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Incidental Exposures and the Nature of Excess Payments

David E. Wilmot

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Reinsurance Dialogue

between
Christopher J. Robey*
and
David E. Wilmot**

November 22, 1991

Re: Incidental Exposures and the Nature of Excess Payments

Dear Mr. Robey,

Incidental Exposures

Before I reply to your comments on incidental exposures, perhaps you and I should step back and tip our hats to those who must underwrite today's complex and multidimensional composite industries. Increasingly, property and casualty underwriters must address risks with an incredibly broad range of operations and services — operations which may be incidental, or which may be small but profound in their contribution to risk exposure.

Reinsurers know that it is only the rare commercial or industrial risk which does not include one or more prohibited classes or operations. Home improvement stores sell propane tanks from their shelves. Independent truckers will not turn down the occasional load of scrap metal, and local contractors will not refuse to install a cottager's deck and breakwater. One manufacturer's buzzer is a component in another manufacturer's fire alarm or in an aeroplane manufacturer's ground proximity detector. These and many other examples of excluded risks or operations are made acceptable because they are incidental to the insured's general operations.

However, you are quite correct in noting the dangers of misinterpreting or misusing the Incidental Exposures clause. In a competitive market which is unduly influenced by aggressive yet inexperienced underwriters, we are in danger of taking an overly

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* Mr. Christopher J. Robey is an executive vice president of B E P International Inc., member of the Sodarcan Group.

** Mr. David E. Wilmot is Manager for Canada, Norwich Winterthur Reinsurance Corporation Limited.

relaxed interpretation of the word "incidental." In consequence, what was intended to be a small "opening" in the exclusion list so a landscape contractor could get around the demolition exclusion and tear down a back-yard garage, becomes a "barn door" allowing a communications company to include satellites in its schedule of risks.

Reinsurers support the Incidental Exposures clause because they understand the complexity and diversity of today's risks. However, that same complexity has made it very difficult to define "incidental" in the limited space of a reinsurance contract. The issue, like so many of the discussions you and I have held, comes down to intent, partnership and utmost good faith. And, as you have correctly pointed out, mechanical definitions of "incidental" such as "10%" do not serve us well. In fact, they may do more harm than good.

You noted that 10% is a widely used guideline for "incidental" but that such a guideline begs the question, "10% of what?" Indeed, it can mean 10% of operations or receipts, 10% of locations on a schedule of risks, or 10% of values. I suppose that, if the underwriter wanted to write the risk badly enough, he or she could determine that the excluded material takes up only 10% of plant floor space or that the excluded operation represents less than 10% of contract bids (although the successful bid for asbestos removal turns out to be 60% of the contractor's 1992 income.)

You also noted that different reinsurers on different treaties or layers of excess reinsurance may view their exposure to excluded risks in their own way. My own example of this situation would be the contractor who excavates below grade in high-density construction areas. Less than 10% of the contractor's business includes such operations, but when the neighbouring office tower collapses into his hole in the ground, the excess reinsurer will be mightily distressed.

However, I think it is a mistake to differentiate among reinsurers when we discuss the Incidental Exposures clause. If we return to intent and look closer at the above example, we discover that the only reason the contractor bought liability limits to $10 million was *because* of these occasional excavations next to high rise office buildings! The excavations were not incidental. In fact, they were the "raison d'être" of the $10 million liability policy. The

excluded operation was far more than 10% of the underwriting exposure, and that should have been the measure of whether or not the exposure could be called "incidental."

To use your own example of ten scheduled warehouses, nine filled with vegetables and one filled with explosives; the question is not what the excess reinsurer will think, and it is not whether or not the tenth warehouse has a higher value than 10%. The correct question is this; "Can you call 17 tons of dynamite an incidental part of a vegetable operation?"

We must drop the 10% concept and ask, "Does an excluded risk or operation represent an incidental part of the underwriting exposure." The lumber mill that transports 60% of its sawn lumber to the United States may not be considered to have more than incidental U.S. sales. The insured whose premiums shoot up after securing a contract to sell 2% of its gauges to a major airbus manufacturer may be far in excess of any sensible definition of incidental.

Unfortunately, not all wordings on the market support the idea that underwriting exposure is the best measure of incidental. A relatively new wording in the Canadian market accepts otherwise excluded risks which "..form a detached and accessory part of the general operations of the insured.." This misleads the reader to believe that it is some "separation" from insurable operations and not the *quality* of the underwiting exposure that determines whether or not the excluded risk is incidental.

Some wordings are totally unacceptable. In one contract, liability arising out of the manufacture of fireworks, nitroglycerine and similar hazardous products is excluded only when "such risks are carried on by the insured as a principal operation." Of course, it is the reinsurers' fault for accepting such a clause, but it is the insurer who must face, and then ultimately pay back to reinsurers, a loss that its underwriters should never have been encouraged to accept.

