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Utmost Good Faith and Financing Reinsurance

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Reinsurance Dialogue

between

Christopher J. Robey [1]

and

David E. Wilmot [2]

March 12, 1991

Re: Utmost Good Faith and Financing Reinsurance

Dear Mr. Wilmot,

In raising the questions of disclosure and intent, you have introduced the grayest of gray areas into our discussion.

The Insurance Institute of Canada Course "General Insurance Essentials" states that "there is a serious responsibility on the part of the applicant (and the agent assisting in obtaining the insurance contract) to provide all the information required by the insurer." It limits this information to what is "material" and defines a material fact as "one which would, if known, affect the minds of reasonable, prudent and experienced insurers, in deciding:

1. whether they will accept a risk,
2. on the amount of premium to be charged,
3. on the conditions applicable to their accepting a risk."

As an example of failure to disclose, you mentioned a large loss which occurs between the date reinsurance underwriting information is prepared and the date reinsurance quotations are to be submitted. However, this raises the question of what is material,

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since a loss, just because it is large, will not necessarily influence the reinsurer's underwriting decision. The normal frequency of such losses in the reinsurance being discussed would have to be considered; the occurrence of a loss, however large, would only be material if it were unusual.

Should the duty to disclose such a loss extend from the date of the reinsurer's acceptance to the date the contract comes into force? Does a reinsurer, once committed, have the right to withdraw its commitment if new statistical information makes a material difference? I think not, but the ceding company must consider the potential problem of having an unwilling reinsurer on its program. However, the reinsurer has the right to withdraw its commitment if basic underwriting information changes, such as to make the risk undertaken materially different from the risk which was accepted.

The ceding company's entry into a new line of business could be a material change in the underwriting information. Again, if the new line is sufficiently different from what it has written previously, so that information on its prior experience may not be valid, it must certainly be declared. However, what is relevant in one type of treaty is not necessarily relevant in others. Beginning to write jewellers' block business would certainly be something a ceding company should declare to its per risk property reinsurer, but it would be of little interest to its catastrophe reinsurer.

To get back to the Insurance Institute course, "the duty to disclose material facts commences with the negotiations leading up to the submission of the proposal or application for insurance and continues throughout the negotiations until the risk has been accepted by the insurer. Facts of this category which become known after the risk has been accepted need not be revealed on the grounds of utmost good faith alone." This again raises the question of changes between acceptance and inception and the course suggests that these need not be disclosed, although I think this is questionable. As an illustration, the course cites an insured who declared at the negotiation that he was introducing a new manufacturing process, but discovers during the term of the contract that there are hazards in the process which would not have been known by a reasonable, prudent and experienced person at the time of the negotiation. The course states that the insured is not obliged to declare this increased hazard to its insurer.

There are three phases to consider following acceptance — the period between acceptance and inception, the duration of the contract and the renewal negotiations. The course is silent on what must happen at renewal, but suggests that the new information discovered by the insured need not be declared either between acceptance and inception or during the contract period. However, it makes it clear that "where new facts arise, the insured is required to disclose these to the insurer. (Example: a manufacturer of asbestos paper now makes dynamite instead.)" Somewhere between these two examples is a line it would be difficult to draw.

If a ceding company insures restaurants and decides, during the life of the reinsurance, that it will no longer require that those restaurants be sprinklered, the illustration given suggests that this need not be passed on to the reinsurer. However, I have some difficulty with the idea that such a fact would have to be declared during the negotiation of the contract — and presumably during the course of the next renewal of the contract — but not during the life of the contract itself.

My example is not a particularly good one, in that such a change would certainly be of no interest to catastrophe reinsurers and would only be of interest to reinsurers on a quota share, surplus or per risk excess of loss treaty if restaurants were the major part of the business covered. The principle is clear, nonetheless.

When underwriting a reinsurance treaty, as opposed to a facultative risk, the reinsurer is underwriting the competence of the ceding company as much as anything else and one could therefore argue that a change in underwriting approach is not material if the decision were made by the underwriters in place during the negotiations, whereas a change in senior underwriters would be material, although the underwriting policy remains unchanged.

Because a reinsurer reinsures the ceding company as much as the ceding company's business, it must leave the ceding company free to make reasonable changes in its underwriting during the course of a contract, without the need to advise the reinsurer every time.

Even at renewal, the reinsurer must continue to rely on its acceptance of the ceding company as an entity, rather than require advice of changes which may have taken place during the previous

twelve months. Individual decisions may not themselves produce a change material to the reinsurer, even though the cumulative effect of these decisions does. This is particularly so when a contract has been renewed for several years, so that the portfolio is significantly different from that at inception, although the individual changes which brought this about were not themselves material.

I think that the reinsurer has the responsibility of keeping up with these gradual changes, by ensuring that its knowledge of the ceding company remains current. This can be accomplished both through updating underwriting information at each renewal, even though year to year changes are not great, and by regularly discussing with the ceding company its operations and plans.

In your comments, you have only talked of the ceding company's responsibility to show utmost good faith in its dealings with its reinsurers. However, to quote a final time from the Insurance Institute course, "this standard of good faith is required of both the insurer and insured". In reinsurance, it is required of both the reinsurer and the ceding company.

You cite the example of an insured who has negotiated policy conditions "which are subtly intended to include that unspoken hazard." In reinsurance, most new clauses are developed by reinsurers, in Canada by the Reinsurance Research Council. When the Council publishes a recommended clause, it often includes an explanatory note. However, the explanatory note can only give a cursory view of the discussions which must have taken place in the committees of the Council in order to produce the new clause. Is it enough to discharge the reinsurer's duty of utmost good faith to its ceding company? Reinsurers are reluctant to comment on hypothetical loss situations, and understandably so, their response normally being "have the loss and I'll tell you if it's covered." However, when the clause in question was developed by the reinsurer, the ceding company should be able to find out how the reinsurer would respond before the loss takes place.

