Document généré le 11 fév. 2025 04:29

Assurances

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Volume 60, numéro 4, 1993

URI : https://id.erudit.org/iderudit/1104923ar
DOI : https://doi.org/10.7202/1104923ar

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Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Découvrir la revue

Citer ce document

Robey, C. (1993). Reinsurance Dialogue. *Assurances*, *60*(4), 667–676. https://doi.org/10.7202/1104923ar

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# Reinsurance Dialogue

between
Christopher J. Robey[1]
and
David E. Wilmot

November 27, 1992

**Re:** 1. **The Role of the Reinsurer**
2. **The Costs Clause**

Dear Mr. Wilmot,

It is tempting to comment further on the first part of your last letter, since while I agree with the principles behind what you write, I do not agree with the way you express them. However, we agreed at the outset to that we would take turns in having the last word and I shall honour that.

## The Role of the reinsurer

Your condemnation of the Canadian reinsurance market is harsh, but not unfounded.

I think, though, that you go a little too far both in indicting reinsurers and measuring their influence on the primary market.

You quote the famous four functions of reinsurance, then add the fifth of policeman, a role I do not think should be the responsibility of reinsurers. Certainly reinsurers should look after their own interests, and in doing so, may influence their clients in their activities, but to lay on reinsurers a wider market responsibility is to expect of them more than they can

[1] Mr. Christopher J. Robey, the author of this letter, is an executive vice president of B E P International Inc., member of the Sodarcan Group.

accomplish. Indeed, you have argued in the first part of your letter that the reinsurer can and should stand back from the primary market.

**Large loss expertise**

When I saw this heading, I thought that you were going to write about the expertise which reinsurers can provide on large individual losses. There is no doubt that they see more such losses than most of their clients and can provide valuable advice on how they should be handled.



However I question reinsurers' expertise in catastrophe losses and the pricing of catastrophe exposures at the level of the individual risk.

By next year, there will be three systems available to Canadian insurers for measuring earthquake exposure:

- IRAS, available through Wellington Insurance Company.
- EQEHAZARD, available from the Insurers' Advisory Organization.
- The service offered by the Munich Reinsurance Company of Canada.

As is evident, only one of these is available from the reinsurance community, and it measures only exposures, with some indication of probability. It is therefore most valuable in determining the amount of protection to buy and roughly what it should cost.

The other two are geared more directly to insurers' day-to-day operations and can be used not only to measure the exposure over a portfolio of risks, but also in the rating of individual risks and the control of accumulation at the underwriter level.

This is not to lessen the role played by reinsurers, and the Munich Re in particular, in raising the awareness of the

insurance market as a whole to the dangers of an earthquake and encouraging insurers to take the necessary steps to first measure and then control their accumulations.

However, reinsurers can offer little expertise in the rating of individual risks for this hazard. Their role is limited, as you suggest, to fixing a proper price for the catastrophe exposure they assume, so that their clients can take it into account in their own pricing.



You are quite right in saying that reinsurers have not done this very well. As John Phelan, President of the Munich Re of Canada, said in a recent speech to the Property Casualty Underwriters Club:

> The harsh fact is that Canadian catastrophe reinsurers have had their pool of catastrophe premiums frequently exhausted by windstorm and hail losses, and consequently are not able to create the resources necessary to cover their earthquake exposure. This simply has to stop.

However, it is harsh to criticize Canadian reinsurers when, first, it has been an international problem and, second, the tremendous increase in natural catastrophes since 1987 could not have been anticipated. Even in 1989, after Hugo and the Loma Prieta earthquake, it was not certain that a new era of catastrophe exposure had begun. Now, after the European storms, Typhoon Mireille and Hurricanes Andrew and Iniki, this much higher level of activity has to be looked at as the new norm rather than an aberration.

Where I think reinsurers can be criticized is in the abruptness of their response. We have had talk of the need to come to grips with the earthquake exposure and to start charging adequate rates for several years, and yet reinsurers only really started doing anything about it for the 1992 year. And then it was not a response to their own legitimate concerns but rather forced on them by the collapse of the retrocession market. If cheap

retrocession were still available, despite the results, I think cheap reinsurance would be also.