Also, it must be remembered that the exclusions themselves already allow considerable underwriting latitude *before* adding the Incidental Exposures clause. Using a generous marine exclusion as an example, we may find that the treaty exclusion does not apply to yachts, small pleasure craft, sports fishing vessels,

inland waterways and sea going vessels under 200 tons. It would appear that only the Queen Elizabeth II is unreinsurable.

In the end, the exclusion list attempts to keep unacceptable risks out of the reinsurance agreement. What makes such risks unacceptable may well be a need for a higher level of underwiting or engineering expertise on a demanding or hazardous piece of business. If the insurer and its underwriters determine that they have that expertise, then they should be able to secure agreement from reinsurers to remove the exclusion. If the insurer has not sought to remove an exclusion, but a particular exposure proves to be more than an incidental underwriting consideration, then perhaps this is an indication that the company should not write the risk.

The Nature of Excess of Loss Payments

Excess of loss contracts are not treaties. As a result, reinsurers do not follow the fortunes of the ceding company when they make excess of loss payments.

Treaty reinsurance refers to those participating contracts of quota share or surplus shared liability in which the reinsurer proportionally follows the fortunes of the reinsured in respect to the policies coming within the scope of the treaty. Quite simply, treaty reinsurance entails the proportional sharing of the original *liabilities* assumed by the insurer. Excess reinsurance, on the other hand, indemnifies the reinsured against the *contingency* of a large loss. While the principles of utmost good faith and honourable intent remain, the excess of loss reinsurer does not follow the fortunes of the reinsured. The consideration for excess protection may be tied to the dollars collected by the reinsured from its policy holders, but the reinsurance agreement is nevertheless a separate contract independent of the assumed liabilities of the reinsured.

If some of the less experienced reinsurers in the Canadian market are unable to grasp this distinction, then those insurers who find the concept subtle may certainly be forgiven.

Misunderstanding manifests itself in a number of ways, but I will restrict this discussion to three problem areas: the distinction between losses paid and losses payable, ex gratia payments, and commercial risk versus insured risk.

Losses Payable

The core of excess of loss payments is the Ultimate Net Loss Clause. Generally, such clauses begin with the words "The term 'ultimate net loss' shall mean the sum actually paid by the Company in respect of any loss occurrence.." Occasionally, the wording will instead say "The term 'ultimate net loss' shall mean the actual loss paid by the Company or for which the Company becomes liable to pay..." This latter wording may have been introduced in order to facilitate the rapid payment of large losses to the reinsured in order to avoid investment loss. Unfortunately, the wording creates a larger problem than the one it attempts to solve.

It must be understood that the excess reinsurer's liability arises out of the reinsured's payment of a large loss and not out of the policy or the circumstances which led to that payment. For example, the excess reinsurer's liability is not the result of Mr. Fernwick's automobile policy, his careless driving, or Mrs. Hollet's subsequent injuries. The excess reinsurer's liability is the result of the insurance company's settlement of Mrs. Hollet's injuries for a large dollar amount.

It is not merely incorrect to use phrases such as "losses payable." Such wordings may be interpreted by a court as having shifted the excess of loss agreement from one of indemnity for loss to one of indemnity against liability This has happened in the United States, and in such circumstances, the reinsurer may be required to participate with and follow the fortunes of the insurer in regard to a particular loss. Some reinsurers fear they could thus be implicated in a third party action.

Also, reinsurers do not want to act like bankers giving overdrafts. While reinsurers may be sympathetic to the cash flow requirements of their client insurance companies, it is not their intention to fund insurers over extended periods of time. A strict reading of this contractual obligation to advance "losses payable" would actually mean "pay as soon as the loss is incurred." Reinsurers could be required to pay for outstanding losses — including IBNRs — thus funding the insurer who in turn would earn additional interest during delays in settlement.

Words such as "losses payable" or "become liable to pay" should be avoided. If an insurer has reason to believe payments will

not be prompt, reinsurers could instead agree to reimbursement of loss once settlement has been quantified and agreed, or where a proof of loss has been accepted, or once a release has been obtained by the insurer.

