Assurances

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The insolvency clause and unregistered reinsurers

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Reinsurance Dialogue

between

Christopher J. Robey[1]

and

David E. Wilmot[2]

September 6, 1995

Re: The insolvency clause and unregistered reinsurers

Dear Mr. Wilmot,

The insolvency clause

In your latest letter, you suggest we retire the subject of special termination clauses, but introduce a new subject which poses problems with the clause which we did not address in our previous exchange — joint cedent reinsurance agreements and the application of the insolvency clause to them. Before we apply the insolvency clause, we must decide how the special termination clause applies when only one of a group forming the ceding company becomes insolvent — is the entire agreement canceled, or only protection applying to the insolvent member?

As you point out, the major issue for reinsurers is the set-off of balances involving money owed by and to the insolvent company. The amount of money involved and the complications in sorting it out will be much greater if the reinsurance continues in force for the other members of the group, but OSFI will no doubt be concerned that cancellation of

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the entire contract would leave a federally registered company without reinsurance because of the failure of a group member outside federal jurisdiction.

It seems to me that the reinsurer in this case is not in any special situation when compared to others with commercial transactions with a group of companies. A supplier may offer a discount based on volume which it has already given to all group members even though the failure of one member results in the volume not being reached. For the reinsurer the position is similar. The sum of the premium charged a group may be less than that which would have been charged to each member individually, and the difference cannot be recaptured following the failure of one group member.

Since the reinsurer is not in any different position than others involved in the insolvency, it is difficult to see why it should have special privileges. Indeed, even if the reinsurance contract contains such privileges, they may not be enforceable in a bankruptcy because of the responsibility of the liquidator to treat everyone fairly.

As you say, many cases of insolvency should result for the reinsurer in no more than unpaid premiums. With deposit premiums a high percentage of the expected premium, the portion of premium unpaid on excess of loss business should be small — where the deposit premium is payable at inception, overpayment would more likely be the case. The main problem would be on proportional business where premiums are paid in arrears.

On the other hand, in some cases, it may result in too much premium being paid by the remaining group members, presuming their reinsurances continue uninterrupted. For example, the top layer of catastrophe protection may not be needed without the accumulation of the insolvent group member's exposure. The same could be true of part of the automobile protection, for example if the insolvent member were the only one writing in Ontario, or if other members of the group wrote only in Quebec. Such circumstances would no doubt result in negotiations between the ceding group which no longer wanted the reinsurance and reinsurers which felt entitled to the premium to offset the unpaid premium from the insolvent member. Circumstances in each case would determine the result of each negotiation.

More difficult problems would arise in those parts of the reinsurance subject to adjustment based on results. In an excess of loss contract with an adjustable rate, what happens if the maximum rate is reached solely because of losses suffered by the insolvent group member? Can the other members pay only the minimum rate applied to their volume or must they pay the maximum rate? Similar difficulties would occur on a commission adjustment under a proportional treaty, except that in this case, the ceding companies would be asking the reinsurer to pay them instead of the other way around.

Where other group members remain in business and will be seeking to renew their reinsurance contracts at expiry, reinsurers can look for a solution more in their favour. However, if all group members are insolvent and their bankruptcies are handled under different jurisdictions, reinsurers are likely to get only the minimum amount possible, since each liquidator will seek to maximize the assets of the company for which it is responsible, as indeed it is required to do.

You suggest the main concern of reinsurers should be "any arbitrary regulatory encroachment into reinsurance offset". Regulators have a responsibility to consumers of insurance products and therefore a role to play in the reinsurance of those products. This role requires a careful balance between protecting insurers against anything which might reduce their ability to pay claims and ensuring that a reliable and strong reinsurance market remains available to play its part in the process. The Canadian regulator's efforts to resolve these issues through discussion suggests that the resolution will not be "arbitrary".

However, the idea that only "arbitrary" measures would result in reinsurers taking a harder line on "troubled" ceding companies is in itself of interest. During soft markets, reinsurers will often complain of the activities of some of their fellow reinsurers, and insurers similarly complain of those competitors which they see as upsetting their market, and of the reinsurers which support them. A stronger application of market discipline, including to "troubled" ceding companies, could be beneficial to all.