After several years of crying wolf, reinsurers do not have the credibility to "educate" their clients and only the sledgehammer of current rate increases will get their attention.

**Market-wide pricing**

It is in their acceptance of underpriced primary business that I think reinsurers are most open to criticism. And yet I do not think it is, as you write, through a "role in promoting adequate and stable original rates" that they should take action.



Reinsurers' influence on market-wide rates is minimal. At the end of the nineteen-seventies, the Strathcona was very much the bête noire of commercial property, writing business almost entirely on the backs of its reinsurers. Yet it only had about 1.5% of the market and, left alone, could not have written much more with the capital structure it had, regardless of the reinsurance available.

It was not the Strathcona, or, if you prefer, its reinsurers, which were responsible for the competitiveness of the market at that time, but rather those much larger companies which chased after it, instead of leaving it to gorge itself for a while before suffering indigestion.

Reinsurers' influence on primary pricing is more psychological than practical. It is the size of the adjustment in reinsurance terms now which will get the attention of insurers and perhaps convince them that the time has come to climb out of the competitive spiral.

The impact on the bottom line in most cases is less than insurers have been getting used to in their loss ratios in recent years. But a change in reinsurance commission affects the expense ratio, to which insurers are much more sensitive than to the loss ratio, even when the dollars involved may be less.

The impact on the commercial property class is much greater than on the company as a whole, so the psychological impact may be enough to change things even if the dollar impact is not.

But ultimately, reinsurers must look after themselves, not wait for insurers to do it for them.

The primary rate level is the basis of reinsurers' pricing, but it is only the basis. They control their excess of loss price directly through the rate. But they also control their proportional reinsurance price through the commission they pay and can adjust for inadequate primary prices by reducing this commission. Certainly such a move will not be popular with their clients, nor the brokers which represent them, but it is reinsurers' prerogative. And their protection.



#### Validation of underwriting

This is a continuation of the issue of correct pricing, since underwriting conditions are inextricably linked to it.

The facultative departments of reinsurers have a role to play here even more than in original pricing. And it is a role which the treaty departments can only play with great difficulty, since it involves the detailed terms on which individual risks are accepted and the quality of the information available to underwrite them.

It can happen that facultative departments continue supporting original underwriting which their treaty colleagues are telling their clients they should stop. Given this mixed message, insurers will normally follow the easier path.

In the past, the support for really poor underwriting has usually come from reinsurers which are not resident in Canada, often not even licensed here. Sometimes it was the reinsurer which controlled the business, the insurer being no more than a front. That is less common to-day, partly because of a tightening of the rules and partly because of the shrinkage of

the unlicensed capacity willing to work that way æ the "innocent" capacity as it was somewhat inaccurately called.

It still happens to-day, but to nothing like the same extent.

To-day it is the mainstream companies supported by mainstream reinsurers which are in the thick of it. If the "innocent" capacity has gone, does that make what is left "guilty"?

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### The value of reinsurance

You chose this as your last heading and I shall follow your example for this segment of my letter, though with a somewhat different meaning.

Reinsurance does have a value and reinsurers must be sure to collect a price for their product commensurate with the value they give.

As you write, consistency is important. First, this avoids the sudden dramatic increases in price which are a feature of the market to-day. Second, it gives the reinsurer credibility when talking to clients about what they should be doing.

But above all, I think reinsurers have to recognize their limited influence over the primary market on a day-to-day basis. They must look after their own interests, not expect insurers to do it for them.

### The costs clause

And now for something completely different, back to a specific issue and away from general market topics.

Proportional reinsurance will pick up claims expenses in proportion to the share of the claim reinsured and this rarely causes a problem.

In Canada, most excess of loss treaties include claims expenses and interest in the ultimate net loss before the

deductible and limit are applied. Some treaties however split these costs in proportion to the excess layers' share of the original loss.

The reverse is the case for facultative reinsurance, pro-rata costs being the norm and including costs the exception.

Each approach has its advantages and disadvantages.

