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Reinsurance Dialogue

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Reinsurance Dialogue

between

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and

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Dear Mr. Wilmot,

Your comments on the definition of "occurrence" in reinsurance contracts made interesting reading and I agree with much that you write.

The "Hours Clause" is amongst the most debated in reinsurance and this debate goes on as much in Canada as anywhere else, although it is rare that much of the clause is actually applied to Canadian losses.

It has always surprised me that so much energy is spent on a clause which, historically, has had almost no application in Canada. However, as you say, the wording must deal with what may be, not what was.

Even so, by necessity, we modify the clause as events show us its weaknesses, so that we are always defining the last occurrence, rarely the next. Indeed, we can take some time to do even that much.

In his book *Reinsurance in Practice,* Robert Kiln refers to a loss in the spring of 1948 which resulted from tornadoes in the American Midwest and ended up with the blowing down of an

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electric transmission line in Rimouski, Quebec, setting off a major conflagration.

The question arose as to whether the tornadoes and the Rimouski fire were the same occurrence, and the wording referred to all losses from the same "atmospheric disturbance." Meteorologists who were consulted at the time said that they did not recognize such a thing as an "atmospheric disturbance."

Nonetheless, nearly forty years later, we still found ourselves debating the definition of "atmospheric disturbance," as you point out in your reference to the May 1986 losses in Ontario.

It has only been since 1986 that the phrase has fallen into disuse and I wonder how many reinsurance contracts in Canada have been renewed with no changes in the wording and therefore still contain that phrase.

In the end, all we are trying to do with these changes to the Hours Clause is re-define proximate cause. In the Insurance Institute of Canada course "Principles and Practice of Insurance," proximate cause is defined as the occurrence that in a series of incidents leads naturally and directly in the ordinary course of events to the loss.

While the need for limitations in time and geographical scope seem well founded, it is otherwise tempting to go back to this definition and then sort out the circumstances of each case as it arises. This, coupled with some form of judicial noting of arbitration awards to establish precedents, would be simpler and certainly no more confusing than what we presently have.

Per Risk Excess of Loss

You refer several times to the lack of trust which exists today between ceding companies and reinsurers and there is no denying that the atmosphere in the reinsurance market today is very different from that which existed between the wars and immediately after the Second World War.

Both the number of players and the number of dollars involved have increased so dramatically that the good old days will never come back, even if they did once exist.

It is this which causes me to question the wisdom of including Hours Clauses in property per risk treaties.

As you say, this produces greater protection for the ceding company. However when reinsurers first began requesting Hours Clauses in per risk treaties, there was no indication that this was their intention — rather, most were under the impression that they were restricting coverage.

I suspect that many of the reinsurers which requested inclusion of the clause would have been surprised to find themselves paying twice the occurrence limit from a single storm and this lack of understanding of the effect of including the Hours Clause is just as likely to give rise to a dispute as an imperfection in the wording itself.

Reinstatement Premium

I fully agree with you that the amount of a reinstatement premium should form part of the negotiations for the treaty and is an important pricing item for both parties. The variety of reinstatement premium calculations and the way they fluctuate as the market hardens and softens make it clear that this is the case.

The timing of payment of the reinstatement premium is a more difficult matter and one where theory, practice and equity may clash.

I agree with you that, in theory, the reinstatement premium is due when the reinstatement takes place, which is at the time of the occurrence.

However, as we have already agreed, the amount of reinstatement premium is a subject for negotiation and the timing of its payment can also be negotiated.

Most wordings are silent on the actual time the reinstatement premium must be paid, however they reduce, and therefore reinstate, the limit of liability by the amount of the ultimate net loss payable by the reinsurer. This suggests that the aggregate limit of the contract, and thus the need to reinstate, is not affected by outstanding losses but only by paid losses, since an outstanding loss is not "payable" by the reinsurer. The practice of deducting the reinstatement premium from loss payments therefore seems to be the best way of proceeding.

