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Reinsurance Dialogue

David E. Wilmot

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Aller au sommaire du numéro

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Reinsurance Dialogue

between

Christopher J. Robey

and

David E. Wilmot*

February 28th, 1993

Re: The Costs Clause and Casualty Multiple-losses

Dear Mr. Robey,

Your latest correspondence deals with the costs clause, or more accurately, with what you perceive to be inequities in the allocation of costs between a cedant and its excess of loss treaty reinsurer. To address your position, it may be best to look at the clause in context.

The so called "costs clause" of an excess of loss treaty is found within and forms a part of the Ultimate Net Loss clause. Quite simply, losses are deemed to include "all adjustment expenses, expenses of litigation, accrued interest before and after judgment, and all other loss expenses of the Company arising from the settlement of claims other than salaries and office expenses." In other words, costs are just one component in the definition of a large loss.

This can be seen more clearly when excess of loss treaties are compared to excess facultative agreements. You are correct in characterising most excess of loss facultative agreements as providing "pro-rata costs in addition to" the limits of liability, while most excess treaty limits of liability are "costs-inclusive." The reasons for these two conventions are simple. Excess facultative reinsurance must give the cedant capacity to write one finite risk *and* its inherent loss expenses. Excess

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* The author of this letter, Mr. David E. Wilmot, is manager for Canada, Norwich Winterthur Reinsurance Corporation Limited.

treaties, on the other hand, protect the *capital* of the insurer above an agreed dollar amount (retention)—an amount which clearly must include costs and interest.

Excess treaties which offer pro rata protection for costs in addition to the limits of liability are not unheard of. (In such cases, the description of costs is removed from the Ultimate Net Loss clause and a separate pro-rata costs clause is added elsewhere.) However, these treaties are relatively rare—no doubt because any advantages they offer an insurer are outweighed by disadvantages. It is true that, with costs paid proportionally in addition to treaty limits, the cedant does not have to buy extra capacity to protect against costs and interest. But today's casualty treaty programmes require additional layers of excess protection anyway, in order to cover OMPP, Michigan no-fault, multi-policy clash exposures and other contingency exposures. On the other hand, the disadvantage of pro rata costs can not be ignored. An overwhelmingly expensive court battle could go un-reinsured if the pure loss were less than the reinsurer's level of involvement. As a result, insurers' best interests are served by costs which are included within the definition of ultimate net loss.

Insurers' best interests are also served when reinsurers refrain from trading reinsurance dollars unnecessarily. For this reason, I am inclined to reject your suggestion that reinsurers contribute to costs every time the treaty retention is threatened.

One of your main points arose from the suggested unfairness of a cedant incurring extra costs in order to reduce a large (reinsured) claim. "It seems inequitable that a reinsurer would not be liable for any expenses if ... an appeal were successful in bringing a loss to a level below its deductible."

I know you only make statements like this to raise controversy and encourage debate, but there is a danger that the casual reader will infer an adversarial stance on the part of reinsurers. (You imply that reinsurers are prepared to "take" successful settlements on the one hand, while refusing to

"contribute" toward defence costs spent for "their" benefit on the other.) Fortunately, insurers are not likely to miss the point. Reducing an excessive claim or eliminating an invalid loss is entirely in the insurer's best interest. Good claims procedure carries its own rewards: excessive claim demands are held in check, bad law is challenged and reversed, experience is improved, reinsurance premiums are reduced, and the cost of doing business is kept under control.

Most insurers do see reinsurance as a "win-win" proposition—an arrangement serving a high level of mutual interest. They understand that what goes around comes around, and they appreciate that anything which increases the amounts paid out by reinsurers must inevitably increase not only the dollar trading of reinsurance, but also the administrative and acquisition loadings that further increase the cost of reinsurance.

It has been my experience that claims managers rely very heavily on their own judgment and experience in determining when to settle a claim and when to contest—regardless of the proximity of an excess retention. Let us not discourage such sound claims practice, and let us not make reinsurance any more expensive than it need be.

Claims Co-operation

Another point which deserves further clarification is the level of claims co-operation which exists between an insurer and its excess reinsurer. Your discussion referred to the claims co-operation clause, but it also left the impression that reinsurers have significant and arbitrary control over a cedant's claims procedures. This is not the case.

Though the claims co-operation clause may be a bit stronger than the "right of inspection" clause present in almost every contract of reinsurance, it is, nevertheless, little more than a tacit agreement that the reinsurer will be allowed to "look over the shoulder" of the claims manager during the settlement of a loss. In a typical wording, the parties agree that "the reinsurer

will be given the opportunity of co-operating in the settlement." The reinsurer has no binding authority, and the clause merely requires that the reinsurer be advised in time to comment on the situation. (Procrastinators take note: a twelve-pound document presented as first notice the day before trial does not count.)

The wordings of many excess treaty contracts would almost suggest that the reinsurer is not only without clout, but without voice: "All loss settlements made by the Company ... shall be unconditionally binding upon the Reinsurer," or "The Company shall, at its sole discretion, commence, continue, defend, compromise, settle or withdraw from actions, suits and proceedings ...as in its judgment may be beneficial and expedient."

Fortunately for reinsurers, the matter is not entirely one-sided. Although it is the cedant who must have final say in a settlement, a failure to consider the sound arguments and the hard-won experience of reinsurers would be neither beneficial nor expedient and could indeed fall outside the principle of utmost good faith. To put this in less adversarial terms, reinsurers represent a significant source of information on unusual or unusually large losses, and insurers should request and take advantage of this expertise.

