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The Reinsurer's Role In The Market

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Reinsurance Dialogue

between

Christopher J. Robey

and

David E. Wilmot*

August 20, 1992

Re: The Reinsurer's Role In The Market

Dear Mr. Robey

Our continuing correspondence has addressed a number of reinsurance topics from the specific and detailed to the broadly theoretical. However, in raising the issue of the "reinsurer's role in the market," you have cut to the very heart of our reinsurance discussions. And, as it happens, we are not entirely in agreement as to what that role may be.

In your letter of June 8, 1992, you described the reinsurer's role as furthering the spread of insurance risk. You argued that the reinsurer, who is merely an extension of the insurer, is "in the same business as the insurer," and cannot "wash its hands of its responsibility to insureds." From this, you concluded that the political risk of imposed policy coverage enhancement (and perhaps even the commercial risk of doing business) must be assumed by reinsurers, or at the very least, shared by reinsurers.

Your definition of the reinsurer's role is correct, albeit somewhat limiting, and so I would like to expand on the topic in the second half of this letter. Of more immediate concern, you have blurred a very important distinction between insurer and reinsurer. The reinsurer does *not* serve insurance clients. The reinsurer's client is the insurer. Just as a software company selling computer systems exclusively to insurance companies is

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"in" the insurance business and derives its income indirectly from the premiums paid by clients to the insurance company, the reinsurer is "in" the insurance business and derives its income from the same source. But this abstract association is in no way a commitment to those insurance clients. To a greater or lesser degree, the reinsurer, like the software company, must distance itself from the original insureds. What does distinguish the reinsurer from the software company is a series of contractual (reinsurance) arrangements specifically drafted to relate the reinsurer's cedant obligations to the cedant's client obligations.

In other words, the reinsurer contracts to indemnify the cedant in a manner that reflects or parallells the cedant's policy obligations to its clients.

Contractual arrangements, such as the Terms and Conditions Clause, the Follow the Fortunes Clause and numerous references to original policies and binders, are drafted to set out the obligations of the reinsurer to the ceding company but *not* the obligations of the reinsurer to any insured. Therefore, in drafting reinsurance agreements, it is important to preserve that distinction between the reinsurer's obligations to the insurer and the insurer's obligations to its clients.

I do appreciate that, unlike the software company, the reinsurer really *is* in the insurance business to the extent that it is regulated by Federal or Provincial Insurance Acts and to the extent that it carries out the business of a particular form of insurance – insurance of insurance companies. However, reinsurance is a contract of strict indemnity between the insurer and the reinsurer (even when the original policy may not be pure indemnity, such as accident benefits under an Ontario automobile policy).

Imposed or Legislated Change

With this subtle but important distinction made, I can now address the two situations you described in which the insurer's policy exposure dramatically changes. The first situation is a legislated change in the policy, such as the introduction of OMPP into existing Ontario automobile policies in mid-1990. The second is an imposed (perhaps "coercively" imposed) redefinition of policy coverage, such as a retroactive increase in the accident benefits of OMPP.

With regard to legislated change, the operative contractual agreement between the reinsurer and the cedant is that of indemnity against losses for which the insurer becomes legally liable to pay. Thus, when enhanced accident benefits were read into all Ontario automobile policies on June 22, 1990, reinsurers assumed responsibility for the suddenly altered values arising out of OMPP. This situation was not unique for excess of loss reinsurers who had previously accepted Ontario third party statutory limits of $50,000 read in as $100,000 and subsequently limits of $100,000 read in as $200,000.

Taking the example a step further, you also cited the interesting case of insurers willingly assuming additional liability under OMPP by automatically offering extended accident benefits. Most insurers had the courtesy to ask for their reinsurer's agreement beforehand, but I must concede that these insurers were no more prevented from offering extended benefits than if they had been unilaterally selling higher-than-minimum statutory limits prior to OMPP. In this example of a modest additional reinsurance exposure, the courtesy of advising reinsurers was all that might have been required. On the other hand, were the cedant to take a unilateral marketing decision that could *dramatically* alter reinsurance exposure, I think reinsurers would have to agree and be given a chance to reprice their product lest they challenge on the principle of utmost good faith.

With regard to "coercive" imposition of additional losses, such as the reading in of earthquake cover on all homeowners policies *after* a catastrophic loss (or reading out the riot and civil commotion exclusion after a lesser occurrence), the reinsurer does not have an automatic contractual obligation. You and I may agree that the reinsurer, like the insurer, is also subject to coercion or commercial considerations or both, but such pressure will not normally arise out of any direct responsibility to original insureds.

