Assurances

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The Nature of Excess of Loss Payments and The Reinsurer's Role in the Market

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Volume 60, Number 2, 1992

URI: https://id.erudit.org/iderudit/1104898ar
DOI: https://doi.org/10.7202/1104898ar

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Publisher(s)

HEC Montréal

ISSN

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

Reinsurance Dialogue

between

Christopher J. Robey *

and

David E. Wilmot **

Le 8 juin 1992

Re: The Nature of Excess of Loss Payments and The Reinsurer's Role in the Market

Dear Mr. Wilmot,

Definitions

Before discussing your comments on the nature of excess of loss payments, I must take up the question of definitions.

Our business is full of words and phrases with meanings no longer evident in themselves. With the great increase in workers in reinsurance over the last thirty years, such words and phrases are now subject to differing interpretations, certainly in different countries but also between different generations in the same country.

One such phrase appears in the first sentence of your comments on the nature of excess of loss payments - "treaty reinsurance".

You have used it to differentiate between proportional and excess of loss reinsurance, a common use, but more usually reserved for the London market, and even there for underwriters of many years experience.

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To-day, and particularly in North America, "treaty reinsurance" is more often used to distinguish automatic arrangements from facultative. "Proportional" replaces it as the term used to distinguish a sharing type of contract from excess of loss.

In itself, it may seem a minor point, but many contracts contain an exclusion for "assumed treaty reinsurance" when it is the intention to exclude all forms of automatic reinsurance acceptances, not just those on a proportional basis.

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However, definitions is not the subject this time, although perhaps it would be an appropriate one for another time.

The Nature of Excess of Loss Payments

The follow the fortunes principle is subject to so much debate nowadays that one must wonder if the phrase still serves any useful purpose. Perhaps we should eliminate it from all contracts and spell out exactly what we mean, instead of using a phrase which has almost lost meaning.

Certainly it cannot be applied to excess of loss reinsurance, where there is not the same sharing of fate as there is under a proportional contract.

Losses payable

To me, the use of "losses payable" as well as "losses paid" in the ultimate net loss clause is more a technical matter than one of principle.

Certainly, reinsurers should not be expected to pay a loss well in advance of the ceding company paying its insured, but a request for prepayment of a large loss to put the ceding company in funds to pay the insured is reasonable.

It would not make much sense for the ceding company to have to sell some investments to pay a loss for which it will be reimbursed shortly after. Of course, a line of

credit at the bank would usually be used, but there are circumstances when it would be more appropriate for the reinsurer to prefund a loss payment which it would make later anyway.

Perhaps the best example would be a major catastrophe. Rapid settlement of claims is not only good for the image of the industry, of which the reinsurer is part, but would keep down the cost of settlement as well.

The reinsurer benefits from such reduced cost, indeed will probably be the sole beneficiary, and it is normal that it help the ceding company to achieve it. If this can be done by advancing funds solely on the basis of the probability of the reinsurer being involved for the amount advanced, it is equitable and good business sense for the reinsurer to make the advance.

Agreement to prefund individual losses can of course be dealt with case by case, since the need should not arise frequently. However, a reinsurer which refused on the basis that the wording referred only to "losses paid" would not be doing itself or its client a service.

Another argument which could be developed is that reinsurers are indeed liable for all losses, outstanding or not, the question being only the timing of the payment. This would be supported by the fact that reinsured outstanding losses are carried on the reinsurer's books, not those of the ceding company. I suspect, however, that the accountants would tell us that is the way it would be done regardless of the wording.

I think the debate to be on a minor point at best. No ceding company should expect to enforce payment of outstanding losses well in advance of its own payment to its insured, whatever the specific wording used, unless the wording actually provided for it. Reinsurance practice is sufficiently well established for that.

Indeed, if the reinsurer is concerned that its ceding company would try such a thing, it should consider whether it

should provide it with any reinsurance at all, since this is likely to be the least of its sins.

Ex gratia Payments

I agree with your comments on ex gratia payments. They should not be automatic under excess of loss covers.

However, there are times when such a payment would be in the reinsurer's interest, for example a loss compromise without admission of liability, so the reinsurer would be wise to

listen to all proposals.

Commercial risk

I cannot dismiss the role of reinsurers in payment of a commercial risk as readily as you do.

Punitive damages are a specific case you cite. However, usually, the action which caused punitive damages to be awarded was taken by the ceding company to save the reinsurer's money as much as its own.

With most claims co-operation clauses, the reinsurer is kept aware of developments on a claim. It has the opportunity to give advice to its ceding company and even instruct the ceding company how to proceed.

It cannot accept the consequences of the ceding company's actions only when they are successful and wash its hands of the consequences when they fail.

Sometimes, the punitive damages will be the result of an action the ceding company took on the instructions of the reinsurer. Already the ceding company bears the damage to its reputation in the marketplace; it is only normal that the reinsurer bear the financial cost of its instructions.

Where the reinsurer has given only passive approval through not commenting on the ceding company's handling of the case, there are provisions in the extra-contractual obligations

clause approved by the Reinsurance Research Council for a sharing of the consequences.

The terms are agreed at the original negotiation of the contract, but if the parties disagree on the course of action to be taken on a specific claim, there is always the possibility of negotiating a specific sharing for that claim.

The reinsurer's role in the market

If commercial risk arises out of "being in business", then we should remember that the reinsurer is in the same business as the insurer and serves the insurance client no less than the insurer does, although in a different way.

