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Reinsurance Dialogue

between

Christopher J. Robey*

and

David E. Wilmot**

September 3, 1991

Re: Errors and Omissions, Risks Inadvertently Insured and Incidental Exposures

Dear Mr. Wilmot,

Errors and Omissions

I cannot take issue with anything you have said about the errors and omissions clause in today's reinsurance contracts. Its intent is clearly to provide the ceding company with the coverage it purchased, no less and no more. If the risk was intended to be covered, it is, even though the ceding company may have made an error in the administration of the contract.

The clause you quote is one of the simplest in the reinsurance contract to-day and it would be a pity to complicate it by trying to deal with every actual and imagined abuse to which the clause is subject. Too often we find it necessary to convert a simple clause into a long one to protect against occasional abuse. Once upon a time, or so I am told, reinsurers knew their ceding companies and would not deal with one if there was any likelihood of the misuse of such a clause. Today, we build in pages of protection against abuse in all contracts, regardless of the reinsurer's opinion of the ceding company.

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It hardly seems a reasoned reaction, but the pressures of the marketplace to-day seem to force a reinsurer to protect itself against a ceding company it does not altogether trust through the wording rather than by declining to deal with it. At the same time, ceding companies who would not normally consider taking advantage of a loose contract will feel the weight of shareholder pressure to do whatever is necessary in a poor year to make it better.

I think though that there are two reasons for keeping the clause simple. Firstly, we have had limited success in avoiding such problems by trying to deal with them in advance; every rime we shut one door, we seem to unwittingly open another. Secondly, trusting people usually results in most people being trustworthy; suggesting that we do not trust them gives the wavering the excuse that we were expecting them to push the rules to the limits anyway.

Risks Inadvertently Insured Clause

The same is true of the risks inadvertently insured clause. Its intention is simple. The contract covers a book of business defined in the contract itself. The ceding company is looking for complete protection on that group of policies and the reinsurer wants to make sure that nothing unexpected will throw off their calculations of the risks to which they are exposed. If an otherwise excluded risk finds its way into one of the policies, without the knowledge of the ceding company, it is protected until the ceding company finds out aboutit and has the time to get it out.

There is a simple clause in common use which works well for 99% of ceding companies and reinsurers. Customising it to broaden or narrow its application can certainly be done, but both ceding companies and reinsurers must be cautious of the other trying to go too far. Saying no is still possible, whether the market is hard or soft, and will make life that much easier when the market changes, as it always has. Rigidity is no more desirable than being open to anything and there may be circumstances where a change in the usual clause is justified, but such cases should be rare.

Certainly, the clause should not be used to pull into the contract something it was never intended to cover, nor to protect the ceding company from its own mistakes. But it must protect the policies it was always intended to, even if the nature of the exposures under those policies changes by circumstances outside the ceding company's control, the most obvious being an expansion of the insured's operations or the purchase by the insured of another company.

The standard Insurance Bureau of Canada policies provide automatic coverage in defined circumstances and it is normal that reinsurance contracts provide similar automatic protection. Where the ceding company only issues such standard wordings, the reinsurer is well protected by the usual reinsurance clause. If the ceding company uses its own customised wordings, the reinsurer will presumably want to know what automatic coverage they provide and take this into account in its underwriting decision.

More difficult is the ceding company which writes a lot of its business on brokers' manuscript wordings, since these do not lend themselves to easy analysis in advance. In this case, the reinsurer relies more than ever on the ceding company's underwriters and must base its analysis of the danger of unexpected exposures on its evaluation of their competence.

But again, the simple clause is the best, coupled with the ceding company and the reinsurer knowing each other.

One part of the usual clause which could use some attention, however, is the rime available to the ceding company to remove the excluded exposure from the contract, once it knows about it.

Gone are the days when insurance policies had a standard period for mid-term cancellation. Now, the delays can be quite different from one policy to another and, within the same policy, for all the different parties which need to be advised of the cancellation. Sorne parties with an interest in the protection given by the policy, such as mortgagors, may want their own clauses added to an otherwise standard policy, which could make it virtually non-cancellable. I do not think that reinsurers should "follow the fortunes" of the ceding company which accepts such a clause, inadvertently or not. But the "risks inadvertently insured clause" should give the ceding company enough time to try to make other arrangements for the excluded risk - a special acceptance or a facultative placement for example - and then enough to cancel the policy to all interested parties if that is the only alternative remaining.

With varying cancellation periods in original policies, having a time limit in the reinsurance contract would provide too long a period some of the time and too short other times. A fixed "after discovery" period followed by a period for cancellation equal to that in the original policy, or the longest of the periods, if there is more than one, seems to be best. A maximum can be added to protect against too long original cancellation periods. The ceding company has the option of seeking a special acceptance for a policy it wants to write, when it must give one of the parties a longer than usual cancellation period to do so.