I say "normally," because you have introduced a recent development in which some cedants, and perhaps even some reinsurers, feel that certain excess of loss contracts have committed reinsurers to a potential, specific, imposed liability – a retroactive increase in OMPP accident benefits. Ignoring the issue of why such an imposed increase could or could not take place, I would like to address this apparent "pre-agreement" to assumed liability in more detail.

Retroactive Accident Benefits

By and large, automobile insurance is reinsured by means of excess of loss treaties. Such reinsurance is purchased in order to protect operating results from "shock" losses or from an unanticipated frequency of large losses. (Quota share automobile reinsurance is also purchased from time to time, but the stated purpose of such cover is surplus relief).

A "shock" loss may be defined as one exceeding the values normally anticipated. An example under OMPP would be the total of income replacement, medical and long-term care benefits payable to several insured people injured in a vehicle. By comparison, a single claimant loss estimated to cost $1,600,000 in accident benefits may not be considered a shock loss because we know that this magnitude of claim will occur with measurable frequency. This claim would be an example of a "large" loss.

You asked how the extra cost of an imposed additional loss would be spread between the segments of market, and you further questioned how a subsequent premium surcharge would be distributed between insurer and reinsurer. These questions may have been rhetorical, but I feel that answers will help us to better understand the reinsurer's market role.

The role of the excess of loss reinsurer is to spread expected large losses and potential shock losses among all the insurers in the marketplace. It is important to note that the reinsurer's role is not to *assume* these large and shock losses – only to redistribute them. And yet, consider what may happen if OMPP accident benefits are retroactively increased.

Should current OMPP benefits be increased four or five years into the future, only the most serious losses of 1990, 1991 and 1992 will still be open and subject to revision. It is likely that most of these claims will involve excess reinsurers. The increase in benefits could be substantial – quite possibly reflecting the indexed and unlimited benefits proposed by the New Democratic Party's Bill 164. What had previously been small losses would become large losses. Large losses would become "shock" losses, and shock losses would climb to unimagined heights.

The increased number and size of losses above cedant retentions could be devastating. At the same time, the increase to net retentions might be negligible. Distribution of this increase, affecting hundreds if not thousands of claims over several years, would be problematic. Strictly speaking, the ultimate net loss clause dictates that any increase in losses will fall entirely on excess of loss reinsurers. Any other basis of distribution, such as sharing the additional loss in proportion to the reinsurer's share of the original loss, would be entirely arbitrary and (in the absence of any agreement to the contrary) subject to charitable good faith on the part of the ceding company.

To help answer the question of loss distribution, consider how compensating premium, if any, would be distributed. Such additional premium would be collected by the insurers from their clients. In theory, the premium would be shared at the discretion of insurers with those reinsurers who had not gone bankrupt, had not pulled out of automobile or pulled out of Canada altogether, and had not, for any one of a dozen other reasons, discontinued their five or six year old shares of the original excess of loss agreements. In other words, compensating premium would not be distributed at all. Far from facilitating the *spread* of large losses, reinsurers would have assumed the loss with no likely means of recovery.

I hasten to point out that this dismal scenario is based on a "worst case" interpretation of an insurer/reinsurer relationship. I would like to think that Canada does not host insurance executives who would attempt to impose such a one-sided and short-sighted interpretation of the reinsurer's role. However, I must concede that a number of reinsurers have not thought through the contractual obligations they so cheerfully endorse.

Role of the Reinsurer

Moving from relatively narrow examples of spreading (or failing to spread) risk to a more encompassing definition of the reinsurer's role in the market, I would like to consider the "text book" as well as the practical aspects of that role.

At a basic text book level, and as every student of the industry learns, the role of reinsurance is the four-fold contribution to financial capacity, underwriting capacity, capital or shock loss protection and, yes, spread of risk. You and I have discussed at length the contractual mechanics designed to achieve these goals, and I will not expend any more time on them here.

At the "practical" level, we see the basic description of the reinsurer's role clouded by competition, economic and political forces, the business acumen of those buying reinsurance and of those selling it, and a flux of other commercial conditions. At this level, we discover new reinsurance "roles" – a quota share treaty moving funds from one tax environment to another, a surplus treaty purchased in order to provide free catastrophe protection, a facultative risk ceded for no other reason than to obtain a second underwriter's opinion, a low-level excess treaty renewed because the rate is so cheap. At this level, the role of individual reinsurers may be that of mentor or dupe, partner or accomplice, sounding board or scapegoat. Such roles do not bear close examination, but collectively, reinsurers serve a number of non-traditional functions which do justify comment. Three "collective" roles of particular relevance to the current marketplace are shock loss expertise, support for market-wide pricing and validation of primary underwriting practices.

