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Aller au sommaire du numéro

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Reinsurance Dialogue

between

Christopher J. Robey

and

David E. Wilmot

June 5, 1995

Re: The Special Termination Clause
Joint Cedant Reinsurance Agreements
Insolvency and the Ontario Auto Reinsurer
Collectible Reinsurance Premium

Dear Mr. Robey:

You have extended our discussion on the Special Termination Agreement to a fairly detailed assessment of the clauses commonly used in Canadian treaty wordings. This is just as well because, while you and I have been exchanging personal views, the Reinsurance Research Council (RRC) has taken upon itself to produce its own "recommended" Special Termination wording. Perhaps our discussions will influence the final outcome of RRC's efforts.

The RRC draft clause includes five "triggers" that can invoke termination. You have addressed all of these to one degree or another in your letter of November 11, 1994.

The first trigger, "failed to meet the minimum asset requirements of regulatory authorities," solves several problems raised in your letter. With no reference to "capital," the clause can be used by mutual as well as stock companies. At the same time, the potentially problematic definition of impairment is neatly sidestepped and left in the hands of regulators where it belongs.

The second trigger, "go into liquidation or have a receiver appointed," has been retained and is just too widely used to be ignored. You suggest that this phrase is out of date because authorities are more inclined to rehabilitate than liquidate. However, recent events show that receivers in bankruptcy are still in use. Furthermore, I suspect that there are many circumstances, such as a west coast earthquake, which could send insurers straight into bankruptcy without the interim step of an order to cease underwriting.

This brings us to the third trigger, "cease writing new or renewal business under the direction or order of an appropriate regulatory authority." I agree with you that this is a "key" trigger, being the most likely course of action on the part of regulators. I also agree that frivolous instances such as a cease order by a regulator in some obscure corner of the globe should not be allowed to trigger termination here in Canada. The word "appropriate" has been used to describe the regulatory authority, and I believe that a "reasonable person" interpretation will prevent abuse. The creators of the current draft wording toyed with the phrase "the regulator in whose jurisdiction policies the subject of this agreement are issued or the regulator in the home jurisdiction of either party or both." (It is easy to see why they opted for the single word "appropriate" instead.)

The fourth trigger receives your qualified support. "Enter an arrangement either by way of shareholding or management or otherwise under which effective legal or presumptive control is assumed by any individual or organisation other than that which pertained at the time this agreement became effective." You expressed concern that, under the strictest interpretation, this clause would allow special termination at the appointment of a new vice-president of human resources. However, I think the wording is such that the "reasonable person" approach to its interpretation would preclude the abuse you described.

The fifth trigger is in wide and relatively unquestioned use. "In the case of the company only, effect a reduction in the net retained share of the business reinsured hereunder without the prior written consent of the Reinsurer."

In earlier correspondence, you and I discussed voluntary and involuntary triggers and the use of retroactive termination to the inception of the treaty. The RRC draft recommended wording simplifies this exercise. Termination of the reinsurer retroactively to inception is an option only under the second trigger. No other trigger justifies such a damaging, one-sided obligation.

RRC has shown its draft to reinsurance intermediaries, many of whom have already responded, and a final recommended wording is forthcoming. For the time being, we should retire the subject of Special Termination Clauses.

The Joint Cedant Reinsurance Agreements

Equally important, and equally timely, are new developments arising out of the recent insolvencies of one or two insurance companies. The first of these affects Joint Cedant Reinsurance Contracts in respect to the Insolvency Clause.

The Office of the Superintendent of Insurance has expressed concerns about the reinsurance offset provision under the standard Insolvency Clause as it applies to Cedant "groups" reinsured on a joint basis. Although I do not wish to get into the current Insolvency Clause in any detail, I should list the key provisions of this clause before addressing the changes to the clause requested by OSFI.

The standard Insolvency Clause is drafted to ensure (a) that the Reinsurer's liability under the contract is not diminished by the insolvency of the Company, (b) that the Reinsurer may participate in the investigation and settlement of claims for which it has an interest, and potentially, charge a proportion of investigation expenses against the Company as part of the expense of liquidation, and (c) that the Company or

Reinsurer may offset any balances in respect to premiums, commissions, losses or other amounts due from one party to the other under this or any other reinsurance agreement between them.

