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From Financing Reinsurance to Risks Inadvertently Insured

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Reinsurance Dialogue

between

Christopher J. Robey [1]

and

David E. Wilmot [2]

June 6, 1991

Re: From Financing Reinsurance to Risks Inadvertently Insured

Dear Mr. Robey,

You have characterised financial reinsurance as a "grey area." It is certainly a *hot* area, with seminars on financial reinsurance being conducted in America, the U.K. and Canada. It is an area mined with contradictions, as you have pointed out in your letter of March 12, 1991. But perhaps we can consider the shades of grey and thus disentangle the contradictions.

You defined financing reinsurance by describing what it is not — an agreement which does not have as its primary purpose the transfer of insurance risk. Mr. Andrew Baraile, in his book *A Practical Guide to Financial Reinsurance*[3] distinguishes financing reinsurance from the traditional reinsurance function of transferring underwriting risk by bluntly stating it protects the ceding companies "bottom line." Indeed, such protection goes beyond underwriting risk transfer to include such things as investment risk, credit risk, operating expenses and the timing risk of loss or adjustment payments.

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[1]Mr. Christopher J. Robey is an executive vice president of B E P International Inc., member of the Sodarcan Group.

[2]Mr. David E. Wilmot is Manager for Canada, Norwich Winterthur Reinsurance Corporation Limited.

[3]New York: Executive Enterprises Publications Company Inc., 1991.

I spoke with Deputy Superintendent of Insurance Robert Hammond about financially complex reinsurance agreements in June of this year. He identified the need to "get at the essence of the situation" regarding a treaty's impact on the balance sheet. For example, the Department, which will not recognize discounting until an agreement of standards can be reached by insurers, accountants and the Department, does not want to see contracts "circumventing" this position. Robert emphasized that, while his department is currently looking into financing reinsurance, he is "not enthusiastic about any [reinsurance] schemes that mask the true situation."

You have suggested that financial "cat and mouse games" between regulators and ceding companies could be avoided if solvency tests were adjusted according to the predetermined net effect of reinsurance transactions. This is not practical if the distinction between financing and traditional reinsurance is minute. How do we identify, let alone account for, a reinsurance contract if the net effect of a traditional reinsurance agreement is almost identical to that of a financing agreement? Occasionally, the distinction between one form of reinsurance and the other may be nothing more than intent, wherein lies the grey area.

A concrete example is in order: A traditional financial assistance quota share treaty.

A ceding company, capitalised at $5 million and writing $15 million of property business, has an acceptable risk ratio of 3-1 and (let us agree) a modest solvency margin. To further improve its situation, the insurer dramatically increases its property rates. However, this *improvement* pushes the risk ratio to an unacceptable level and causes the insurer to fail its minimum asset test! The insurer resolves the problem by arranging a quota share treaty, thus transferring a portion of the financial obligations of risk ratio and the reserves for unearned premiums to a reinsurer.

This is a practical solution, no doubt acceptable to the insurance authorities. However, it is tempting to take the example further. Both the insurer and reinsurer expect ceded premiums to be quite profitable. Because of this, the negotiated terms can only be described as *extremely* favourable. A scale commission maintains a thin reinsurance margin and stretches well beyond the expected range of loss ratios. In other words, the "cost" of the quota share

treaty is strictly limited. The treaty does produce a real transfer of risk, a point which would be clearly proven if the cedant experienced a major catastrophe loss. On the other hand, the scale commission includes a loss carry forward feature which dramatically reduces this risk, or at worst, transfers this underwriting risk into a loss payment timing risk. Going even further, the Chief Executive Officer gives reinsurers a guarantee that "we wouldn't walk away from our reinsurers while they are in a loss position." A subtle version of these sentiments even appears in correspondence between the parties.

Taking the example yet another step, the commencement date is prior to negotiations. In my example, the cedant realised its need for financial assistance only after January and February results showed that policy count was not going to drop in spite of the rate increases. It was May before treaty negotiations were completed for a January 1 inception date. Moreover, due to growth and profitability, the ceding company determined to increase its capitalisation by the end of the year. For this reason, it was able to cancel the treaty as of 12:01 a.m. on the following January 1, with return of unearned premiums.

Of course, this example is an attempt to explore the limits of traditional reinsurance without stepping over a line you described as financing reinsurance. The Quota Share treaty, in spite of its modest cost, brief existence and single-minded purpose, is a *traditional* reinsurance agreement. Risk was transferred and government regulators could rest assured that capital was available to offset an untoward experience that might otherwise have threatened policy holders.

Now, compare the example to an identical contract in which the parties determined in advance that the contract would be "settled-up" after December 31. In the second case, the terms are unchanged. The reinsurers' margin is equally thin. Inception is late and cancellation includes portfolio return. The side agreement to recover reinsured losses is no more specific (but the accompanying handshake carries considerably more meaning.) Perhaps the negotiations address the timing of premium payments and current interest rates more thoroughly than was the case in the first example, but otherwise there is no discernible evidence that the line between

traditional and financing reinsurance has been crossed in this second example. And yet it has.