Large Loss Expertise

As supposed experts on large losses, reinsurers should be in a position to help insurers identify and price such exposures. At its simplest, this means charging the right reinsurance price for catastrophe exposure and helping cedants to understand the rationale behind such pricing. While this may appear to be self-serving, it is a part of the reinsurance function of banking sufficient premium to properly spread risk.

Canadian reinsurers appear to have failed the market in this role. Like insurers who under-price their product and then shock clients with a dramatic price increase, reinsurers have failed to help their cedants identify the premiums which must be collected against inevitable catastrophes. Canadian insureds have received the benefits of cheap catastrophe reinsurance for a number of years. Average rates on line are notoriously low by world-wide standards, despite Canada's exposure to earthquake and hurricane. Unfortunately, Canadian insurers have not reaped the benefit of this cheap reinsurance – their insureds have. In the meantime, world-wide reinsurance losses have spiralled out of control, retrocessional markets have collapsed, and the modest "bank" built up by a number of Canadian insurers has disappeared, along with their bankrupt, merged or defunct reinsurers. Consequently, insurers are now experiencing sharp price increases and capacity restrictions when they can least afford it. It is small consolation that Canadian insurers did not experience the three and four hundred per cent catastrophe rate increases of the Japanese market or this year's Caribbean prices which, in many cases, actually exceed gross premium income! Nevertheless, insurers must now adjust to catastrophe rates for which they have not collected original premiums, and they must face increased exposures (due to reassessment of PMLs, the loss of pro-rata protection, or both) for which the reinsurance market may not provide sufficient capacity.

Market-Wide Pricing

The reinsurance community is not a rate review board for the Canadian property and casualty industry. And yet, reinsurers play a role in promoting adequate and stable original rates. Reinsurance acceptance or rejection of original rates takes place daily in the facultative departments of reinsurance companies. Excess reinsurance allows reinsurers to apply a sufficient rate even if original premiums are inadequate. Pro-rata treaty conditions such as scale commissions and "loss corridor" clauses ensure that cedants are *buying* capacity and not merely subsidising poorly rated business.

However, if support of price stability is one of the roles of reinsurance, then Canadian reinsurers have again failed their clients. Due to fierce competition, reinsurers have probably exacerbated the radical swings in the Canadian underwriting profit/loss cycle. This was certainly the case during the liability crisis of the mid 1980s. Now, in the depths of a commercial property price slump, more than one insurer has asked if reinsurers can force a turnaround in the market. I have no doubt that, if reinsurers were to enforce original rate increases, they would be cursed for doing so throughout the following period of prosperity. Nevertheless, reinsurers must address their function as a stabilising force instead of serving as an underwriting sink which prolongs down cycles and a pricing catalyst that exaggerates market "corrections."

Validation of Underwriting

Reinsurers can play a role in supporting sound original underwriting and claims handling. Unfortunately, they can also support and foster unsound competition. Loose reinsurance terms, support for badly engineered or underwritten business, and any unquestioning acceptance of sloppy claims handling, will give the wrong companies an extended lease on life. Thus, maverick insurers are able to acquire business on the basis of inadvisedly broad coverage and low price while tapping overall industry premiums via subsidies from reinsurers.

In markets less competitive than Canada, reinsurers have helped to curtail unsound underwriting practices and have even squelched the market entry of known troublemakers. Overly competitive Canadian reinsurers have not served this stabilising function well.

The Value of Reinsurance

Reinsurance is supposed to stabilise results, but a weak reinsurance market simply amplifies the cycles of loss and correction. Reinsurance should spread the impact of large losses, but reinsurance without good faith and long-term commitment operates within such a narrow time frame that "banking" is discouraged and losses must be repaid immediately. Reinsurance is designed to offer capacity support, but indiscriminate support cheapens capacity that should be reserved for solid underwriting.

Cheap and uncritical reinsurance is no better than the naive capacity of the 1970s or early 1980s created by aggressive and inexperienced reinsurers. It's fine to have accommodating and inexpensively priced reinsurance. But perhaps such reinsurance is one of the reasons we seem unable to make any money in this business.