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Reinsurance Dialogue

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Reinsurance Dialogue

between

Christopher J. Robey

and

David E. Wilmot*

February 18, 1994

Re: The Net Retained Lines Clause

Intent to Commute

Dear Mr. Robey,

The Net Retained Lines Clause

You have made a strong argument for the elimination of the Net Retained Lines clause, but before we expunge the clause from our respective word processors, I should like to examine its role in excess of loss treaties more closely.

At its simplest, this clause makes two points not generally found elsewhere in the treaty—not even in the Ultimate Net Loss clause, as you suggest. The clause limits the scope of cover to those liabilities retained by the Cedant for net account, unless specifically stated otherwise. It goes on to say that this limitation is not altered by the Cedant's inability to collect amounts due from other reinsurers, for whatever reason.

The clause spells out the reinsurers' position with regard to net or common account exposure while gently noting that it is not the practice of excess of loss reinsurers to assume the commercial risk of non-collection from other reinsurers. I

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like to see these points made. I would be reluctant to throw them out of the excess treaty.

However, you are correct in stating that use of the clause could cause problems of interpretation if improperly handled, and your specific examples should be addressed:

- If it is intended that the excess treaty provide common-account protection or to assume responsibility for losses arising out of ceded liabilities in any way, then the Net Retained Lines clause must clearly identify these other proportional agreements. It may be possible to get around the internal quota share arrangements of group-companies by naming all group members as Reinsureds, but thought should be given to the structure of these and other pro rata reinsurances while drafting the treaty wording.
- The introduction of occurrence limits in pro rata property treaties can be dealt with relatively easily, if it is indeed the intention of catastrophe reinsurers to assume the occurrence "spill-over." The Net Retained Lines clause could include an agreement to the effect that a specific exception has been made to the clause, or alternatively, the treaty could state that an additional protection has been afforded the Cedant by the Reinsurer, notwithstanding the Net Retained Lines clause.
- Frequently, underlying excess of loss or specific excess reinsurance will inure to the benefit of an excess of loss treaty. As you have said, the Net Retained Lines clause does not have to comment on these inuring excess agreements because the clause limits itself to defining the scope of *liabilities* exposing the treaty and not the impact of any *losses* that may occur. In fact, inuring excess protection should be dealt with elsewhere in the excess treaty, if at all. One common practice is to warrant the cedant's use of inuring excess protection. The Net Retained

Lines clause need not mention inuring excess of loss protection.

- By the same token, extensions of the Net Retained Lines clause, to capture line guides or to tie down underwriting policy, are most inappropriate. ("This Agreement shall only protect that portion of any insurance which the Company, *acting in accordance with its established practices*, retains net for its own account.") In an extended (albeit useful) digression, you noted that some reinsurers have gone so far as to define and exclude material change through the use of the Net Retained Lines clause. Although I have not seen examples of this, I agree with your view that it is both unnecessary and unwise. Material change is already addressed by contract law, and, as you said, any effort to define what is material must inevitably fail by omission.

Despite the cautions noted above, the Net Retained Lines clause serves a necessary function, and must remain in the excess of loss treaty in one form or another. I note that one reinsurance broker, perhaps as a result of your ruminations, has chosen to omit the clause as such, and instead, bury its two key messages in the Retention and Limit of Liability clause. This suggests both a reluctance to dispense with the clause and penchant for fixing that which isn't broken.

I would now like to move from a wording you wish to put out to pasture to one so new that it has not yet found its legs—the automobile accident benefits Commutation Clause.

Intent to Commute

Reinsurers and reinsurance brokers have produced a variety of accident benefit commutation wordings in the short time since the introduction of the Ontario Motorist Protection Plan, OMPP. In fact, RRC is working on yet another version of the clause, even as I write this. With such a wide and conflicting range of wordings, it is becoming increasingly important that interested parties understand the *intent* of these agreements rather than the strict wording of one version or another. I will go so far as to say that, with good will and a proper understanding of the reinsurance product, it may be possible to amicably conduct accident benefit commutations *in spite of* the shortcomings inherent in wordings currently on the market.

Ontario automobile insurers have not embraced commutation with enthusiasm, but the majority have recognised that accident benefit claims, with payment-streams of 20, 40 or

60 years and more, required some recognition of the time-value of money. (Others simply appreciate that their treaties will not be completed without a commutation clause.)