On the other hand, since reinstatement coverage is then provided backdated to the date of the occurrence, it would seem equitable for the ceding company to pay interest on the reinstatement premium from the date of occurrence to the date of payment.

It seems unlikely however that such a provision would find favour, even in a hard market.

Layers of Catastrophe Coverage

One question which you did not address is the application of Hours Clauses to different layers of a catastrophe reinsurance programme.

It is my impression that reinsurers expect the occurrence definition to be applied in an identical fashion to each layer of catastrophe protection, however there is nothing in the wording to require this to be done and I know of at least one case in Europe where it was applied differently.

Since recoveries from higher layers of a programme are deducted from the loss before calculating the recovery from the underlying layers, the use of different definitions should not change the total recovery of the ceding company, however it could re-distribute the recovery amongst the layers.

Casualty Definition of Occurrence

It is interesting that in insurance the definition of occurrence is a casualty problem, while in reinsurance it is a property one. Apart from asbestos and similar claims which you cite, the casualty reinsurance definition is rarely disputed; where any disagreement may arise, there are sufficient precedents in insurance to help resolve the question.

In fact, in a recent arbitration decision in the United States concerning pollution liability, it was decided that the insurance application of the occurrence definition carried through to the reinsurance. Given the variety of wordings in existence, it is dangerous to look at such a decision out of context, but it does give an indication of how such questions should be resolved.

As for the inclusion of liability in all classes treaties and the possible accumulation of liability and property losses in the same catastrophe, this seems to me to be improbable, except in a conflagration. Liability losses which can be traced in some way to a windstorm or an earthquake are unlikely to have the same proximate cause as the property losses from the same event.

It reminds me of a ceding company's contention some years ago that all traffic accidents in a snowstorm were caused by the snowstorm and were therefore one event. This ignored the fact that a high percentage of the cars being driven in the snowstorm were not in an accident, which suggests that the drivers had some control over what happened to them and made the snowstorm itself an unlikely proximate cause for all the accidents which took place.

If ten drivers go around an icy curve and all come off the road, the ice would seem to be the proximate cause.

If eight of the ten come off the road, two may have been lucky and the ice could still be the proximate cause.

If two of the ten come off the road, while eight successfully navigated the corner, the ice, while certainly a contributing factor, would not seem to be the proximate cause.

Leaving cases such as asbestos to arbitrators or the courts to define the proximate cause is clearly fraught with dangers for the industry as a whole, both ceding companies and reinsurers. However, our experience with defining a property occurrence does not encourage me to think that we will do better in defining a casualty one.

Workers' Compensation is somewhat different, since it is a first party coverage and thus closer to property than to liability. Indeed, a 168 hours "natural hazards" clause is regularly used.

You end up by urging a greater combination of good faith and technical precision, which I applaud. But it would be a mistake to believe that good faith no longer exists; such is the imprecision of our wordings that the existence of good faith is demonstrated regularly.

The Most Favoured Reinsurer Clause

From one of the longest and most debated clauses in reinsurance contracts, I should like to turn to one of the shortest and least debated — the "Most Favoured Reinsurer Clause."

In fact, this is more a market custom than a clause and rarely appears in writing. I have never actually seen it in a contract. It says, in essence, that all reinsurers participating on a reinsurance treaty or facultative placement must do so at identical terms and conditions.

Although the existence of a market custom is normally notoriously difficult to substantiate, there is no doubt that this one is generally subscribed to by reinsurers and reinsurance brokers in Canada. It is less readily accepted by ceding companies, who are less familiar with the reinsurance market and therefore with its customs.

I can only guess at the origins of the custom, however I suspect that, like so many things in reinsurance, it goes back to the Lloyd's market.

Because of the system in Lloyd's, where all underwriters sign the same slip, it is inevitable that they all participate on the same terms, since these are laid out in the slip. This is basic to the leader system under which the Lloyd's market operates.