The "including costs" approach has the advantage for the ceding company of giving it a finite net retention in dollar terms, but the disadvantage of an undetermined maximum potential liability, since the total of possible costs has be estimated. This makes deciding how much reinsurance to buy difficult, particularly when coupled with the need to allow for more than one policy being involved in an occurrence.



For the reinsurer, the "including costs" approach has the advantage of a finite limit. However, it provides the problem in underwriting of gauging the exposure to a layer from policies which have a limit below its deductible.

"Pro-rata costs" has the opposite effect. The ceding company does not know exactly what its net retention will be, but need only buy protection up to whatever multiple of the maximum original limit it thinks prudent, without having to estimate how much more to buy for expenses.

Reinsurers on the other hand can determine exactly which policies expose their layer, but do not have a fixed limit to their liability.

**Pro-rata costs**

But there is another problem with pro-rata costs which seems to me to demonstrate the inequity of this approach, at least as it is handled to-day. It is the possibility for the reinsurer to avoid participating in any way in expenses which were incurred for the sole purpose of reducing its liability.

It is quite common for disputes on the duty to defend to arise under primary and excess insurance policies, where the

same pro-rata costs clause is used. However, while the issues are the same, their immediacy is different, since in reinsurance the duty to defend always falls to the ceding company, never to the reinsurer.

It seems inequitable that a reinsurer would not be liable for any expenses if, for example, an appeal were successful in bringing a loss to a level below its deductible, but would pick up its share of those same expenses if the appeal were unsuccessful.



It would be more equitable for the reinsurer to pay for the expenses in proportion to the benefit it hopes to derive from their being incurred.

This can be achieved with the present clause by negotiation and it would be wise of an insurer to discuss with its reinsurer the split of expenses before paying substantial amounts for the purpose of reducing the reinsurer's loss. However, if the reinsurer refuses to participate, which is its right, the ceding company has a dilemma.

The reinsurer would be within its rights to invoke the principle that the ceding company must act as if unreinsured, and must therefore incur all reasonable expenses necessary to minimize the loss, even if it incurs no benefit itself from the expenses it must pay.

This could work, even if inequitable, if the circumstances were always clear-cut.

However in many cases there will be an insured, or more likely a third party, who is as convinced that the higher level of claim is justified as the ceding company or reinsurer is that it should be reduced. It is then a matter of judgment as to what expenses are reasonable.

But a reinsurer could challenge the decision of a ceding company not to pursue the reduction of a claim and the outcome of what was essentially a matter of judgment could be at best bad feeling and possibly an uncovered claim.

It would avoid this type of problem if the reinsurer were always responsible for those expenses which are incurred to reduce the reinsurer's potential loss. This could be achieved by dividing the expenses pro-rata to each party's potential liability rather than their actual liability.

The reinsurer would always have the possibility of involving itself in decisions on such expenses through the claims co-operation clause which is in most excess of loss treaties and facultative certificates.



There would be no doubt of the potential liability where the expenses were incurred in an unsuccessful battle, but nor is there in the present system.

It is when the money is spent in a successful battle that the difficulty arises. How should the reinsurer's potential liability be determined? Which expenses cannot be challenged and which are questions of judgment? When the ceding company and the reinsurer agree, there is no problem. It is when they disagree that some guidelines are needed. And without some guidelines established when there are no real dollars involved, they could disagree often.

The largest reserve carried by the ceding company during the life of the claim could be used as the measure. This would reverse the usual relationship in looking at reserves, since the ceding company tends to want to set it no higher than necessary to protect its reinsurance results, while the reinsurer wants it as high as possible to ensure no future surprises.

This balance would normally be enough to prevent the ceding company from carrying an unrealistically high reserve just to obtain a higher reimbursement of expenses. If the reinsurer chose to challenge a reserve level and the two could not agree, then an independent claims expert could act as arbitrator, since the issues would not warrant use of the normal full arbitration procedure.

It is certainly not an ideal approach, but it will not be applied in an ideal world. And the end result would be more

equitable than that produced by the strict application of the clause currently used.

Yours sincerely,

Christopher J. Robey