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REINSURANCE DIALOGUE

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REINSURANCE DIALOGUE

between Christopher J. Robey and David E. Wilmot

February 4, 1999

Dear Mr. Wilmot:

Extra contractual obligations clause and excess of policy limits clause

Your letter of last June, discussing the application of reinsurance to the ice storm which hit Quebec and Eastern Ontario, provides a timely example of an old problem.

I fully agree with you that both insurers and reinsurers, for the most part, responded with great responsibility to the loss. However, inevitably, the passage of time has provided a slightly different perspective.

The Reinsurance Research Council responded admirably by producing a bulletin on what losses it expected to be covered in catastrophe reinsurance contracts, however it is an advisory body only and insurers know that its recommendations are not automatically followed by the market. Since reinsurers did not quickly reinforce the Council's message when alternative interpretations began to circulate, some confusion over coverage lingered for far too long. Nonetheless, overall, reinsurers did an excellent job of providing fair and consistent coverage to all their clients.

Reinsurers also responded admirably to the interpretation of contract clauses relevant to the loss and provided coverage on a "what should be done" basis, rather than a strict interpretation.

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You touch on one of these issues in your letter by writing that "reinsurers were also quick to conclude that the entire atmospheric event, from the beginning of the freezing rain on Monday or Tuesday to the cold snap late Saturday, fell within the 168 hour definition of one occurrence." This was indeed settled quickly, the question of whether or not there was in fact more than one storm quickly giving way to a common sense approach.

Equally admirable was the understanding of reinsurers as to what the Hours Clause meant in the circumstances, rather than what it may actually say. The usual loss occurrence definition limits coverage to "all individual losses sustained by the Company during any period of 168 consecutive hours arising out of and directly occasioned by the same event".

As you write, it was quickly agreed that the cause of loss was contained within a 168 hour period. However, the clause requires that individual losses be sustained by the company during that period – it is not just a time limitation on the cause of loss.

It is evident on reading the entire clause that the definition assumes the loss is sustained when the cause of loss occurs. In the case of the ice storm, however, that did not happen. As an example, losses for additional living expenses can be traced back to the loss of electricity resulting from the ice storm. However the losses themselves were sustained over a period much longer than 168 hours, with very few of them actually being sustained in the 168 hours of the ice storm itself. Reinsurers acted professionally and responsibly in interpreting the hours definition to apply to the cause of loss, rather than the loss itself. Nonetheless, as you suggest, we need to learn from this loss in order to change the loss occurrence definition to take into account our experiences arising from it.

Another aspect of the loss where reinsurers demonstrated their willingness to share with their insurance clients in the fortunes of the business in which they both participate was the question of fire losses. Although some fire losses would have been triggered directly by the ice storm, in most cases some intervening cause would have come into play. Nonetheless, a few of the fires could be traced to an insured's efforts to minimize what would otherwise have been a much greater loss directly related to the ice storm. In these cases again, reinsurers acted with a high level of responsibility in allowing ceding companies to include them in the ice storm loss for catastrophe purposes.

One final thought on this. As you point out, the loss occurred in an area of Canada subject to earthquake, which would bring far more devastating damage. While insurers responded admirably to the circumstances, for many it was a scramble to improvise solutions and it was clear that civic authorities were no better prepared. One has only to wonder what would have happened if schools and the like had not been available as temporary shelters and people did not have homes to go back to when the electricity came on. There is much to be learned from the ice storm experience and insurers, which carry the largest load of any industry in a loss of this type, should be in the forefront of making sure those lessons are identified and applied to minimize their loss the next time around. Since reinsurers reimburse the bulk of the loss to their insurance company clients, they would seem to have a clear interest in ensuring that this is done and assisting their clients in achieving it.

International Buying of Reinsurance

Consolidation and globalization are changing the face of the Canadian insurance industry. One result has been an increase in the purchase of reinsurance protection for Canadian insurers within international reinsurance programs. Another is the international influence exercised on the marketing of local programs. Both pose problems for the Canadian insurer and reinsurer which are worth exploring.

International Influence on Local Programs

The influence of overseas owners is evident in most reinsurance programs purchased by the local member of a multi-national group. While there is frequently considerable control over program design, this is usually handled internally. To outsiders, the influence is most noticeable in marketing.

In a few cases, this is limited to the approval of reinsurers which can provide protection to the local entity. More often than not, however, the head office has a list of reinsurers which it considers core and which therefore get a preferential place on any program.

This is not usually a problem for the local buyer, since the reinsurers concerned are normally leaders in the Canadian market as a natural off-shoot of their international stature. However, it is not always the large international reinsurer which offers the most competitive terms in the local market. The local buyer can therefore find itself paying a higher price or accepting more restrictive conditions in order to comply with the head office requirements. Although this would usually be an acceptable price to pay for the international group, a local office is unlikely to receive any compensation for the additional cost to it of following global policy. However, it would be rare that the impact would be enough to make the local buyer uncompetitive in its market and, if this extreme were reached, one hopes that relief from a global policy would be available.

It is more difficult to measure the impact of specific agreements between international buyers and reinsurers. In some cases, they can erode the traditional basis of the reinsurer relationship.

The principle of proportional signing down of authorizations had all but disappeared before the global influence was evident on reinsurance buying, and was certainly not a response to it. However, global buying is undoubtedly a major barrier to its reinstatement as a standard.

More difficult to assess is the impact on the much talked about but rarely written down "most favoured reinsurer" clause. This clause requires that all reinsurers on a contract participate on the same terms and conditions. Obvious breaches, where clearly different terms and conditions exist, are rare. However, global agreements between an insurer and a reinsurer are more common today and are, in a sense, a hidden additional condition to each of the reinsurance contracts between the two parties. The form of these agreements will normally be an incentive paid by the reinsurer to the insurer to have the reinsurer participate on as much of the insurer's reinsurance program world-wide as possible. It could be in the form of a straight rebate of premium or, more likely, a profit commission on the global relationship. Either way, it changes subtly the terms of each contract in a way which is not available to other participating reinsurers and is a change which is never openly declared.

