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Reinsurance Dialogue

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Reinsurance Dialogue

between

Christopher J. Robey[1]

and

David E. Wilmot[2]

April 19, 1990

Dear Mr. Wilmot,

Over the years, in our capacities as broker and reinsurer, we have frequently had cause to debate questions relating to insurance and reinsurance. However, constraints of time and the protection of our relative corporate interests have not always allowed us to develop our arguments as freely as we might wish.

I should personally welcome an opportunity to transfer these debates to a forum where we would be able to take the time to expand on our arguments.

Undoubtedly our backgrounds as broker and reinsurer will lead us generally along the same lines as we take when debating an issue dealing with a specific contract, however the lack of anything specific to be resolved will also enable us to delve more deeply into the purely theoretical as well as the practical aspects of our positions.

Assurances, dedicated as it is to the theory and practice of insurance in Canada, would seem to be an ideal vehicle for such a debate and including our exchanges in the "Chroniques" section will ensure that there is a regular reinsurance contribution in the magazine.

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If the idea appeals to you, I invite you to fire the first shot, and I shall respond and also introduce a new topic in the following issue.

Yours sincerely,

Christopher J. Robey

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May 7, 1990

Dear Mr. Robey,

I welcome your challenge to debate reinsurance issues in *Assurances*. As you have suggested, this open forum will allow us to explore the theory as well as the day-to-day practice of Canadian reinsurance.

In recent years, contentious issues have tended to polarize the attitudes of Canadian insurers and reinsurers. Contracting parties, who occasionally forget that they are partners acting in utmost good faith, fail to understand or trust each other's interpretation of the reinsurance contract. This is particularly true when the contract itself must be altered to reflect changing world events. If we can increase the dialogue between the reinsuring parties, then the standards of reinsurance contract wording can be improved and future conflict minimized.

For that reason, I would like to explore this process of change, using as a subject the Hours Clause or Definition of Occurrence. This clause, which *should* be relatively straightforward, has evolved and expanded its use from catastrophe treaty to property risk excess to casualty excess of loss contracts. More than anything else I can think of, this "evolution" demonstrates how historical events can reshape the reinsurance contract and, occasionally, threaten the accord that must exist between reinsurance partners.

Catastrophe Hours Clause

Catastrophe treaty coverage is limited to losses occurring during a single event and within a set period. Windstorm losses, as an example, must fall within a 72 hour period. Various other events are listed in the Hours Clause, each with their own hour limitation and, in some cases, territorial limitation as well.

The concept is simple, and yet the coverage, the time of loss and even the identification of a single storm front have all been questioned or challenged in recent years. Catastrophe treaties, after all, are intended to protect the insurer's capital and solvency. Insurers can be (and have been) bankrupted by an event for which they did not buy proper or adequate reinsurance protection. The stakes are high, and reinsurers know they cannot always depend on the good faith that existed at the inception of the contract. Reinsurers fear that otherwise trustworthy insurance executives may explore every contract ambiguity if the insurer (or its trusties in bankruptcy) are faced with a devastating and under-reinsured catastrophe loss.

The best example of prudence over good faith is the reinsurers' simple expedient of insisting, in the hours clause, that "no period commences earlier than the date and time of the occurrence of the first recorded individual loss." It is not expected that a windstorm will exceed 72 hours for a Canadian portfolio of property business, but should it do so, a second, non-overlapping 72 hour period would pick up the subsequent loss above a second insurer retention. Hopefully, property insurers will have bought enough excess protection to cover a catastrophic loss. But reinsurers who may be sceptical of cedant intent make it clear that a 72 hour period can not predate the first recorded loss. This prevents an insurer from setting a first 72 hour period well in advance of the storm and ending in the middle of the event so that a second 72 hour period can be invoked for the duration of the storm. If the loss were so large as to otherwise exceed the limit of catastrophe protection, this tactic would effectively double the insurer's catastrophe limits.

No Canadian insurance executive would enter a treaty contract with the intention of distorting the hours clause in this way, but reinsurers recognize the growing economic pressures of the financial community and the management changes that often accompany those pressures. The need to limit the inception of the 72 hour period was born out of experience.