Insolvency and the Ontario automobile reinsurer

Any legislation brings with it some measure of interpretative problems, but the Ontario Motorist Protection Plan and Bill 164 which modified it must be breaking records. The law was complicated to begin with, and rushed through to meet a political agenda, so the legislators left much to be worked out afterwards by the Ontario Insurance Commission and insurers in the Ontario automobile market. However I doubt anyone thought about the priority of payments when an insurer becomes insolvent until it actually happened.

There is certainly a risk to reinsurers that claims transferred to a non-primary insurer will accumulate with claims that insurer already has from the same accident, with reinsurers disproportionately affected by the accumulation. However, I believe that most claims do not involve multiple injured and circumstances would suggest that many of those which do would result in the injured all claiming under the same policy.

There are also many circumstances in which another insurer can become involved, not all of which put it in a non-primary position. The May 22, 1995 edition of Thompson's World Insurance News contained an amusing, and at the same time alarming, case study of how many insurers could be eligible to pay the same claim, and most of them were in a primary position. Where the other insurer does suffer the accumulation of victims, there is no doubt that its reinsurers are disproportionately affected and taking on a liability they had not contemplated.[3] You write that an argument could be made that

[3] Although the risk is sufficiently remote that the reinsurers are unlikely to have charged for it even if they had contemplated it, but that is a different issue.

any recovery from assignment of the loss could be treated as salvage, thus reducing the reinsurer's loss. I would go further and suggest that it would be difficult to formulate an argument that it could be treated any other way.

Your example of how reinsurers as a group could pay out $1.40 for each $1 of claim is fascinating and undeniable. Perhaps it is a further argument for a stronger application of the market discipline discussed earlier.

Collectible reinsurance premium

I have no argument with your point under this heading. Dare I again mention market discipline?

Unregistered reinsurance

First let me stress, given the topic of the first part of this letter, that unregistered reinsurance does not mean unreliable reinsurance, or unregulated reinsurance, or under-financed reinsurance. It is true that those reinsurers with non-existent domiciles or dubious assets are not registered in Canada, but nor are many of the strongest companies in the world, including the parent companies of many Canadian reinsurers. Unregistered usually means no more than that the reinsurer has not sought to write Canadian reinsurance on a registered basis, or, more likely, not sought to write it at all.

The Canadian reinsurance market is well served for the most part by its registered reinsurers and there is adequate capacity for most business. Registered reinsurers discourage the regulator to admit new reinsurers for this reason and, no doubt, because they do not wish to see newcomers competing with them on a market which is quite capable of generating enough competition without their help.

Nonetheless, the number of registered companies writing reinsurance in Canada has dropped from a high of fifty-seven in 1988 to forty-one to-day. In addition to this, the number of syndicates at Lloyd's writing Canadian reinsurance has dropped in the same period form about a hundred and sixty to about fifty. In many cases, the business of the withdrawing reinsurer was transferred to another reinsurer remaining in the market, but some reinsurers and syndicates simply withdrew and left their business to be taken up by others in the open market.

A major measure of the competitiveness of the market is the number of decision-makers and that has clearly reduced dramatically over the last few years. This is perhaps why reinsurers are now outperforming the market as a whole, as they should in non-catastrophe years. Along with competitiveness, capacity has reduced. Even when the operations of a withdrawing market were merged with a continuing market, the resulting capacity was often less than the combined capacity of the separate entities.

The drop in competitiveness is a discussion for another day and the drop in capacity has not resulted in problems in most contracts. The one area where it has made a significant difference, however, is the catastrophe market, in large part because it has coincided with a greater understanding of the size of catastrophe exposure insurers face, an understanding prompted in large part by the efforts of a few reinsurers.

The shortfall in capacity was a worldwide one, with Canada less affected than some other territories, and the solution was similarly a worldwide one, not driven in any measure by the Canadian need. A number of well-financed reinsurers have been set up in Bermuda with, as their primary function, the writing of catastrophe reinsurance. Since a geographic spread is essential, Canada, although not an important consideration in the creation of these companies, is nonetheless an element in their seeking geographic balance. Other reinsurers in other parts of the world have also become more interested in Canadian catastrophe business as prices have increased. However, these new markets are unregistered.

