Assurances

Assurances

Reinsurance Dialogue

Christopher J. Robey

Volume 61, numéro 3, 1993

URI : https://id.erudit.org/iderudit/1104962ar
DOI : https://doi.org/10.7202/1104962ar

Aller au sommaire du numéro

Éditeur(s)

HEC Montréal

ISSN

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

Découvrir la revue

Citer ce document

Robey, C. (1993). Reinsurance Dialogue. *Assurances*, *61*(3), 489–494. https://doi.org/10.7202/1104962ar

Reinsurance Dialogue

between

Christopher J. Robey[1]

and

David E. Wilmot

August 25, 1993

Re: 1. Casualty multiple losses

2. The Net Retained Lines Clause

Dear Mr. Wilmot,

Casualty multiple losses

It is interesting that, until asbestosis losses, the reinsurance market was far more concerned with the definition of "occurrence" in property contracts than in casualty ones. Indeed, despite asbestosis and the other examples you cite, property occurrences still give more common problems, if not more serious ones. In insurance, on the other hand, it is the definition of a casualty occurrence which produces more questions.

You have given two examples of circumstances where the structure of a casualty reinsurance programme could result in a lack of cover for the ceding company — wider underlying excess cover and the use of an interlocking clause. However, these are rare tests of the adequacy of the limit under a reinsurance programme, which is far more likely to be tested for the same weaknesses by more common circumstances.

The issue you raise of the interlocking clause, used to bring together losses from the same occurrence covered under

---

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

separate contract years, is no different than the issue every ceding company must face when deciding how much reinsurance protection to buy — how many policies could reasonably be expected to be involved in a single occurrence? If this question is answered adequately — it could never be answered definitively — it will survive a test from the interlocking clause just as well as the more likely test of joint liability under more than one policy from the same contract year.

The issue of the wider underlying excess cover is
490 similar. If adequate cover would have been purchased on an all classes basis, then the same amount will be adequate on this basis.

The more limited cover in the higher layers was introduced as a replacement of all classes coverage all the way up in large part because of the unwillingness of many reinsurers to provide all classes cover. Limiting the higher layers to property, which is their only exposure, permits these reinsurers to participate and the ceding company to obtain the capacity it needs. The inclusion of other classes in the deductible is necessary for the program to work as designed. So long as the reinsurer is aware of the structure, it should not have any surprises in the circumstances of any claim it receives.

Neither structure is likely to be abused. Most reinsurers to-day will turn down an all classes program where they believe separate programs more appropriate. Normally it is only when a class cannot stand alone, usually because of its low premium volume, that it is included with other dissimilar classes. As for the interlocking clause, it is just as often the reinsurer participating on several years of the ceding company's programme which asks for it as a protection against paying two limits on the same occurrence.

One subject you mentioned in passing warrants, I think, further mention.

You refer to property and casualty losses from the same occurrence, giving as examples, the terrorist attack at the

World Trade Center in New York and possible liability claims following an earthquake because of failure to build to code etc. It is an issue you raised in your first letter of this exchange, in the July 1990 issue of Assurances.

As I said in my response then, I think it would be difficult to include liability losses which occur at the time of an earthquake or other such disaster in the same occurrence as the earthquake. Where one building collapsed while its neighbour did not, and it can be shown that the surviving building was built according to code but the collapsed one was not, the proximate cause of the liability loss would be the failure to build to code, not the earthquake. If they both fell down, there may still be a liability case, but no damages despite the negligence, because the earthquake, not the negligence, caused the damages.

Net Retained Lines Clause

Now to another clause which sometimes appears in excess of loss contracts, the net retained lines clause.

Proportional contracts reinsure policies and, for a share of the premium under the policies reinsured, reinsurers will pay the same share of any losses under those policies. Non-proportional contracts, on the other hand, reinsure losses. Coverage applies to all losses from one occurrence, regardless of how many policies may be involved.

The definition of what part of the loss is covered is set out in the ultimate net loss clause. It would typically define what costs, such as legal fees and expenses, can be added to the loss, set out how salvages and recoveries are to be dealt with, and specify what other reinsurance recoveries must be deducted. This is usually all other reinsurance other than underlying excess of loss and, sometimes, quota share reinsurance.