Periods other than 72 hours are imposed by the Hours Clause. Earthquake is limited to 168 hours or one full week. This time period, in use for a number of years by reinsurers, is now recognized in IBC's standard policy form as well. As luck would have it, just as insurers are about to move to this extended time period for earthquake, the largest supplier of Canadian catastrophe treaty protection, the London market, represented by the Reinsurance Offices Association or ROA, is contemplating a shortened 72 hour period for earthquake. Hopefully, this conflict will be resolved without inconvenience to Canadian insurers. Reinsurers operating in Canada do not intend to create a "gap" in their clients' catastrophe protection and the ROA wording committee has been made aware of IBC's use of 168 hours.

Territorial limits are also imposed. Riots and civil commotion are restricted to one municipality or county "and the municipalities or counties contiguous thereto." History students will note that the introduction of this limitation coincides with the death of Martin Luther King and the resulting riots in several American cities.

In recent years, Canadian hours clauses have further limited coverage to 168 hours "for all other events" (or words to that effect.) This limitation was introduced in the 1970s by Canadian reinsurers afraid that the definition of "event" might be loosely interpreted by some insurers. The coverage for "all other events" was so broad as to include potentially unreinsurable situations not yet contemplated. The suggestion by one reinsurance intermediary that "reinsurers shouldn't be allowed to exclude something they can't describe" was not constructive, and reinsurers' fears of abuse were, in fact, well founded: in Great Britain, several property insurers tried to collect the limits of their catastrophe treaties by claiming that a particularly severe winter, and all the burst pipes and damaged roofs throughout that winter, constituted a single event. Today, after the eruption of Mount St. Helens and after the subsidence of hundreds of homes due to a particularly dry summer, most wordings, including the current Lloyd's wording, include a 168 hour limitation on all events not otherwise addressed in the hours clause.

Another challenge to the spirit of partnership and cooperation between insurers and reinsurers arose when high winds and tornadoes swept across south-western Ontario in May of 1986. One atmospheric disturbance with both a leading and a trailing storm front (that is, two fronts) caused insurers and reinsurers to put forward "one-loss" and "two-loss" theories of catastrophe treaty recovery. The amounts involved did not threaten insurer solvency, but the debate polarized insurers and reinsurers nonetheless. A two-loss interpretation of events would cause insurers to incur twice their catastrophe retention, and a one-loss interpretation would incur additional losses for reinsurers on higher catastrophe treaties. In the end, separate arbitrations determined the May 30th/31st catastrophe to be both one event *and* two events depending on the hours clause wording used by the reinsuring parties.

But these findings do not explain the conflict. Many insurers suspected reinsurers of adopting a two-event interpretation simply in order to reduce their share of the loss. However, most reinsurers tried to take a professionally detached interpretation both of events and their treaty wording. These reinsurers were less interested in some short-term savings than they were in the "correct" interpretation of *any* one-loss versus two-loss dispute. Many reinsurers feared that, in a much bigger catastrophe, some of their cedants would reverse themselves and demand a two-loss judgement to overcome inadequate limits of catastrophe protection.

It would seem that each side distrusted the motives of the other. Certainly, little was said or done at that time to explain the larger issues or to allay the hostility which caused insurers and reinsurers to go to arbitration.

Property Excess and the Hours Clause

The hours clause is no longer restricted to catastrophe treaties. Current market practice suggests that insurers include the clause in their property risk excess treaties as well.

Ever since the early 1970s, when a windstorm destroyed an entire Australian town, reinsurers have sought to limit their catastrophe exposure on property risk excess treaties. These treaties, priced to pay for only a few excess losses at most, protect insurers against single shock losses or a frequency of unusually large losses in one year. When most of the buildings in the town of Darwin were totally destroyed, reinsurers were faced with hundreds of total losses to their excess of loss treaties. Treaties for which reinsurers had collected perhaps 80,000 or 100,000 Australian dollars suffered losses of several million dollars. From that time, reinsurers have limited their catastrophe exposure to property risk excess treaties. Normally, an occurrence limitation, equal to some small multiple of the per-risk limit of liability, will be imposed. Thus a treaty providing $1,000,000 in excess of $1,000,000 each and every risk may also be limited to $3,000,000 any one occurrence.