Utmost good faith is the basis of all relationships in reinsurance, but it cannot be viewed by either party as a blanket protection.

The materiality of a specific fact is often subject to dispute, although, if there is any doubt as to its materiality, it is always

best to declare it. By establishing this as a pattern, the greater trust which would develop between the ceding company and the reinsurer can only improve the climate for dealing with problems which subsequently arise.

However, we are working in a world of "what if" and it is foolish to think that we shall have thought of everything in advance. It is essential, therefore, that both parties, while relying on "uberrima fides," do not forget "caveat emptor."

Financing reinsurances

From one gray area to another.

There is more and more talk today of reinsurance products which go under various names, such as financial reinsurance, finite risk reinsurance, alternative reinsurance or non-traditional reinsurance. I have adopted the term "financing reinsurance," not because I think it any better than the others, but because it is the term used by the Canadian regulators.

The instructions for completing the annual statement to the Canadian insurance regulators states that "where an agreement that is called a reinsurance agreement does not have as its primary purpose the transfer of insurance risk, such an agreement will be regarded as a financing or funding agreement and not as reinsurance."

The instructions go on to state three conditions which must be met in an agreement whose primary purpose is to effect the transfer of insurance risk. These are:

"1. Specify a fixed premium amount."

On the face of it, this would exclude all rated excess of loss treaties. If the premium under a proportional contract is considered to be the premium net of commission, it would also exclude all proportional contracts with an adjustable commission or a profit commission.

"2. Provide that reimbursement to the cedent, by the reinsurer, follows closely the cedent paid losses (or follow normal reinsurance agreement terms)."

This does not usually pose any problems.

"3. Does not have a pre-determined limit to reimbursements payable by the reinsurer."

This would exclude any excess of loss contracts with reinstatement limitations.

Clearly, this attempt at defining financing reinsurances misses the mark — a catastrophe treaty falls within the definition, while a quota share with fixed commission does not.

In reality, the definition lies in the intent, not the structure, of the contract. However, even in the intent, we start off with a basic contradiction. All the text books state financing to be one of the basic functions of reinsurance, yet the regulatory authorities attempt to forbid financing reinsurance. The key is the need for transfer of risk, but even "risk" defies definition.

There is insurance risk — the reinsurer must have a reasonable possibility of showing an underwriting loss from the transaction.

There is investment risk — the reinsurer may obtain a lower yield on its investment of the proceeds of the transaction than it had used in fixing the terms of the transaction.

There is timing risk — the reinsurer may not have the funds as long as it had anticipated in fixing the terms of the transaction.

Insurance risk can be built into any prospective transaction, since it deals with unknown future losses. However, for a genuine transfer of insurance risk, the chance of loss must be reasonable. A catastrophe layer excess of $100,000,000 may represent a reasonable transfer of risk for a ceding company writing in British Columbia, even though it has never had a loss greater than $5,000,000 in the past. However, the same treaty would not represent a reasonable transfer of risk for a company with the same premium income but none of it from British Columbia.

But is transfer of underwriting risk enough when it is all but guaranteed that the investment income from the proceeds of the transaction will exceed any foreseeable underwriting loss? Current practice says that it is not. If a fixed premium is paid at inception and expected to earn sufficient investment income to pay the

aggregate limit of the contract, with something to spare, this is not considered a proper reinsurance transaction.

However, a quota share treaty covering a stable book of business which, historically, has produced loss ratios within a ten-point spread, would be considered a legitimate reinsurance, even though the investment income from the premium and outstanding losses is clearly more than enough to cover any underwriting loss.

In fact, a quota share treaty provides the ceding company with two different functions. Firstly, for losses up to the historical loss ratio, it provides financial support for the balance sheet and solvency tests. Secondly, for losses over the historical loss ratio, it provides partial stop loss protection. In the same contract, this is acceptable reinsurance. However, if the stop loss protection were placed separately from the financial support, the stop loss would be acceptable but the quota share would not.

And yet, what harm does a financing reinsurance do? Basically, it changes the timing of entries on the ceding company's balance sheet. It also may have tax implications, which I will not go into.

The change in the balance sheet is of interest to the regulatory authorities and shareholders. In Canada, most insurance companies are not publicly traded themselves, so that any adjustment to the balance sheet through financing reinsurance is likely to have become no longer material by the time it reaches the financial statement of the parent.

However, adjustments to the balance sheet are of major interest to the regulatory authorities, who are concerned with solvency.

Their approach to the problem — "thou shalt not" — forces the contracts underground and creates a battle of wits between the regulator and the ceding company, aided and abetted by its broker, reinsurer and accountant.

And yet, there can be many reasons for negotiating a financing reinsurance other than hiding a weakness in the balance sheet. An example could arise if automobile insurance is taken over by the Ontario government. Insurers will certainly be reluctant to see their balance sheets affected for several years to come by

fluctuations in outstanding loss reserves on a class of business they no longer write and reinsuring these fluctuations through a loss portfolio reinsurance should be an acceptable method of balance sheet management.

If the regulators were simply to require that, where a reinsurance transaction was designed to produce a pre-determined net effect, it must be declared as such and the solvency tests adjusted accordingly, many of the existing cat and mouse games could be avoided and the regulators' time freed up to dig up those financing reinsurances which will still be hidden, precisely because the ceding company does not want to adjust its solvency margins.

By trying to ban all financing reinsurances, harmless or not, it seems to make it more likely that the harmful ones will escape attention.

Yours sincerely,

Christopher J. Robey