One could flounder aimlessly with questions and further investigation. Why, for example, would the reinsurance margin be identical even though underwriting risk has been excluded from the second example? (Possible answer: reinsurers are more astute about the value of lending capital when their minds are not focused on underwriting risk!) Suffice it to say that distinctions are subtle and regulators must continue to examine closely the intent of such agreements. Cat and mouse games will remain a possibility just as they are in security trading, banking and trusts, and other financial arenas. In any event, I have little doubt that regulators are aware of the shortcomings and ambiguities inherent in *any* written set of instructions regarding financing reinsurance. Ultimately, we must determine the *intent* of any such reinsurance agreement in order to determine if it disqualifies itself as traditional. The best one can do is red flag reinsurance conditions characteristic of financing reinsurance:

- Reinsurance costs with a wide margin for adjustment or with inordinately large profit commissions, contingent refunds or paybacks of any description;
- Conversely, reinsurance costs which are disproportionately high in relation to risk;
- A limitation on reinsurance recover which, when related to the cost of reinsurance, eliminates or almost eliminates risk;
- Little or no risk transfer;
- Undue credit for investment income or the time-value of money;
- The failure to transfer premiums, reserves or both;
- Reimbursement of losses out of phase with actual loss payments or payments which are unrelated to actual losses;
- Inordinately short contract periods, cancellation penalty clauses, or both;

- Side agreements, however named.

You suggested there is a place for financing reinsurance. There may be a number of situations in which a cedant's "bottom line" could benefit despite correct acknowledgement by and adjustment of the tests of solvency. However, tax implications can also be a significant consideration in financing reinsurance. These implications cannot be ignored and may represent either another barrier to financing reinsurance or another reason for driving the intent of a particular contract underground. (I am reminded of the financial reinsurance treaties considered a few years ago when the Anti-inflation Board demanded that excess insurance profits be returned to policy holders. Of course, that was also the year many offices and boardrooms were lavishly redecorated. Should we also explore the hidden intent of cherry wood panelling and indirect lighting?)

In addition to insurance regulators and tax authorities, the very owners of the ceding company may fall victim to "bottom line" misinformation as a result of financing insurance. I would not want to presume in every case that shareholders understand the full implications of reinsurance deals arranged by their managers. Full disclosure is in order, and again, the underlying intent must be identified for *all* interested parties.

Due to these regulatory and taxation factors, amongst others, I'm afraid we will continue to see financing agreements attempting to wear the clothing of traditional reinsurance. If my examples and conclusions are valid, then no set of rules or conditions will completely separate one from the other, and regulators must continue to fathom the *intent* of financially complex reinsurance arrangements.

Errors and Omissions and Risks Inadvertently Insured

Returning to traditional reinsurance and the intent of day-to-day underwriting, I would like to consider the Errors and Omissions Clause and Risks Inadvertently Insured. There exists some misunderstanding regarding the relationship between these clauses as well as their purpose and scope.

Historically, the Errors and Omissions Clause was intended to cover risks erroneously omitted from or incorrectly recorded to the bordereau of a surplus treaty. Upon discovery of

such an error (invariably following a loss), the cedant would retroactively correct the error and the reinsurer, satisfied that similar risks were ceded in the same way, would pay its share of the loss. Today, insurers and reinsurers have extended the use of the clause to include delays, errors and omissions in both pro rata and excess of loss agreements. Omissions may include the failure to promptly report a large loss or to submit an account. I could argue that such minor errors require no special protective wording, but the clause is too well entrenched to take issue at this late date. On the other hand, reinsurers are now faced with the responsibility of explaining what the clause does *not* do.

The wording in common use is short enough to include here: "Any inadvertent delay, error or omission shall not be held to relieve either party hereto from any liability which would attach to it if such delay error or omission had not been made, providing such delay, error or omission is rectified upon discovery."

I have encountered efforts to expand the purpose of the Errors and Omissions Clause to include more than reporting or accounting errors. As a result of such efforts, at least one Errors and Omissions wording used in the Canadian market goes on to assert that it will not override the exclusions, the cancellation or termination provisions, risks inadvertently insured clauses or sunset clauses. The extended wording reflects the intended limitations understood to be included in *any* Errors or Omissions Clause.

The clause is not an errors and omission policy issued by the reinsurer to the ceding company's management. Errors in claims handling are outside the scope of this clause and may be addressed by other treaty articles, if at all. Management errors, trading risks, the failure to recover premiums from a bankrupt broker, and other commercial risks are not covered by the Errors and Omissions Clause. Most importantly, underwriting errors such as the acceptance of an excluded risk or peril are not covered by the clause. A careful reading of the above wording makes this last point quite clear.

Treaties are careful to name the classes of insurance they protect. At the same time, these treaties will exclude specific classes and perils. Ultimately, a carefully drafted list of exclusions serves

the best interest of the ceding company — allowing the insurer flexibility while permitting the reinsurer to issue its full capacity.

What, then, does an insurer do if an insured attaches excluded risks or perils or extends its activities to encompass excluded operations? Insurers recognize this possibility and, in such situations, must consider the reinsurance principle of "following the cedant's technical insurance fortunes." Reinsurers are inclined to either support the new exposure until it can be cancelled or reinsured elsewhere, or else accept the extended risk as a special acceptance under the treaty. This approach is set out in the Risks Inadvertently Insured Clause.

However, more than one version of the Risks Inadvertently Insured Clause may be found in use. Reinsurers are occasionally asked to support a version which extends the definition of "inadvertency" (sic) to include errors in risk acceptance. If an excluded risk or peril is accepted in error, reinsurance coverage is afforded until the error is discovered and rectified.

There are a number of dangers inherent in such a clause. Clearly, the clause must not become a substitute for careful underwriting controls and audits within the underwriting department. Also, reinsurers will continue to expect a high level of underwriting care despite the use of this clause. They may have considerable difficulty understanding a fleet of 747's inadvertently written into the property treaty. Most important, the clause is no protection against habitual abuse of the underwriting guide or the exclusion list. Insurers who routinely ignore underwriting restrictions are no longer making inadvertent errors, and they will have difficulty convincing reinsurers that the Risks Inadvertently Insured Clause is applicable.

Yours sincerely,

David E. Wilmot