OSFI would like the following paragraph added to the Insolvency Clause whenever one or more members of the group are provincially registered, are federally registered as a foreign branch, or are not registered in Canada:

> In the event of the insolvency of any company or companies included within the designation 'Company,' this clause will apply only to the insolvent company or companies.

OSFI concerns rest with federally registered companies (under its jurisdiction) whose reinsurance receivables (and therefore, assets) are threatened by affiliated companies *outside* its jurisdiction or control.

In effect, the clause will segregate the members of the group of companies that had been reinsured under a joint Cedant reinsurance contract. For the purposes of offset (and I presume, only for the purposes of offset), each member company's payables and receivables become segregated and "crystallised" at the moment one or more members are deemed to be insolvent. The reinsurer who entered an agreement with the group may find that he must pay funds due to one member of the group while unable to offset the funds due from another member of the group.

It is difficult to measure the impact of this requirement on reinsurers, but the pre-insolvency structure of the group and the territorial and class distribution of its business will give some clues as to the potential risk of loss through insolvency.

In most cases, the insolvent member company will probably face a considerable liability for outstanding losses – much of which is likely to be reinsured. If this is the case, the reinsurer should have sufficient outstanding (and withheld) funds to offset against any defaulted payments from that insolvent member of the group. At the same time, the other member companies are either solvent (but for some reason, have not come to the aid of their troubled affiliate) or they too are insolvent and pose an additional dilemma for the Reinsurer. In either case, reinsurers must deal with each member as an individual entity. Each of these entities may have receivables as well as payables that will allow the reinsurer to offset more or less successfully with each.

Reinsurers' fears of a quick, internal group realignment of payables and receivables should be prevented by good faith and by the "crystallisation" of payables and receivables. Assuming this to be the case, the OSFI requirement would have little, if any, impact on the settlement of accounts between the reinsurer and the various companies in the group.

Under different circumstances, the insolvent company could face payables due to reinsurers but hold no outstanding losses with a particular reinsurer. In this case, the reinsurer would have no offset potential against the insolvent member company. As a simple but realistic example – the group's automobile and general liability excess treaty premium is driven by the Ontario auto exposure, but the premium income of the non-Ontario group member accounts for about half of the treaty's subject premium. This member becomes insolvent, largely due to experience in a different class of business, and the remaining group member(s) continue to seek full Ontario auto reinsurance protection, having paid only half the treaty premiums.

However, unless someone expects the reinsurance cover to respond individually to each group member – for example, provide the full limits of a catastrophe programme for each group member – the new clause will tend to expose reinsurers to little more than unpaid premiums.

What should be of greater concern to reinsurers is any arbitrary regulatory encroachment into reinsurance offset. In a number of American jurisdictions, regulators have indicated they will not allow offset in the event of insolvency. Even in Canada, it is conceivable that regulators could attempt to limit offset in various ways, such as disallowing the adjustment of a swing rate or a scale commission after insolvency. Were this to happen, reinsurers would, out of necessity, be forced to take a harder line on "troubled" Cedants. They would find it increasingly difficult to reinsure groups with a weak member. Those with the greatest need for reinsurance could be turned away or forced to buy from less stable reinsurance markets, exacerbating the problems regulators hoped to eliminate.

Insolvency and the Ontario Auto Reinsurer

A Cedant insolvency can affect reinsurance in unusual ways. A most interesting situation has been created by the new Ontario Auto plan, Bill-164. Later this summer, a court-requested motion for direction will determine what happens to Ontario automobile no-fault claims when the insurance carrier has become insolvent. There is a suggestion that each such claim will fall to the "next" or "non-primary" insurer under the priority of payments provision of the Insurance Act. A related issue to be determined at the same time is whether or not the "non-primary" insurer can accept an assignment from the claimant, enabling it to claim back against the company in liquidation, thus ranking with other claimants of insurance loss.

I cannot guess the outcome of these proceedings, but it is interesting to consider the potential complications in respect to reinsurance, particularly excess of loss reinsurance.

If accident benefit losses are no longer the (immediate) responsibility of the insolvent company, may I presume that even the large losses will move to the "non-primary" insurer? One envisions a windfall for the excess of loss reinsurer. However, I suspect the reverse to be the case. Bear with me.