This example may not breach the "most favoured reinsurer" clause, since such payments would actually make the reinsurer's terms less favourable than those of other reinsurers. But the overall relationship between the ceding company and the reinsurer can influence the terms a reinsurer will offer on a specific contract, putting other reinsurers on that contract at a disadvantage. This has happened for many years within Canada, but is now much more prevalent when international relationships are a consideration.

As the consolidation of both insurers and reinsurers continues, such global agreements will become more prevalent, perhaps to the point where the most favoured reinsurer clause will be openly acknowledged as not applicable in certain specific circumstances.

Global Reinsurance Programs

There is no natural division to show when reinsurance should be bought locally or as part of a wider program. Newfoundland companies buy their own reinsurance programs, covering only Newfoundland exposures, while national companies writing a larger volume in the province include those exposures in a national program. With the introduction of first party as the principle means of compensation in Ontario automobile, the natural link between Ontario and, say, Alberta automobile no longer exists, but automobile is still considered a natural grouping for buying reinsurance on a national basis.

Extended internationally, there is no natural reason why a reinsurance program should stop at national boundaries any more than it should stop at provincial boundaries, so there is nothing basically wrong in having Canadian exposures included in a reinsurance which also covers exposures from many other countries.

However, the greater the variety of exposures included in the protection, the more the purchasing of the protection requires careful planning.

Cost sharing

The most immediate question for local management is the calculation of its share of the cost of such a program, and this will also be of interest to the regulator and the tax authorities. The rules for transfer pricing introduced by Revenue Canada in July of 1998 provide a good basis for deciding what that cost should be, particularly since using a higher cost could result in both disallowance of part of the deduction for tax purposes and a penalty.

Revenue Canada's basic principle for transfer pricing, the "arm's length principle", is similar to that which would be required by the regulator and requires simply that non-arm's length transactions must be carried out at the same terms and conditions that one would expect with arm's length parties. The application of such a principle, however, may not be as straightforward.

Limits and retention

An international program will frequently carry higher limits than would be necessary for the Canadian protection alone. Can the Canadian entity be charged a proportion of the entire premium, or only of that premium up to the exposure it believes it has? The

Revenue Canada arm's length principle would seem to suggest that a Canadian program should be priced specifically and this amount charged to the Canadian entity for its participation in the international program. This would automatically mean that the Canadian entity did not pay for protection above its perceived exposure, but would also eliminate such simple allocation methods as proportionate to the premium base. Whichever method is used, the Canadian entity can expect a difficult conversation either with its head office or Revenue Canada, perhaps both.

A different problem arises at the bottom end of the program, since the deductible for the international group will almost certainly be higher than the Canadian entity can carry based on its own finances. This will usually result in the purchase of some form of underlying protection for the local entity. If purchased in the open market, some design problems exist, but they are easily resolved. However, if the protection is provided by the parent company, there are issues of both pricing and structure.

The pricing issues are similar to those for the Canadian entity's participation in the overall pricing, and the arm's length principle would again have to apply. However, the group may prefer to take advantage of the use of internal reinsurance by using a customized structure which would not be available in the open market. Establishing arm's length pricing for such a structure will certainly be more difficult.

In addition, whether the structure is traditional or customized, it will need to be documented in a traditional manner in order to satisfy the regulator.

Horizontal capacity

More difficult problems arise in determining the amount of horizontal cover necessary, where the international program contains aggregate limits, such as limited reinstatements.

Most Canadian catastrophe reinsurance programs are placed with one reinstatement, so, for example, the regulator in British Columbia does not worry about an earthquake in Quebec using up all the available horizontal cover and leaving British Columbia policyholders bare.

As the scope of the protection is broadened, the possibility of multiple events in the same contract period increases and a limitation to one reinstatement becomes more problematic. It would be easy to design a program with multiple reinstatements, or one limit per defined catastrophe zone, however reinsurers may not be amenable to such a structure and, if they were, might require a price for it which the buyer would not consider reasonable. Nonetheless, the local company has the responsibility of demonstrating to the regulator that the reinsurance cover it is paying for will be there if needed, and will not have been used up in another territory.

Another issue around reinstatements is who pays the reinstatement premium. Will the Canadian entity have to pay an additional premium if the cover needs reinstating because of an Australian loss? If only the territory suffering the loss has to pay the reinstatement premium, is the reinstatement premium calculated on the worldwide premium base or just the premium base for that entity? The total premium paid for these global reinsurances would result in a reinstatement premium large enough for these questions to be of importance to the local manager.

Specialty Coverages

Particular attention is also needed where apparently similar coverages in different territories are not as alike as they seem. The best example of this in Canada is Ontario automobile.

Automobile reinsurance programs in most parts of the world are designed to cover liability only, but such a protection would not pick up the first party exposure under Ontario automobile unless it was specifically added.

More subtle, and more likely to be missed overseas, is the fact that loss transfer for heavy commercial vehicles has no occurrence limit on it, since it is not the third party liability exposure it appears to be and therefore not subject to the liability limit in the policy.

Local executives would know this, but the international buyer may not. The all too prevalent tendency for minimal consultation between the international buyer and the local management makes the risk of this type of gap in coverage all the greater.

Conclusion

Questions such as these are dealt with regularly by international buyers, but the local company has generally had little input into the decisions. With Canadian regulators looking more closely at reinsurance arrangements in general and catastrophe protection in particular, local management will have no choice but to get more involved and make sure not only that it is fully protected, but exactly how that protection is put together.