There are valid reasons for commuting Ontario accident benefits, including reduced reinsurance accounting, a reduced exposure to reinsurance insolvency, and a shorter turnaround in the pricing of treaty experience. In any event, after the five year period of most commutations, the insurer has already received the benefits of excess reinsurance.

Nor are commutations new to excess of loss reinsurance. Clauses have appeared in Canadian contacts since the early 1980s, and perhaps earlier. In its simplest form, the clause is an agreement to capitalize losses after an agreed period of time, using an actuary to resolve any disagreement as to value.

Unfortunately, since the introduction of OMPP in June of 1990, reinsurers and brokers have made quite a meal of the clause, while complicating and distorting its intent. It is not my intention to unravel the various clauses in these pages, but I would like to explore the intent behind agreements to commute accident benefit losses. This exploration will be limited to one petty annoyance and two issues I find particularly frustrating.

First, the annoyance: Canadian commutation wordings have been written to be included in the Ultimate Net Loss Clause. Those reinsurers drafting the 1990 and 1991 versions felt moved to explain that each accident benefit claim is made up of the sum of (a) the commuted value of outstanding losses and (b) payments, if any, made prior to commutation. This extended explanation is superfluous, but it is one that has given reinsurers a continuing sense of comfort which they are not now prepared to relinquish. I suggest we merely substitute the word "capitalize."

On a more serious note; much energy has been given to debating and drafting "present value" commutation wordings as opposed to "full value" or "layered" commutation wordings. Thanks to the tireless efforts of one reinsurance intermediary, there may *still* be a few insurers and reinsurers who do not fully grasp the distinction. As a result, a few treaties with layered commutation clauses have been priced as if they contain present value clauses, and problems may yet arise when the time comes to actually perform the commutation. The distinction between present value and layered commutation is, of course, the difference between capitalizing the *loss* (present value) and capitalizing the *reinsurers'* undiscounted loss (full value).

This distinction should never have become an issue. If it is the intention of the commutation clause to retain the relative value of the insurer's retention and the reinsurers' limit of liability, then capitalization of the reinsured loss fails to do so. Full value or layered commutation has taken short-term advantage of a few reinsurers, though hopefully not at the expense of long-term relationships and the long-term cost of reinsurance. The market for layered commutation has now disappeared, although loss settlements have yet to take place. (One small blessing from Bill-164: layered commutations are totally impractical inasmuch as an insurer would have to buy reinsurance limits of liability approaching $60 million.)

A second point of confusion relates to the most fundamental principle behind the capitalization of losses 10, 20 or 40 years in advance of their ultimate settlement. That is, commutation is an agreement to settle a loss without knowing its final value. It is a means of agreeing and settling (I repeat, *settling*) losses based on estimated values derived from measurable criteria. These estimated values will invariably be wrong. But the margin of error will be small if commutation is conducted after the claimant's situation becomes stable. Once the claim is finally commuted, there should be no recourse by either the insurer or the reinsurer. Commutation is full and final.

This last point seems to trouble insurers and reinsurers equally. A reinsurer asks, "What if I commute but the claimant dies two months later?" Answer: the commuted settlement was lower than it might otherwise have been *because* it considered the possibility of an early death. An insurer asks, "What if I commute only one claim and the claim deteriorates?" Answer: this too was considered in the commutation, but why worry? —a claimant living many years longer than expected will receive these unanticipated benefits at the *far* end of his or her life, where their discounted value is relatively small.

Commutations, as originally conceived, are intended to be full and final settlements. The parties agree to settlement knowing that each and every value will be slightly wrong, but that every commutation represents a fair assessment based on what was known at the time of commutation.

A number of insurers, reinsurance brokers and even reinsurers seem to anticipate difficulties in arriving at amicable commutation settlements. I prefer to think that the many Ontario automobile agreements were entered into by gentlemen of utmost good faith, who shared a commonality of intent when negotiating their treaties. Given that the intention was to capitalize losses after an agreed period of time, it follows that commutations should proceed to full and final settlement on a basis considered equitable by both all parties.

Yours sincerely,

David E. Wilmot