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REINSURANCE DIALOGUE

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REINSURANCE DIALOGUE

between Christopher Robey and David Wilmot

August 25th, 1999

Dear Mr. Robey:

International Buying of Reinsurance Follow the Fortunes

In your letter of February of this year, you explored the trend toward globalisation of reinsurance purchasing. I too am concerned by the increasing tendency of international insurers to dictate the reinsurance buying practices of their subsidiaries in Canada. Such increased intervention may make sense to the parent organisation seeking to co-ordinate worldwide activities and to leverage global buying power, but it makes it too easy to overlook the unique needs and circumstances of individual regions.

This has been a particular concern to Canadian cedants and reinsurers who have always found it a struggle to communicate to European or American parents the distinct nature of Canadian exposures. Canada's legal environment is far less capricious that that of the U.S. Catastrophe frequency and severity are the envy of most industrialised nations. On the other hand, Canada's complex, multi-province and ever-changing automobile system combines the worst elements of unlimited European coverage with the severity of North American injury costs. Under these circumstances, Canadian subsidiaries may well wonder whether their reinsurance requirements are understood and if their cost of protection is competitive.

Even when parental limitations are no more than a prescribed list of reinsurance markets, the domestic insurer may be disadvantaged. Most international reinsurers are represented in Canada, but international scope does not ensure a local expertise in every discipline. Moreover, when creativity or an innovative approach is

required locally, the prescribed international reinsurer may lack the "right stuff" or may be hamstrung by international constraints.

No doubt, the "bulk buying" of international reinsurance may introduce small savings, as a greater volume of premiums under protection must mitigate the loading for uncertainty. However, such one-size-fits-all coverage can create hidden "lost opportunity" costs far in excess of these theoretical savings.

Less theoretical are some potential problems associated with the parental purchase of world-wide catastrophe protection, already identified by you. Storms and earthquakes in other countries could exhaust the coverage and reinstatements supposedly available to the Canadian insurer. Sticky questions surrounding reinstatement premiums in the event of a Canadian loss must also be resolved. To these I would add the potential problem of a single event involving Canada *as well as* another territory. It is conceivable that the catastrophe reinsurance limits (dollar limit or hours limitation or both) will have been exhausted before a particular weather event even reaches the Canadian border.

Like you, I think that insurers subject to international control of their reinsurance protection must be aware of the regulatory implications, must examine the pennies saved against the dollars put at risk, and must satisfy themselves that lost flexibility has not created potentially hidden opportunity costs.

Follow the Fortunes

Looking over past correspondence, I was surprised to see that we had not specifically addressed one of the most fundamental (yet misunderstood) concepts in reinsurance - follow the fortunes. This important principle of reinsurance has been a silent cannon underlying our many discussions over the years, and it is a worthy topic for this, my final letter in our series of dialogues.

Historically, follow the fortunes has been linked to the errors and omissions clause. Cessions of proportional reinsurance must follow the terms, rates, conditions, interpretations, modifications, cancellations and all other aspects of the original policies and binders. However, mistakes can happen, so the contract wording guarantees that the cedant "shall not be prejudiced in any way by any involuntary omission, delay or error..."

Thus, if an underwriter forgets to record the treaty cession on a particular risk, the oversight can be corrected retroactively, even after a loss. (Indeed, the loss is often what brings the ceding error to

the attention of underwriters.) Assuming the cedant can demonstrate a pattern of ceding similar risks to the treaty in a like manner, the reinsurer will accept an appropriate share of both the premium and the loss.

But the principle of following the fortunes goes further than that. The clause recognises the imprecise nature of underwriting, the vagaries of claims settlement, and the myriad opportunities for someone to question or "second guess" the actions and decisions of the insurer. Within reason, the reinsurer will not question the cedant's actions and decisions, it being implicit in the pro rata agreement that the reinsurer will follow the fortunes of the ceding company.

It is not even necessary to include the words "follow the fortunes" within the contract. By long tradition and market practice, following the fortunes is an intrinsic, often unspoken principle of pro rata reinsurance. Unfortunately, it is by including the words without forethought that confusion or misunderstanding may arise.