Proper drafting of the clause will leave no doubt as to how the loss is to be calculated for reinsurance purposes. However, it is quite common for the contract to contain also a net retained lines clause.

This clause defines what part of the policies which are the subject of the reinsurance can produce losses to the agreement. In its most basic form, it limits this to that part of the policies which the ceding company retains net for its own account.

If both clauses are properly drafted, they accomplish the same purpose and produce the same loss to the contract. But if there is a mistake in drafting either one, the contradiction can only confuse the interpretation of the contract.

492

I have rarely seen a net retained lines clause which mentions underlying excess of loss reinsurance. One can argue, as I have, that excess of loss reinsurance reinsures losses not policies, so underlying excess of loss contracts do not change the ceding company's net retention under the policies which are the subject of the reinsurance. On the other hand, they do reduce the loss to the ceding company's net retention, so it is ate best ambiguous.

Of more concern is the failure I come across from time to time to modify the net retained lines clause to include in the net retention cessions to quota share reinsurance, where the excess of loss is for common account. In such cases, the ultimate net loss clause is invariably changed, since it seems to be the focus for defining exactly what losses are covered.

Some versions of the net retained lines clause may seek to do more, for example to require the ceding company to maintain the same underwriting policy as was in place at the time the contract was negotiated, particularly as it concerns cessions to a surplus contract and the purchase of facultative. Some may go as far as to incorporate the ceding company's line guide into the contract.

I think incorporating the line guide is going too far. A ceding company should be able to make adjustments to its guide during the year without the permission of the reinsurer, so long as it does not materially increase the reinsurer's liability.

The measure of materiality is also at the heart of any condition in the net retained lines clause which prohibits the company from making any changes in its underwriting policy. Indeed the reinsurer seems to be firing at the wrong target, or at least concentrating on one target while ignoring a more important one.

The reinsurer must be concerned that the underwriting policy, including the line guide, which will be in force during the contract is close to the one which was in place when the results used to underwrite the contract were achieved. Indeed, as the contract gets under way, changes in policy become progressively less important to the reinsurer, presuming the contract is on a losses occurring basis, rather than a policies issued one. A smaller and smaller portion of the policies written will expose the contract as it gets closer to its termination. Even a major change in December will have no material impact on the exposure to loss of the reinsurer on a calendar year losses occurring contract.

The possible additions to the net retained lines clause therefore revolve around the question of materiality. The ceding company should not be prevented from making changes which do not increase materially the reinsurer's liability, or even required to get the reinsurer's permission for them. On the other hand, the basic principles of reinsurance require that changes which have a material impact on the reinsurer must be discussed with it.

A clause can be added to the contract requiring such changes to be discussed, however spelling out in a contract one of the basic principles underlying it can be dangerous. If the clause sets out some of the things which the reinsurer considers to be material, it leads to the presumption that what is not mentioned is not material. However, it is almost impossible to set out in advance all the material changes which may occur.

Use of such phrases as "for example" or "and the like" can also be limiting, since they suggest that other unspecified changes considered material are of the same type as those

specifically mentioned. It would be better, I think, to rely on the all-inclusive principal of materiality without attempting to define it in the contract.

Since the net retained clause seeks to accomplish what the ultimate net loss clause also does, it would be preferable to select one to do the job and do away with the other. Including both, even in a well-drafted contract, is confusing, since the person seeking to interpret the contract will presume there was a reason for including both clauses and seek the difference therefore presumed to exist between them.

The better clause to use is undoubtedly the ultimate net loss clause and the net retained lines clause should therefore be eliminated.

This choice becomes even clearer with the introduction into surplus contracts of a loss occurrence limit. If the overflow from this limit is protected in the catastrophe program, the ultimate net loss clause needs no further change, since it already provides for the deduction of recoveries from other reinsurances. What is not recovered because of the occurrence limit is not deducted.

The net retained lines clause however does not permit inclusion of losses under the part of a policy ceded to the surplus, even if there is no loss recovery from the surplus because of the loss occurrence limit. The change needed to the net retained lines clause complicates an already unnecessarily complicated combination of clauses.

This new difficulty with the net retained lines clause underlines the fact that excess of loss contracts reinsure losses not policies and the clauses in the contract should reflect this, as the ultimate net loss clause does but the net retained lines clause does not.

Yours sincerely,

Christopher J. Robey