

REINSURANCE DIALOGUE

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between Christopher J. Robey
and David E. Wilmot

June 6, 1998

Dear Mr. Robey:

Predictability of Catastrophes

Your letter of November 20th, 1997 asks what reinsurers would do if they could predict catastrophic events over relatively short periods of time - such as just prior to a treaty renewal. Would reinsurers abandon clients in their hour of greatest need? I think not. Your letter suggested that reinsurers are investing time and resources in efforts to "predict catastrophes before they happen," but I must emphasize that this is not the case. While reinsurers are indeed investing in catastrophic research, they do so not to predict the time and place of the next event, but rather to better understand the frequency, size and geographic nature of events over relatively short (10 to 20 years) periods of time. Their efforts, like those of primary insurers, are intended to better anticipate losses and price the product they sell. Faced with infrequent but volatile events, reinsurers struggle to understand the broader context in which past losses reveal some pattern of future probability. If reinsurers follow the debate on global warming and or try to make sense of Atlantic storms in relation to El Niño and rainfall in North Africa, it is because they believe they can better understand past loss experience and more confidently guess at future pay-back periods.

I do not think reinsurers intend to leave clients in the lurch by dodging an earthquake any more than I think they could decline to

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renew based on the Farmers' Almanac. Quite the reverse, one can find examples of reinsurers maintaining support in the face of exposure to imminent loss. A recent Canadian example is the successful placement of additional catastrophe reinsurance for a cedant exposed to Manitoba flood losses just days before the Red River peaked in Winnipeg.

Another example occurred earlier this year. Following the January ice storm losses, reinsurers competitively priced reinstatement covers for Quebec insurers in the full knowledge that El Niño had not yet dissipated and that the quickly patched-together Quebec Hydro system would remain fragile for many months to come.

We can find other instructive examples of reinsurance support in the face of adversity by looking beyond the catastrophe market. The reinsurance of Surety on an excess of loss basis demands and normally receives renewal-to-renewal treaty support despite known contractor difficulties. The cedant and reinsurer may be aware of a particular contractor's imminent failure prior to treaty renewal, and yet, long-term surety reinsurers are unlikely to walk away from the treaty.

Of course, common sense must also prevail. A new surety reinsurer will not see this as the ideal time to start a treaty relationship, particularly if there are poor prospects for a long-term relationship.

Expanding on this point, one must draw a line between "strongly possible" (as were the above examples) and "certain". Reinsurers have responsibilities in maintaining a treaty partnership even though the level of risk may fluctuate from year to year. However, this partnership dissolves when the client decides to throw himself in front of a bus. Your example of volcanic activity on the island of Montserrat is instructive. As you noted, insurers (and presumably, their reinsurers) continued to provide property insurance as the threat of devastation grew. Only when it was clear that a large part of the island was lost to inevitable destruction did insurers withdraw.

An interesting hybrid of the fortuitous and the certain is created by Y2K (the so-called Millennium Bug). At the very least, the underwriting exposure created by Y2K could test the relationship between insurers and reinsurers faded with imminent and potentially severe losses. The Reinsurance Research Council has indicated that the many Y2K losses occurring on and about the 1st of January 2000 cannot be aggregated under an all class or a catastrophe excess treaty. (There is almost a certainty of multiple losses.)

At the same time, reinsurers around the world have indicated that they would follow the fortunes of cedants with regard to statutory or named peril losses (such as fire or explosion) unpredictably caused by or contributed to by a Y2K mishap.

However, it is another matter if the insurer decides to deliberately accept exposure to Y2K business interruption or to legal action against policy holders who have failed to prepare for Y2K. Losses that occur despite every effort to correct computers, audit suppliers and prepare contingency plans may be considered fortuitous, but it would be irresponsible for an insurer to issue insurance as the substitute for an insured's corrective efforts. It would be equally irresponsible for a reinsurer to partner with an insurer who has not excluded or carefully underwritten against commercial Y2K exposures.

Your concern regarding withdrawal of cover was recently voiced in the U.K. by someone addressing ABI's stand on Y2K. The individual likened the Association of British Insurers and their Y2K exclusion to an umbrella salesman who takes back all his umbrellas just before the rainstorm. Of course, this unfortunate allusion is sophistry. Insurers are not in the retail trade. Rather, they are in the business of spreading the losses of the few among the many. If customers need buy only when they know they are about to have a claim, then a number of us will indeed find ourselves selling umbrellas on street corners.