Some years ago, a U.S. court deemed that the words "follow the fortunes" created a partnership between the insolvent ceding company and its reinsurers. As a result of this unexpected interpretation, reinsurers quickly developed an expanded clause. In Canada, most proportional treaties include words to the effect that "... the reinsurer shall follow the technical insurance fortunes of the Cedant in respect of all policies falling within the scope of this Agreement ..."

In another U.S. case, insurers defending Dalkon Shield liability claims insisted that the principle required facultative reinsurers to pay legal costs in excess of their contracted limits of liability. In that case, the court disagreed, determining instead that "...the 'follow the fortunes' provision is expressly subject to the other conditions in the [contract of reinsurance]." Regardless of the court decision, the follow the fortunes clause in many of today's pro rata agreements is supported by words such as "...cessions to the reinsurer under this Agreement shall in no circumstances exceed the limits mentioned in this Agreement."

Even with carefully drafted clauses, confusion persists. One common mistake is the belief that follow the fortunes extends to risks inadvertently insured. This is not the case. As we have just seen, the clause does not expand the terms or the subject matter of the agreement. There may well be a clause in the treaty to address risks inadvertently insured, but follow the fortunes is neither a substitute for nor an expansion of that clause.

There is also confusion regarding the *degree* to which the clause supports the activities of the ceding company. The reinsurer is not obliged to follow the cedant whose activities deviate wildly from business practice and common sense. Moreover, although the clause commits the reinsurer to follow the cedant's *underwriting* fortunes, this commitment does not extend to the cedant's *commercial* fortunes.

The clause does not commit the reinsurer to stand behind grossly irresponsible conduct, fraud, criminal acts, or management practices that lead to commercial (as opposed to underwriting) losses. If the claims manager runs off with funds directed to a particular reinsured claim, the theft is not shared. If the cedant's failure to exercise normal auditing control leads to the loss of broker-held funds, the reinsurer does not absorb a share of the collection loss.

Moreover, if the insurer decides to disregard policy coverage when settling a claim (ex gratia payments) or to underwrite or price business contrary to treaty warranties, then the follow the fortunes clause will not substitute for an ex gratia payment clause, nor will it override treaty warranties.

Further confusion regarding the principle of following the fortunes relates to its omission from non-proportional treaties. As you know, the phrase cannot be included in an excess of loss treaty wording (although I have seen people try). Quite simply, the non-proportional treaty is not a sharing of the policy experience, but rather a qualified transfer of financial responsibilities from the insurer to the reinsurer for a fee. Introducing the words could even impose unexpected duties on the insurer.

Having said that, my greatest concern regarding the misinterpretation of the follow the fortunes principle relates to excess of loss treaties. Recently, I have seen insurers invoke a sweeping interpretation of the clause as proof of the excess reinsurer's duty to pay claims. A timely example is drawn from the Quebec ice storm of early 1998. A number of insurers, and even one or two reinsurers, identified losses to be included in or excluded from catastrophe treaties on the basis of following the cedant's fortunes.

This is incorrect for the reasons described above. If a principle must be invoked in order to resolve ice storm losses, I suggest utmost good faith as it relates to the intent of the agreement. Of course, insurers should be aware that unlike follow the fortunes, utmost good faith cuts both ways, imposing as it does a duty on *both* parties to follow the intent of the treaty.

Again using the Quebec ice storm as an example, one or two insurers concluded that catastrophe reinsurers should pay all the automobile collision claims and all the burglary claims that occurred during the ice storm. This position ignored the fact that these were all separate events, and disregarded the fact that auto collision and related premiums were not even included in the treaty cover. Having suffered a loss well beyond their catastrophe treaty retention, they argued, reinsurers could be expected to follow the *entire* misfortune. (In the end, these insurers relented when they saw that the number of auto collisions actually dropped during the ice storm.)

On the other hand, reinsurers invariably receive reports of claims settlement abuse following catastrophic events. Such reports create a concern that claims settlement excesses may be based in part on the opportunity to win market share at the reinsurer's expense.

Ideally, our reinsurance dialogue on principles such as follow the fortunes and the many treaty clauses we have discussed over the last few years will add to a general understanding of a complex and dynamic discipline. I will end our discussions on contract wordings, meaning and intent with my favourite Tom Peters quotation:

"You won't reduce the paperwork in a lasting fashion until you remove the underlying cause for it - mistrust and adversarial relations."

Yours truly,
David Wilmot