Large losses, along with the small, will go to other insurers, and these insurers will have their own excess of loss reinsurance – reinsurance with retentions that may be higher or lower than that of the insolvent insurer. In any event, there are likely to be instances in which the "non-primary" insurer has another claimant arising out of the same occurrence. (After all, this non-primary insurer was next in line to pay the claim.) Needless to say, the reinsurer faces a larger potential for multiple-claimant occurrence losses.

Complications increase as the non-primary insurer contemplates making the assigned claim back against to the insolvent insurer, assuming assignment is going to be permitted*. The non-primary insurer, with its own excess reinsurance in place, could be discouraged from seeking only partial recovery under assignment. The non-primary insurer is promised full reinsurance recovery of the excess portion of the loss if it is retained as part of the insurer's ultimate net loss. But the insurer may see only a partial recovery, such as 60¢ on the dollar, if the loss is claimed from the insolvent insurer. In some circumstances, the non-primary insurer would be discouraged from assigning the loss except for two things. First, the insurer has a duty to mitigate the loss and, in effect, treat the loss as if there is no reinsurance in place. Second, an argument could be made that excess reinsurers should treat partial recovery under assignment in the same way as salvage or any other partial recovery. In other words, the excess reinsurer absorbs the recovery shortfall of 40¢ on the dollar in the form of a somewhat larger ultimate net loss.

*(If assignment is not allowed, the insolvent insurer will avoid so many accident benefit losses that it could conceivably emerge from liquidation with a positive cash position. This prompts me to make a suggestion: You and I will create an insurance company writing nothing but Ontario automobile business. We let it run into a modest deficit so that, as an insolvent insurer, we no longer have losses to pay. Even after deducting the cost of liquidation, you and I will make millions!)

Using this reasoning, the reinsurer could face a form of "double indemnity." If large losses are claimed from the insolvent insurer, it matters not at all to the excess reinsurer that these losses will be paid out by the liquidator at 60¢ on the dollar. The reinsurer's responsibility to the liquidators is 100¢ on the dollar for the excess portion of the loss. If reinsurance exists for both the insolvent insurer and for the non-primary insurers, reinsurers could pay the full excess loss to the liquidators *plus* the 40¢ shortfall to the non-primary insurer. A reinsurer on both programs could conceivably pay $1.40 for each dollar of excess loss in this example.

296 Please understand that I am not criticising circumstances that, on the surface at least, would appear to produce an inequity for reinsurers. Nor am I advocating a change in reinsurance responsibilities. Rather, I wish simply to note that reinsurance *principles* (in this case, the Ultimate Net Loss Clause versus the Insolvency Clause) may, at times, appear to be in conflict or be capable of producing inequities, but they are the principles that we must live with none the less.

I will demonstrate this with the introduction of one final topic – a topic which preserves our theme of insolvency, more or less.

Collectible Reinsurance Premium

Having explored reinsurance problems created by the insolvent insurer, I will quickly touch on an issue arising out of the demise (by insolvency, misappropriation or other misadventure) of a primary broker. Recent events at either end of Canada may result in millions of dollars of uncollected premiums for a number of insurers.

The failure of an insurer to collect premiums from one or more of its brokers has no bearing on the subject premiums declared under a reinsurance contract. This should go without saying, but, as with so many issues we choose to address in these pages, there is room for misinterpretation.

Quite simply, neither premiums payable to a proportional reinsurer nor subject premiums on which an excess of loss reinsurer's rate applies can be presented to reinsurers *net* of uncollectable. Uncollectable premiums constitute a commercial trading loss which is unrelated to reinsurance.

Reinsurers are asked to reinsure the liabilities arising out of the original insurance policies, not the ability of the insurer to handle receivables. Reinsurers do not cover the collection risks of the Ceding company. Reinsurance as you and I have discussed many times, follows only the technical insurance fortunes of the Cedant.

Looking at the treaty wording, reinsurance premiums payable under a proportional or non-proportional treaty are based on original premiums resulting from policies described in the treaty (less cancellations, returns, and, if agreed, possible inuring reinsurance or obligatory contributions to unsatisfied judgment funds or insolvency plans). It is on this basis that proportional premiums must be ceded and excess of loss subject premiums presented for rate adjustment.

Yours sincerely,

David E. Wilmot