The rationale for this limitation is clear. In the event of a Canadian catastrophic loss, reinsurers will accumulate claims not only from the catastrophe treaties they provide to insurers, but from pro-rata treaties and risk excess treaties as well. There is not enough premium in risk excess treaties to justify the *unlimited* catastrophe exposure that exists without an occurrence limitation.

Property insurers should be aware that this limitation in their per risk covers may require the purchase of higher catastrophe limits. The insurer is also responsible for telling catastrophe reinsurers of its risk excess limitation. Otherwise, if catastrophe reinsurers have contracted the risk excess retention to be a warranty, they will not pay for these additional losses.

A relatively new development is the introduction of a full-blown hours clause in the risk excess treaty. Previously, "occurrence" had simply been defined as any single event. Reinsurers began adding the hours clause to risk excess treaties "because the word 'occurrence' must be defined." This now means that, should an event last several days, the risk excess treaty's occurrence limitation will be reinstated — automatically and without any reinstatement premium. Inasmuch as this produces marginally greater protection, the insurer should ask to have the hours clause in its property risk excess treaties.

Reinstatement Premiums

Underlying to the hours clause is the reinstatement of catastrophe coverage. Reinstatements have taken on increasing importance, no less so because of the series of unrelated catastrophes which rocked the catastrophe market in 1989. Catastrophe coverage was exhausted by hurricanes and an earthquake coming out of North America, and additional reinstatement covers were purchased for the final months of 1989 — often at prices that exceeded the original premium for the full year. In early 1990, unprecedented windstorms in the UK and Europe caused similar reinstatement problems.

Reinstatement premiums, and the payment of these premiums are not always understood by those who must account for them. Again, a better understanding of each other's expectations would go a long way toward reinsurance accord.

Reinstatement premiums have not always been an important consideration in catastrophe treaties. Reinsurers once commonly agreed to "throw in" reinstatement protection, offering one free reinstatement plus one at pro-rata additional premium. (Normally, there wouldn't be too many days left in the contract year by the time a second reinstatement was required.) Today, reinstatement premiums are taken more seriously. To many reinsurers, such premiums are a form of experience rating. If there is a catastrophe loss, then the insurer pays a bit more premium. The insurer enjoys a lower premium if the treaty is loss free. To say that the reinstatement premium is no more than a fee for providing the reinstatement is a misconception. After all, the reinsurer clearly decided to provide a reinstatement when the treaty was negotiated.

Once this is accepted, then a number of principles fall into place. For example, reinstatement terms are seen by reinsurers more as negotiation tools than as payment against the risk of a second loss. Conditions such as the number of reinstatements, or 100% time versus pro-rata time, are part of the "up front" cost of protection. The insurer is expected to pay the reinstatement premium if there is a loss to the treaty — even if the contract year is almost over. Reinsurers do not normally consider reinstatements to be an optional purchase.

If reinstatement premiums are negotiation tools, then it is possible to use them with considerably more flexibility. One reinsurer has found reinstatements to be a practical solution for an insurer unwilling to pay the going rate for excess protection. The insurer, convinced there would be no losses, and the reinsurer, convinced that there might be, agreed to a treaty with a very low rate but a reinstatement premium several times that of the original rate.

The payment of reinstatement premiums is another point of dispute. These premiums are based on the original treaty rate and not on the minimum or deposit premiums of the treaty. Reinstatement premiums must be adjusted to actual subject premiums (once they are known) just as other reinsurance premiums are adjusted.

In principle, reinsurance premiums are due when the loss occurs. The loss is "automatically reinstated from the time of occurrence of the loss" and "the Company agrees to pay a reinstatement premium for the balance of the term hereof." In Canadian practice, however, this does not appear to be so. Some insurers are inclined to postpone payment of the reinstatement premium until the loss is fully settled. Many reinsurers counter this by deducting their premium from catastrophe loss payments, and then adjusting these payments and premium recoveries as the loss moves toward settlement. In no event can an insurer postpone payment of reinstatement premiums until the treaty's limit of liability is fully exhausted. Partial claims to the treaty limit of liability are also due when the loss occurs.