In Canada, however, the slip system is not used and many features of the Lloyd's leader system are not subscribed to by Canadian reinsurers. Nonetheless, the principle that all reinsurers must participate on the same terms and conditions is one that has survived the Atlantic crossing.

And yet I wonder why it is that reinsurers would insist on this clause, other than that there is safety in numbers.

For example, it is customary for a broker to obtain several quotations on an excess of loss treaty and then recommend to its client a rate at which it believes 100% of the treaty can be placed. This is rarely the lowest or highest rate quoted, but is normally around the lower end of the range where most quotations sit. It is then anticipated that those who quoted a little higher can be persuaded to come down to this "market" rate — there is rarely difficulty in convincing those who were lower to go up.

Nonetheless, there seems to be no reason why a reinsurer which quoted, for example, a rate of 1% should be entitled to a rate of 2% simply because that is what most other reinsurers felt the rate should be. If the reinsurer were willing to write his share of the treaty at 1%, the ceding company should be able to use that participation, along with other independently rated participations, until the full 100% is subscribed.

The reinsurer is doing no more than he said he was willing to do when giving his quotation. Indeed, it is the ceding company and the broker which would have the bulk of the problems from such an approach, because of the heavy administration of a treaty placed at varying rates and, presumably, varying deposit premiums and, quite possibly, varying contractual terms.

The end result would in fact usually be that the ceding company would pay about the same premium as it would have paid under the existing market rate system and would therefore prefer the market rate system because of its ease of administration. Reinsurers, however, would not suffer from any greater administrative burden, and yet they are the ones to insist on the market custom.

The custom also raises a number of questions as to circumstances in which it should or should not apply.

Perhaps the most common concern is brokerage. It is generally accepted that the clause refers to terms and conditions between the ceding company and the reinsurer only, whereas brokerage can differ from reinsurer to reinsurer, since it is a separate agreement between the broker and the reinsurer. However, this is not universally accepted.

Other variations can become more complex.

A ceding company markets a layer of $500,000 excess of $500,000 at a rate of 3%, but can only place 80% at that rate. It then places 20% of a layer of $400,000 excess of $600,000, also at a 3% rate. The layer excess of $600,000 is a different placement and therefore may not technically breach the market custom, but it certainly breaches the intent.

However, if the rate for $400,000 excess of $600,000 is 2.75% rather than 3%, the breach of intent is less clear and it becomes a matter of judgement as to what is the value of the unpriced layer of $100,000 excess of $500,000. It is safe to assume that even the reinsurers participating on $500,000 excess of $500,000 at 3% would not all agree on the worth of the first $100,000 of their coverage.

In similar circumstances, a reinsurer who is not willing to write $500,000 excess of $500,000 at 3% discovers that he can retrocede $250,000 excess of $750,000 at 0.75% and is happy to

retain $250,000 excess of $500,000 at 2.25%, enabling him to write the full layer at the 3% rate offered.

Since this is an arrangement made by the reinsurer, independently of all other parties, the clause is not breached.

But if the retrocession is arranged by the broker placing the main layer of $500,000 excess of $500,000, there would have to be some question as to the application of the market custom.

If the ceding company itself is the retrocessionaire, then a serious question arises. In fact, the end result is no different than if the ceding company had placed a separate coverage for $250,000 excess $500,000 at 2.25%, and the principle would be the same as in the earlier example of a layer of $400,000 excess of $600,000 at 2.75%. It is the "back door" impression left by the retrocession that gives it a sinister look.

We have enough trouble interpreting these types of questions when the clauses are in writing; sorting them out on an unwritten market custom would seem to be an impossible task.

Reinsurers who participated in the example used at a 3% rate without any special arrangements may well feel that other reinsurers have gained an advantage over them. However, the reinsurer at 3% is doing no more than he offered to do and, if any advantage has been obtained by others, it is a result of their superior negotiating or business skills.

That, after all, does no more than reflect the competitive nature of the marketplace.

Yours sincerely,

Christopher J. Robey