Ex Gratia Payments

Another example of the failure to understand the payment responsibilities of the excess of loss reinsurer is seen in misguided efforts to include ex gratia payments in the definition of ultimate net loss. Pro rata reinsurers may or may not care to include ex gratia payments in their proportional contracts, but at least their losses are shared proportionally with the insurer and are supported by an equal proportion of the insurer's premiums. The excess of loss reinsurer does not share in the original premiums and an ex gratia payment is not proportioned between the insurer and the reinsurer. Invariably, such a payment would be borne entirely by the excess reinsurer. Any benefits that result from an ex gratia payment, such as placating an important producing broker, would not inure to the excess reinsurer's benefit. More importantly, agreement to ex gratia payments is a blank cheque, given without recourse to discussion or agreement. As such, ex gratia payments do not belong in an excess agreement. If there is a valid reason for making such a payment, then there must be mutual agreement (and, perhaps, a proportioning of the amount) between the insurer and the reinsurer.

Commercial Risk

The third and most troubling example of the misunderstanding regarding excess reinsurance payments is found in an apparent failure to distinguish between insurance risk and commercial risk. "Insurance risk" refers to the exposure to loss arising out of the original insurance coverages as defined within the excess agreement. "Commercial risk" refers to financial and operating risks which arise out of "being in business" and do not relate to the contractual liabilities assumed by the insurer. Commercial risks may include the failure to collect premiums from a broker, fictitious losses created through employee fraud, pressure from the government to roll back profits from a previous year, or punitive damages against the insurance company for wrong doing in the settlement of a loss.

Such losses cannot be transferred to a reinsurer whose excess of loss agreement is intended to cover losses arising solely out of insurance risks. Excess reinsurance was not extended to include economic loss, the criminal actions of employees, or political risk insurance. Coverage in the form of specific insurance may or may not be available elsewhere, but such losses are not addressed in the excess contract, nor has a premium been charged. For this reason, one must be careful to distinguish between loss attributable to the policies of insurance and loss attributable to commercial risk. An example may be helpful:

Consider the political ramifications of an earthquake hitting the greater Vancouver area. Catastrophe reinsurers will have collected a small percentage of excess premiums based on risk exposure, aggregated liabilities, original policy coverages and other rating factors. When the damage is tabulated, insurers will pass substantial amounts of insured loss to these catastrophe reinsurers. However, a newly elected, socially conscious, yet financially impaired provincial government is "appalled" that many homeowners can not recover fully from their insurance companies. The premier tells the press,"Insurers have been negligent in assessing insurance to full value on most homes and they have been derelict in their duty to promote the purchase of earthquake insurance!" It becomes clear that, if insurers want to continue doing business in the province, they will have to pay to value and read in earthquake cover retroactively.

Would insurers attempt to pass this burden to reinsurers? The additional loss of hundreds of millions of dollars would be borne entirely by excess of loss reinsurers with no rationale other than preservation of the commercial status of insurers who themselves would contribute nothing of the increase. Such a legislated change is not reinsurable. Though related in an abstract way to the original property business, this example illustrates a *commercial* loss. The excess reinsurer will not — *can* not — contribute to this political risk because it does not participate in the underwiting activities of the insurer, it does not share in the premiums and results, and it does not follow the fortunes of the reinsured.

Due to recent events, I must give another, more immediate example of the fundamental misunderstanding that persists:

Much talk relating to the Ontario Motorist Protection Plan has centred around the possibility of accident benefit increases and the further possibility that these increases will be applied retroactively. (That is, they will be applied to the ongoing benefits of existing OMPP accident victims as well as to future accident victims.) There is no basis in law for mandated retroactive increases, and, in fact, case law indicates such increases are not possible. Nevertheless, the speculation reveals a problem. If, in seven or eight years time, the government imposed or, more likely insinuated, a retroactive increase on all continuing loss payments, the burden of such an increase should not be passed to excess of loss reinsurers. The reasons are much the same as those of the first example. After seven years, the impact of retroactive increases would fall almost entirely on the excess reinsurers. The burden of these increases could be considerable, and yet there would be little or no sharing of the responsibility between the insurer and the reinsurer — the reinsurer would shoulder the losses without having collected a premium for the risk and with little recourse to future premiums.

Should a retroactive increase in accident benefits be put forward, it will not likely be legislated and mandatory but rather "recommended" and imposed by coercion. The imposed increase would likely be adopted by insurers as a "forward-thinking commercial decision" related to the four or five billion dollars of Ontario automobile premiums they wish to continue writing. And yet, excess of loss reinsurers, some no longer even participating, would be asked to pay this enormous additional loss out of excess premiums which were no more than a fraction of a percentage of the original premiums. Those reinsurers who do not follow the fortunes of the insurer in respect to premiums and original liabilities can not be asked to follow the fortunes in respect to political risk.

Insurers and reinsurers must recognize the limited role of excess reinsurance and they must appreciate that, for a small percentage of original premiums, the excess reinsurer does not follow the insurers' fortunes, fund losses, accept or share in original liability, issue blank cheques for ex gratia payments or assume the insurers' commercial risks.

Yours sincerely,

David E. Wilmot