Incidental Exposures Otherwise Excluded

A clause with similarities in concept to the risks inadvertently insured clause is the addition to the exclusion list dealing with incidental exposures otherwise excluded.

The purpose is clear. A reinsurance contract should apply to an original policy covering risks, some of which are protected by the reinsurance and some of which are not, so long as the bulk of the exposure was intended to be protected.

The clause used to refer to a majority of the risks being included and there are no doubt some of those contracts still in force. However, most people to-day would agree that 49% of the exposure being excluded should be enough to exclude the policy completely. *Majority* did however have the advantage of a reasonably definite meaning, something which *incidental* does not.

As with much of the reinsurance contract, the clause is subject to extension of its application, although probably more through sloppy drafting than deliberate intent. I have seen too many contracts which cover war or nuclear perils, if incidental to risks otherwise included.

Presuming however that the contract is well drawn up, the most difficult aspect of the clause is determining when an exposure goes beyond what is incidental.

My dictionary defines *incidental* as "happening or likely to happen in fortuitous or subordinate conjunction with something else," which does not sound much different from *majority* in the way it is applied to an exclusion list, given that the same dictionary defines *subordinate* as "of less importance; secondary."

For the sake of this discussion, and regardless of the dictionary definition, I shall assume that 10% or less is incidental. This is a level often quoted, though probably not to the point of being accepted market practice.

The question is, 10% of what?

Reinsurer' s exposure is not identical to that of the ceding company. While proportional reinsurers will have much the same concerns as the ceding company, excess of loss reinsurers exposure can be substantially different and can vary depending on the level of the deductible.

The original insurer and the proportional reinsurer may be more concerned with the frequency of small claims than the remote potential of a big one. This is not necessarily because the former are for its own account and the latter reinsured, but rather because the former will usually make up the bulk of the money paid out in daims. A low level excess of loss reinsurer with a low limit of liability is also more likely to be concerned with claims frequency than with the one big one, whereas the higher up the layers the reinsurer is, the greater its concern with the one big claim as opposed to a multitude of small ones.

Because of the different nature of the exposure of the parties involved, each is likely to answer the question "10% of what?" differently.

As usual, an extreme example best illustrates the issue.

Suppose an insured has ten warehouses, nine for vegetables and one for explosives.

If measured by the low layer excess of loss reinsurer, the warehouse full of explosives may be incidental, because even if there is a loss, it will produce no larger a loss to the treaty than a warehouse full of vegetables, because of the low limit of liability. However the high layer reinsurer would consider the explosives warehouse to be its major exposure, because it is far more likely to produce a major loss than one of the others.

Various bases can be used to measure the 10%. In the above example, 10% of the warehouses would mean that the policy was covered. But what if the vegetable warehouses were small, while the explosives warehouse was large? It would still be 10% of the total, but more than 10% of the capacity.

In either case, it would be more than 10% of the sales. But what if the explosives warehouse were empty half the year and the vegetable warehouses full every day? It would now be less than 10% of sales and still only 10% of the total. The insurers and low level excess of loss reinsurers would be a lot more comfortable, but the high level excess of loss reinsurer would not be helped much. To him, the explosives are still the major hazard.

Whatever basis is used to measure the 10%, it will not work for everyone, because what each one looks at in measuring an incidental exposure is what is incidental to them and this varies too much from one party to the other.

The only answer is to leave *incidental* undefined. The dictionary definition I quoted above is not too helpful, but the definition in the utilities which corne with my word processor captures better the meaning sought in its application to exclusions - "not part of the essential nature of a thing." The thesaurus with the same word processor is of no help in finding an alternative word, offering *alien, foreign, accidenta!, extraneous, adventitious* and *extrinsic.* However, given our penchant for making wordings unintelligible, *adventitious* has its attractions!

Since reinsurers with different exposures will inevitably have different opinions on what is incidental and what is not, the decision must be taken from the ceding company's point of view. It is, after all, the desire to protect the ceding company which all the reinsurers have in common.

Ideally, the ceding company would discuss doubtful cases with its reinsurers, but the number of reinsurers involved on most programmes does not make this practical. If the "leader" concept were sufficiently accepted in Canadian reinsurance, the ceding company could discuss such cases with the leaders, but this still does not overcome the problem of the leaders on different contracts having different opinions because of their differing exposures.

Ultimately, the ceding company must decide for itself and reinsurers must accept that decision, so long it as not obviously unreasonable. An understanding of the ceding company's underwriting standards and knowledge of its underwriting staff will help the reinsurer to anticipate what the decision is likely to be and can be taken into account in the underwriting of the reinsurance contract. Too many bad decisions could cost the ceding company its reinsurance, or at least make it more expensive, but the ceding company must be protected for reasonable decisions taken in good faith, whether or not the reinsurer agrees with them.

Yours sincerely,

Christopher J. Robey