'unité canadienne. C.P. 1986, Succursale «B».

Brochure bilingue à laquelle ont collaboré un excellent économiste, Douglas Fullerton, et les services du gouvernement canadien. Elle ne manque pas d'intérêt en ce qu'elle établit les besoins de capitaux de la province de Québec et la manière dont on y a fait face jusqu'ici. Toutefois, il faut parfois se méfier un peu de l'orientation donnée aux textes. Il est fort intéressant de constater ce qu'a été la politique financière de la province de Québec depuis quelques années, face aux énormes saignées pratiquées dans le Trésor public pour les besoins croissants de l'administration, par les assurances sociales et par le financement des travaux de la Baie de James. Il faut aussi noter ce qu'écrit M. Fullerton au sujet des tendances actuelles:

> «Une demande croissante de fonds d'emprunt, notamment pour les travaux de la baie James;
>
> un recours accru aux sources européennes et japonaises de capitaux, ainsi qu'à des prêteurs différents, notamment les banques;
>
> un raccourcissement des échéances, avec une diminution des obligations à long terme et un accroissement des emprunts à court et à moyen terme;
>
> une dépendance accrue vis-à-vis de la Caisse de dépôt et de placement et des obligations d'épargne du Québec;
>
> des efforts renouvelés en vue d'emprunter ailleurs qu'au Canada.»

Pour être tout à fait équitable, il faudrait également noter que le gouvernement actuel a hérité de très lourdes charges, dont il parvient à se tirer le mieux possible en période de crise. Il ne faudrait pas oublier également que, de son côté, le gouvernement fédéral a depuis quelques années accumulé une dette énorme, qui explique en partie la faiblesse du dollar. Cette fois, cette remarque est de nous. J.D.