True, there will occasionally arise a situation in which the interests of the cedant and the interests of the excess of loss reinsurer are so divergent that they cannot be ignored. Not every divergence of opinion can be "resolved" by means of claims co-operation. Consequently, there is no substitute for a clear and mutual understanding of what the treaty was intended to cover and how the parties are expected to respond.

And on that note, I will introduce a topic which could conceivably test the claims co-operation clause should unanticipated claim patterns arise.

Casualty Multiple-losses

Excess casualty treaties offer protection against occurrence losses—including multiple-policy losses. It is accepted that such treaties will aggregate the claims of two or more insureds involved in the same loss occurrence . If treaty terms are broad enough, it is even possible that different classes of business could aggregate. This is clearly the intent of "clash" or "shock loss" casualty covers. However, matters become less clear as insurers endeavour to retain their single net retention under a wider and wider range of circumstances.

A number of clauses have been developed to ensure only one net retention under a multiple-loss situation.

The first of these clauses I will refer to as the "wider underlying excess reinsurance" clause. (I can find no clear evidence of a formal name). It is used in the upper layers of an excess of loss programme when the lower layers provide a broader definition of cover. The best example would be an upper layer property catastrophe agreement sitting on top of one or more all-class excess treaties. The clause makes it clear that the overlying treaty's definition of ultimate net loss ***includes*** all losses falling within the terms of the wider underling excess programme—at least, up to the upper limits of that wider underlying programme.

Overlooking (for the moment) many other problems inherent in all-class programmes—such as property catastrophe retentions that tend to be too low and casualty occurrence exposures that tend to be too loose—the "wider underlying" clause introduces problems of its own for both the reinsurer and the cedant. The aggregation of a casualty loss with a property loss or, more likely, a property catastrophe loss, is not out of the question. The World Trade Tower explosion is very likely to generate a serious liability action (failure to anticipate despite the existence of warning studies) in addition to its multi-million-dollar physical damage and business interruption claims. At the other end of the scale, a Canadian earthquake could generate

liability claims arising from actions such as building code non-compliance.

The all-class programme would have to respond to these property and casualty accumulations as a single ultimate net loss. For the insurer whose reinsurance programme is doing double duty, the all-class structure could mean the loss of tens of millions of dollars of reinsurance protection in return for the questionable advantage of assuming one retention instead of two. For reinsurers, this clause and programme structure are likely to mean greater exposure for which no premium has been collected.

At the very least, both parties should consider such programmes carefully. Consider for example: do the upper layer catastrophe treaties have a two-risk warranty, or could catastrophe reinsurers face a single property loss arising out of the same occurrence that exhausts the underlying casualty limit? Does a cedant really want "full value" casualty protection which would needlessly consume a large part of the underlying all-class protection in a multiple policy occurrence?

A second clause intended to ensure a single retention under a multi-policy occurrence is the interlocking clause. This clause recognises that two or more claims-made losses could arise out of one occurrence and yet have different *reporting* dates. The clause ensures that these separately dated claims are nevertheless treated as one ultimate net loss. The clause goes on to combine claims-made and losses-occurring claims arising out of a single occurrence. In this way, the clause preserves the treaty intention to aggregate a single occurrence.

However, the clause goes on to aggregate policies issued over a period greater than one reinsurance contract year. The clause "interlocks" the underwriting activity of one treaty year with that of another. Reinsurers participating on one contract could be invited to adjust their retentions and limits of liability in relation to the treaty limits and the loss experience of another contract year—a year on which they may or may not participate.

There are at least two problems with this approach. Any attempt to combine the losses of one underwriting period with those of another misses a fundamental principle of excess treaty protection. Excess reinsurance is purchased on a year by year basis to protect each year's book of business. The treaty may cover losses occurring during the treaty year or it may cover policies attaching, but it does not cover the policies of another treaty period—policies that may be written in the future under some as-yet-unknown underwriting directive. The portfolios of separate (perhaps distant) years bear no relationship to one another. From the standpoint of excess capacity or excess protection of capital, the fact that policies from the two periods share a common occurrence is nothing more than an inconsequential oddity.

On the other hand, the contractual linking of these losses could have a negative impact on the insurer's underwriting capacity and capital protection. In order to save a few dollars by pro rating two retentions into one, the insurer is once again asking its excess reinsurance programme to perform double duty. The interlocking clause not only pro rates the retentions of the separate treaty years, but the limits of liability as well. Consider the situation in which an insurer buys sufficient excess protection in each of two "interlocking" years, but the common-occurrence claims of each year approach or exhaust each year's reinsurance programme. Although the insurer thought it had bought sufficient excess protection, the pro rating of the treaty limits of liability mean that there will be inadequate excess cover.

The aggregation of casualty losses is a much broader topic than is suggested by the two clauses noted above. Casualty issues such as asbestos, urea formaldehyde foam insulation, HIV-positive blood transfusions, electromagnetic field emissions and other as-yet-unannounced surprises, could sorely test the intentions of casualty (or all-class) excess of loss treaties. The interpretation of "occurrence" becomes critically important to the availability of excess recovery. For example, a handful of very large claims will impact reinsurance capacity and net retention quite differently than will a vast number of smaller claims. The

reinsurance protection of a multi-claiment, common occurrence casualty loss can not be interpreted retroactively in order to fit the dimensions of the claims. The definition of a casualty occurrence must be understood and agreed before such losses occur. For this reason, continuing dialogue is needed to ensure that understanding and agreement precede casualty multiple losses.

Yours sincerely,

David E. Wilmot