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Introduction to Reinsurance

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Some Basic Reinsurance Concepts

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Overview

- What is Reinsurance
- Insurance/Reinsurance similarities
- The Parties to the Reinsurance Agreement
- Why Insurers Buy Reinsurance
- Types of Reinsurance Agreements
- How Reinsurance Works



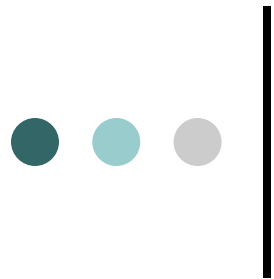
Reinsurance: A Definition

- Insurance for Insurance Companies
 - An insurance company, called the primary or ceding company, shares portions of its liability with another insurance company, known as a reinsurer
- Reinsurance is a transaction between insurance companies only
 - The underlying policyholder has no interest or privity in the reinsurance contract
 - The subject matter of a reinsurance contract is the risk the Reinsured undertook in its original policies.
 - The reinsurer “reimburses” the insurer for its portion of paid claims
- The heart of reinsurance is utmost good faith (*uberrimae fides*)



Insurance/Reinsurance Similarities

- Both
 - Protect against uncertain, future events
 - Involve a transfer of risk
 - Require a payment of premium
 - Pay for certain types of expenses
 - Require underwriting (selecting, analyzing, pricing) skills



Insurance/Reinsurance Differences

Insurance:

- Buyers have varying knowledge levels
- Responds to an event
- Provides Defense and Indemnification
- Pays on behalf of
- Mainly a domestic enterprise
- Highly regulated

Reinsurance:

- Buyers assumed to be knowledgeable –no *contra proferentem*
- Provides Indemnification only
- Reimbursement contract
- International
- Unregulated