Casualty Definition of Occurrence

While it may make sense to include a definition of occurrence in an excess of loss casualty treaty, the need for or use of a casualty *Hours Clause* requires closer examination. Again, because of events and changing perceptions of the reinsurance relationship, misinterpretation and mistrust can impede cooperation between the reinsuring parties.

Property catastrophe and casualty treaties are often combined in a single excess treaty or program. It is not uncommon to create high level excess protection on an "all classes" basis. However, some of these programs are structured in ways that have not been fully tested. Interesting treaty wordings and, perhaps some unexpected losses could arise out of this practice.

At the simplest level, catastrophes are not restricted to property and auto physical damage losses. Workers' Compensation claims can become a significant factor in the windstorm or earthquake losses. Even in Canada's legal climate, casualty losses are expected to follow a major earthquake due to inadequate services, buildings not meeting minimum code requirements, and many creative efforts on the part of individuals seeking some form of compensation.

A "catastrophe" treaty covering all classes may create some interesting problems. Obviously, the accumulation of casualty as well as property physical damage losses could consume reinsurance capacity faster than anticipated. (However, this begs a question as to whether or not the accumulated casualty losses would have been covered under a treaty of their own — a question that will be considered in a moment.) Problems may arise because of the unexpected size and nature of the casualty contribution to a catastrophic occurrence.

One illustration of the potential for serious conflict arises from the unusual combinations of treaties used in a single program. For example, some programs consist of all-classes excess treaties only for the first five or ten million of cover, followed by strictly property catastrophe cover in the layers above. These top layers are rated on physical damage subject premiums only. However, if a catastrophic loss includes substantial liability claims, then the limits of liability in the lower all-class treaties will be partially or totally consumed by non-property losses. Therefore, either the catastrophe treaty must pay property catastrophe losses excess of a much lower property Ultimate Net Loss, or else the insurer must face a gap in cover that will be retained for net account. Neither solution is satisfactory, particularly as the drop down or the gap in cover could be as much as the entire underlying all-class program.

Equally vexing problems may be created by reinstatement premiums applied only to the property portion of an all-class catastrophe loss or the delayed settlement of property losses that sit on top of long outstanding liability claims. If property and casualty business are to be protected under a single occurrence treaty program, then more dialogue must take place between the reinsuring parties *before* a substantial loss occurs.

Even more important is the agreed meaning of "occurrence" in a casualty treaty. Can the definition of occurrence reach beyond an isolated *event* and embrace multiple claimants suffering related losses over an extended period of time? Asbestos related claims in the United States and Urea Formaldehyde Foam Insulation (UFFI) claims in Canada come to mind. A changing legal climate in Canada, including class actions, contingency fees and an increasingly litigious perception of social well-being, may produce multi-claiment losses that sweep through the layers of "contingency" or "sleep-at-night" layers of casualty excess of loss treaties now in force.

The casualty definition of occurrence — "losses arising out of or caused by one event" — would seem to preclude catastrophic accumulation of similar or even identical events. And yet, some insurers have sought to claim on their accumulated losses for all UFFI contractors and installations. Again, there must be a clearer agreement of intent before a truly serious multiple event occurs.

Summary

The Hours Clause has developed over recent years because of events and, to a greater degree, because of changing commercial attitudes toward the reinsurance contract. In an era of substantial financial transactions and increasing market complexity, our 15 to 20-page contracts of reinsurance may seem naively simple. Regrettably, these high financial stakes do not tolerate contract ambiguity, nor will they rely entirely on Utmost Good Faith.

New situations will likely arise in the 1990s to further challenge treaty wordings and reinsurance intent. An atmosphere of co-operation and trust is needed to help reinsuring parties find constructive solutions to those challenges — solutions that preserve good faith and partnership while adding precision to contract wordings. We can encourage that atmosphere by better portraying the needs and expectations of each reinsurance partner to the other and by encouraging dialogue among those who draft and interpret reinsurance contracts.

Yours sincerely,

David E. Wilmot