Insurers and reinsurers are unlikely to learn how to predict catastrophic losses, although they will no doubt continue to increase their ability to anticipate such events. Increased knowledge and experience will influence rates and coverage over periods of time, while market forces will continue to influence pricing and terms from year to year. I doubt that reinsurers will ever find a way, scientifically or commercially, to jump on and off catastrophe treaties.

New Catastrophe Lessons

Hard on the heels of the January 1998 Ice storm, and following your lead on the predictability of future catastrophes, I would like to take this opportunity to look for some possible lessons arising out of Canada's largest catastrophic event to date.

The insurance industry is to be congratulated on its ability to control the situation, mitigate loss, settle claims expediently, and maintain positive communication with the media and with insureds. These efforts were conducted despite the adversity of operating

from within the affected disaster area while drawing on the efforts of staff who were themselves victims of the ice storm. When normal claims procedures became impossible, many insurers quickly adopted creatively flexible approaches to the handling of large volumes of claims. Most did so in a way that did not open themselves and their reinsurers to excessive claims abuse.

But not all insurers were able to move with the same speed or settle losses with the same degree of control. The company-by-company average freezer loss, for example, would appear to have ranged from \$200 to more than \$700 each. Reinsurers (who themselves responded quickly - often paying out their first treaty layers before being contacted by their clients) observed the settlement activities of their ceding companies with above-normal interest. Perhaps as a result of this, each cedant's relative ability to respond to catastrophic losses with practicality as well as alacrity will be factored into the cost and terms of their future treaties.

Coverage issues were quickly addressed following the ice storm loss. Although a formal RRC statement was not issued until early March, some reinsurers gave helpful indications that they would respect and support their treaty partner's *expedient* settlement of losses, but also signaled that *ex gratia* payments or the reckless disregard for policy coverages would not be welcomed. In spite of the enormous numbers of losses, the demands of brokers, and the sometimes unreasonable expectations of policy-holders, many insurers used intelligent and creative approaches in order to strike the correct balance of control and flexibility.

There is a sometimes-expressed fear, particularly among those reinsurers who have not established close relationships with their clients, that insurers will throw money at catastrophe losses once the retention has been breached - that excess of loss dollars might as well be used to buy future business through generous claim settlements. This did not appear to be the case in the January ice storm as insurers continued to honor the principle of settling losses "as if there were no reinsurance in place".

One of the most interesting aspects of the loss was the unusual (if not unexpected) nature of the event. As a rule, hours clauses do not address ice storms or snow loads. As a result, such losses fall into the deliberately nebulous "not otherwise defined" category. "Freeze" is defined by the hours clause, but it was quickly agreed by insurers and reinsurers alike that the very limited freeze definition would capture only a portion of the damage sustained. 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. Insurers had little difficulty agreeing with this interpretation. Certainly, it meant that they faced only one treaty retention with little or no danger of breaching the limit of catastrophe treaty protection.

But the loss continues to grow, and we cannot ignore how close the Island of Montreal came to losing water pressure. (I'm told that fire fighters were locating bulldozers in the event that they had to fight fires without water.) The ice storm fell mainly in a territory exposed to earthquake, and it was largely for this reason that Canada's largest and most unusual loss happened to be fully reinsured.

I wonder how quickly an event definition would have been agreed had we faced a much larger loss - one that threatened the treaty limits of several insurers. Would the freezing temperatures that finally arrived on the Saturday been considered a separate and distinctly reinsured event? Would insurers have studied Weather Canada reports in an effort to define a 72-hour reinstatable event? This time, we were lucky. But winter storms and province-wide floods can cover longer stretches of time. Earthquakes have after-shocks. Any of these events can threaten the limits of treaty protection and challenge contract wording.

Hours clauses appearing in treaty contracts around the world have undergone many revisions in the recent past - not in small measure due to Canadian events such as the Barry/Leamington tornadoes. Large sums of money hinge on the interpretation of original intent, and so you and I will no doubt see further changes in the future. Notwithstanding this, the recent loss may encourage even greater use of what the Canadian market already considers its standard hours clause - NMA2244.