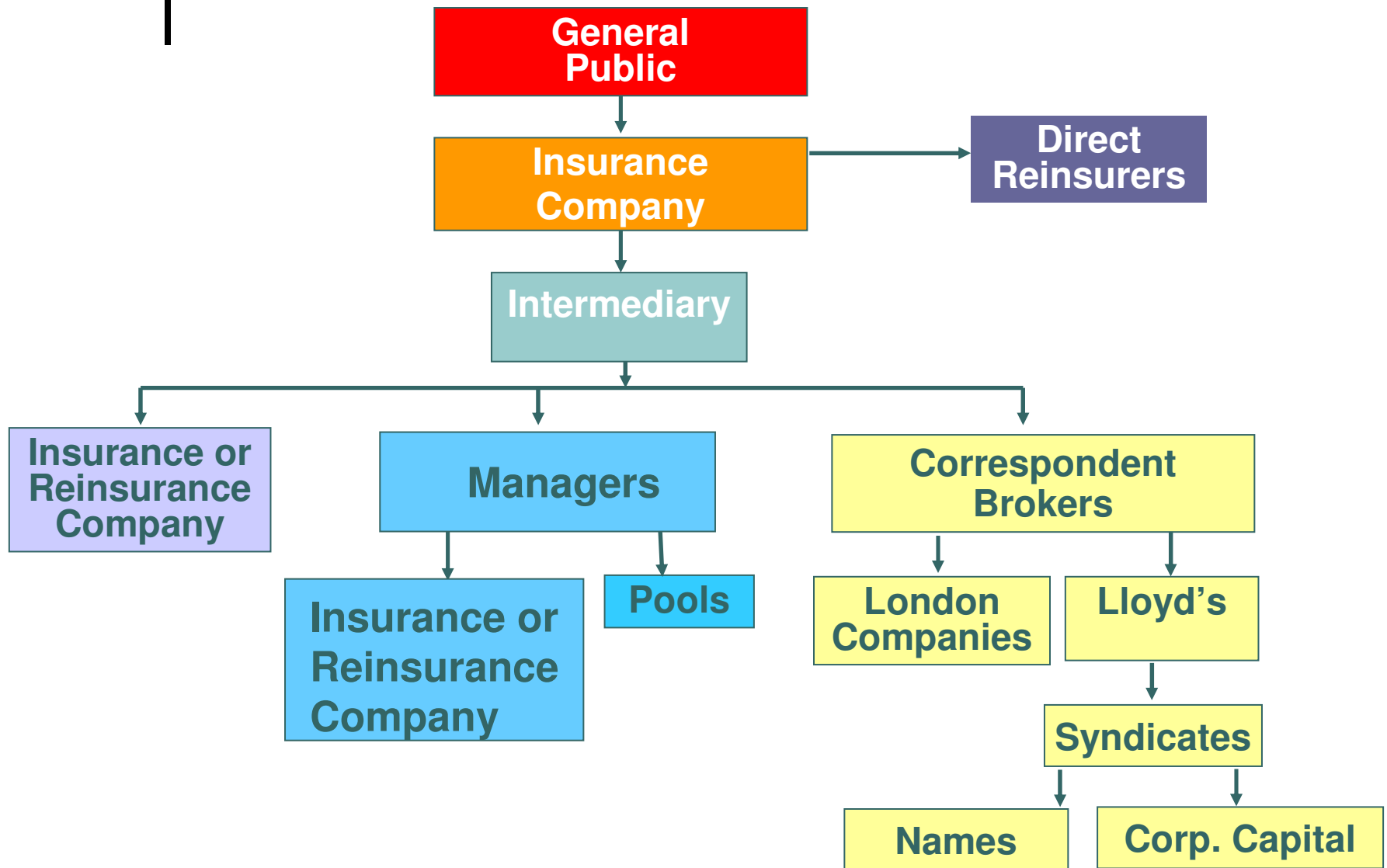


How Reinsurance Works

It spreads the risk of loss incurred by the reinsured under its policies and redistributes the premiums received by the reinsured, according to the reinsured's own business needs:

- Shifts risks from one insurer to another
- Allows “sharing” of risks to reduce burden on a carrier
- Frees up capacity for a carrier
- Allows coverage of large risks or books of business
- Reinsurance is often a “subscription” market

The Parties to the Reinsurance Transaction



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Types and Characteristics of Contracts

Andrew Maneval



The Two Main Types of Reinsurance

“FACULTATIVE” REINSURANCE

Reinsurance transacted on an individual risk basis. The ceding company has the option to offer an individual risk to the reinsurer and the reinsurer retains the right to accept or reject the risk.

“TREATY” REINSURANCE

A transaction encompassing a block of the ceding company's book of business. The reinsurer must accept all business included within the terms of the reinsurance contract.



Characteristics of The Reinsurance Contract Types

FACULTATIVE:

- Individual risk review;
- Right to accept or reject each risk on its own merit;
- A profit is expected by the reinsurer in the short and long term and depends primarily on the reinsurer's risk selection process;
- Adapts to short-term ceding philosophy of the insurer;
- A contract or certificate is written to confirm each transaction;
- Can reinsure a risk that is otherwise excluded from a treaty;
- Can protect a treaty from adverse underwriting results.

TREATY:

- No individual risk scrutiny by the reinsurer;
- Obligatory acceptance by the reinsurer of covered business;
- A long-term relationship in which the reinsurer's profitability is expected but measured and adjusted over an extended period of time;
- Less costly than "per risk" reinsurance;
- One contract encompasses all subject risks.



Forms of Reinsurance

- **Pro Rata Reinsurance (Proportional)**

Sharing concept – Ceding company and Reinsurer share premiums and losses in a determined percentage.

- **Excess of Loss Reinsurance (Non-Proportional)**

For a part of the premium, Reinsurers cover losses above a specified retention by the Ceding company, up to a predetermined limit.