In its study of earthquake in British Columbia, the Insurance Bureau of Canada estimated the total capacity required at $5.8 billion, whereas the total available to-day is only

$1.5 billion. Clearly additional capacity from new markets is needed to enable the insurance market, including reinsurers, to meet the needs of the Canadian marketplace. However, there is good reason not to expand at anything but a normal rate the market for general insurance and reinsurance, since the need is localized in catastrophe contracts.

The main barriers to the entry of new reinsurers into the Canadian market are the long process to become registered and the complications for ceding company and reinsurer alike in operating unregistered.

Operating unregistered is far from an ideal solution, since it thrusts the potential burden onto the ceding company, which cannot take the same credit for reinsurance as it could with a registered reinsurer. Again in catastrophe business this is not a major problem in non-catastrophe years. However the need for adequate reserves from an unregistered reinsurer following a loss can put the ceding company in a difficult position, even if the problem is one of timing only, for example when the required reserves were deposited by the reinsurer after the date at which the ceding company had to report to the regulator. Despite the tolerance of the regulator in such circumstances, no company wants to rely on such tolerance too often. The problem is complicated by the limited acceptability of letters of credit as security to guarantee a reinsurer's obligations. The purpose of the regulator is admirable — to ensure the funds are available in Canada — and letters of credit have been regularly challenged in other jurisdictions, so that they are not as ready a source of cash as they might seem. However, they are the preferred choice of international reinsurers and their lack of acceptance in Canada causes some reinsurers to stay away and, in other cases, causes the ceding company to accept the reinsurer anyway, knowing that it could have a problem with the regulator, but seeing it as the best way to obtain the reinsurance capacity needed.

Another restriction is the requirement that a full operation be maintained in Canada, with staff capable of dealing with the regulator whenever necessary, keeping detailed records and doing all data processing. The Canadian regulator rightly requires a strong presence in Canada for a company seeking to write a cross-section of Canadian business, but some less demanding approach can be justified for a company seeking only to write a small volume of premium in a class where the Canadian market needs their capacity. Catastrophe business, by its nature, is international and many of the well-established Canadian reinsurers rely heavily on their parent's international operations to write their Canadian catastrophe contracts.

On the other hand, the regulator has the problem of "drawing the line". Some of the new Bermuda reinsurers set up initially as catastrophe specialists are beginning to write other business. If the Canadian regulator allowed a catastrophe reinsurer to operate under less strict rules than other reinsurers, it would face the problem of deciding when the reinsurer had crept over the line from being a specialist to a general reinsurer, an almost impossible call to make before the event and a difficult one to correct after.

There is room in the Canadian market, I think, for a new category of reinsurer seeking only a limited and specialty place in the Canadian reinsurance market and I shall refer to this category as "approved reinsurers".

The requirements for approved reinsurers would be minimal, in return for which they would have to limit their activities in the Canadian market. Approval would be granted on the basis of head office financial statements, or the interpretation of them made by one of the international rating agencies, such as Standard & Poor's, which publishes a breakdown of the financial statements of foreign companies, adapting the different standards of the country of origin to their own format. With such an approach, it would not be necessary for the reinsurer itself to make any application to the Canadian regulator, since this information could be obtained by the ceding company or reinsurance broker seeking to obtain the approved status for the reinsurer. The sponsoring company or broker would also have the responsibility of keeping the information on file with the regulator up-to-date. Once the reinsurer was approved, its Canadian ceding companies could take credit for all reinsurance placed with it as if it were registered.

In return for these limited requirements for gaining entry into the Canadian market, approved reinsurers would be limited in the amount of annual premium they could write, perhaps to $10 million per reinsurer and 10% of the total for registered reinsurers cumulatively. This would ensure that they did not encroach on the position in the market which registered reinsurers hold, while allowing them to provide a service to Canadian insurers in those areas where the additional capacity is needed.

The demands of the insurance market to-day are such that a flexible approach is needed in many areas and one of these is certainly in the area of catastrophe capacity. The market is asking for such flexibility from government to enable it to develop the catastrophe capacity the country needs to provide for economic recovery following a major earthquake and some flexibility in admitting strong foreign reinsurers into the market to augment that capacity will speed the process without endangering the stability of the market.

Yours sincerely,

Christopher J. Robey