Because of the frequent discussion of this point, in part, as you point out, because of questions relating to the Ontario Motorist Protection Plan (OMPP), I will take it further and expand it into a new topic for discussion.

The role of the insurance industry is to spread the cost of loss by individual members of the general public, both private and commercial, amongst all of them. Insurers play the public role through their direct contact with the insured. Reinsurers play their role in the background by helping insurers spread the risk still further.

Reinsurers are part of the market; they benefit from it, for without it, they would have no purpose.

Reinsurers' income originates with the insured. While a direct relationship should not exist, and the insurer and reinsurer should be careful to see that none can be inferred, the reinsurer cannot wash its hands of its responsibility to the multitude of insureds which rely on the reinsurer's clients for security.

It is undeniable that the possibility exists of government-imposed liability over and above the terms of the individual policies, whether it is imposed by legislation or coercion.

Any insurer choosing independently to increase payments to an insured over those required by its policies would do well to consult its reinsurers beforehand, rather than expect them to follow automatically.

However, such changes rarely come about that way.

Any change would be discussed first with the industry. Indeed such discussion would be necessary for any form of coercion to take place and it is certainly well established as the norm for legislation.

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In all probability, the industry would be represented in the discussions by the Insurance Bureau of Canada (IBC) to which most if not all licensed reinsurers belong. Reinsurers therefore have a forum for participating in the discussions with the government.

If they are not satisfied with that forum, they have their own organization, the Reinsurance Research Council (RRC), through which they can speak directly to government.

If the IBC agrees to a voluntary change and recommends it to its members, can reinsurers morally say that the change has nothing to do with them?

Certainly they can discuss with their ceding companies the appropriate way to deal with the change and it would frequently be inequitable to pass the whole cost on to reinsurers. But it would usually be just as inequitable for reinsurers to refuse any part of it.

The possibility of extra payments following a Vancouver earthquake is a good example.

It is unlikely that an individual insurer would choose to pay more than the policy requires without consulting its reinsurer, although it can be expected to give the insured the benefit of the doubt in determining coverage. If the government wanted coverage widened for all insureds, it would want it from all insurers and would handle the discussions through an industry organization.

The industry as a whole, including reinsurers, would have to decide how to respond, including how to spread the extra cost between the segments of the market. Reinsurers should not pay all the additional cost, but they certainly have a role to play.

Since insurers would probably be able to recoup at least part of the additional loss through a subsequent premium surcharge, the distribution of that would also need to be discussed.

An insurer which is not willing to take the risk of such possible arbitrary government action has the option of withdrawing from the British Columbia market, or any other market where the possibility is feared, for there is ultimately no other defence against it. The same is true for a reinsurer.

After all, legislation and coercion can apply to reinsurers just as much as to insurers. It is the same government which licenses them both, under the same legislation.

New proposed legislation in Ontario shows this to be the case, though perhaps accidentally.

Restrictions on withdrawing from the market which are in Bill 164 apply equally to insurers and reinsurers, since the law makes no distinction between them. The way the legislation is worded suggests it was not intended to apply to reinsurers, however if insurers are to be restricted in their right to withdraw from the market, restrictions must also be imposed on reinsurers, since most insurers could not stay without them.

Increased benefits under expired OMPP policies would be dealt with the same way as an extension of coverage following a Vancouver earthquake. Whether legislated or adopted "voluntarily" by insurers, the insurance market, including reinsurers, would have an opportunity to voice their opinion on the change.

This has in fact already happened under OMPP. When it was first introduced, all insurers "voluntarily" read in the highest available weekly benefits limit for a few months and I

am not aware of any reinsurer refusing to honour claims at that level.

The reinsurer undertakes to reimburse the ceding company for amounts it is legally liable to pay. Coercion would not produce legal liability, but reinsurers can expect to be coerced as much as insurers. If coercion of reinsurers were unsuccessful, insurers could insist the change be legislated and legislation would produce a legal liability. Reinsurers are part of the market and cannot hide.

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And reinsurers will be listened to. Despite how it may sometimes seem, they are important to their ceding companies, for without them, most ceding companies would be out of business.

That reinsurers should not share in the increased cost of changes because they did not collect any premium for the exposure is not much of an argument when their ceding companies did not collect any premium either.

Where the possibility of such unplanned increases in exposure is recognized in advance, reinsurers also have a duty to alert their ceding companies to their position. A clause to exclude such increased costs can easily be written - one such clause, the "benefits in force" clause, already exists and could be applied to OMPP claims.

Indeed one can argue that a reinsurer which does not exclude a foreseeable increase in benefits is tacitly accepting it. Certainly there has been enough discussion of the possibility of a

retroactive increase in accident benefits under OMPP that no reinsurer could deny knowledge of the possibility.

If the reinsurer had discussed such a possibility before pricing the contract, is the ceding company not entitled to assume that such a possibility, if not specifically excluded, was included in the price?

Certainly the reinsurer cannot be expected to foresee every eventuality, but neither can the ceding company. Where it is possible, such circumstances should be provided for. Where it is not possible, the parties must negotiate an equitable solution. The burden should no more be thrown entirely on to the ceding company than it should be thrown entirely on to the reinsurer.

Reinsurers are part of the marketplace; they share the benefits of it and should share the pain. The discussion should not be whether unexpected increased exposures should be shared, but how. That is a debate to be undertaken case by case, since each case will be different.

Yours sincerely,

Christopher J. Robey