Forms of Reinsurance

- **Pro Rata (“Proportional”)**

- Quota share
- Surplus share

- **Excess of loss**

- Per Risk/Per Policy/Per Insured/Per Location
- Per Occurrence (catastrophe)
- Aggregate Stop Loss



Quota Share Reinsurance

40% Quota Share			
	Gross	Ceded	Net
Policy Limit	\$500,000	\$200,000	\$300,000
Premium	\$ 12,500	\$ 5,000	\$ 7,500
Loss	\$275,000	\$110,000	\$165,000



Per Occurrence Excess

Multiple Risks in One Occurrence

Example:

Casualty Per Occurrence Excess

[\$450,000 excess \$50,000]

AL Loss:	\$100,000
WC Loss:	\$ 35,000
Occurrence Loss:	\$135,000
Retention:	\$ 50,000
Reinsurers Pay:	\$ 85,000

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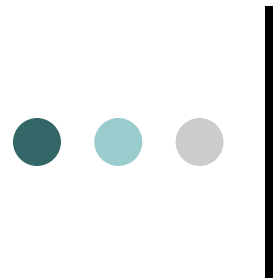


Anatomy of a Reinsurance Claim

Timothy A. Papka

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The Anatomy of a Reinsurance Claim

- Basic Terms Revisited
- Does Reinsurance Apply
- Reporting the Reinsurance Claim
- Assumed Reinsurance
- Reinsurance Accounting



The Anatomy of a Reinsurance Claim

Basic Terms Revisited

- Reinsurance: “insurance for insurance companies.”
- Cedent or Ceding Company: The insurance company buying the reinsurance.
- Reinsurer or Assumed Reinsurer: The insurance company that provides reinsurance is assuming the risk from the cedent.



The Anatomy of a Reinsurance Claim

Does Reinsurance Apply?

- Ceding company claim handler receives a new loss and establishes a reserve;
- Review for applicable reinsurance: Ceding Company reviews for any reinsurance that may apply to the new loss.
 - Treaty and facultative
 - Risk attaching vs. losses occurring
 - Retentions
 - Exclusions
 - Inuring reinsurance
 - Reporting requirements
- Once reinsurance is determined to apply, special attention needs to be taken on the reinsurance reporting requirements.



The Anatomy of a Reinsurance Claim

Examples of Notice Clauses

- The Company shall give notice to the Reinsurer, as soon as reasonably practicable, of any occurrence which results in, or is likely to result in, a claim against this contract, and the Company shall keep the Reinsurers advised of all subsequent developments.
- Whenever a claim is reserved by the Company for a subject loss amount greater than \$5,000,000.00 and/or whenever a claim appears likely, in the Company's opinion, to result in a claim under this contract, the Company shall notify the Reinsurer.



The Anatomy of a Reinsurance Claim

Reporting the Reinsurance Claim

- When to Report: Now? Depending on reserves?
Depending on injury?
- Who to report to: Broker? Directly to reinsurer?
- What type of Reporting: “Bordereau” or Individual?
- Updates: Every six months or significant event.



The Anatomy of a Reinsurance Claim

Assumed Reinsurance

- Assuming reinsurer receives notice of loss from the ceding company
- Assuming reinsurer, like the cedent, will review its contract to determine if the loss is covered under the reinsurance agreement and that other contractual requirements have been met:
Reinsurance does not always equal coverage.
 - Reported to the correct treaty:
 - Commencement & termination
 - Risk attaching vs. losses occurring
 - Retention met
 - Business Covered clause
 - Definition of occurrence or event
 - Exclusions
 - Warranties
 - Is there “inuring” reinsurance

- ● ● | The Anatomy of a Reinsurance Claim

Assumed Reinsurance (cont.)

- Has the cedent provided sufficient information? Assuming reinsurer may ask questions/seek additional information from the cedent about the claim (policy details, claim details, reserve information) so that the reinsurer can independently evaluate the claim.
- Assuming reinsurer may audit the claim files of the cedent (reserve analysis, internal reports) through the inspection of records clause.
- Right to Associate.



The Anatomy of a Reinsurance Claim

Reinsurance Accounting

- Cedent, through its reinsurance accounting department, will then bill the assuming reinsurer.
- Billings may generate additional questions:
 - Claim related inquiries
 - Billing related inquiries
- Final Billing: Ceding company should also send out a closing notice to the reinsurers.

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Two Key Principles in Reinsurance:

“UTMOST GOOD FAITH”(UBERRIMAE FIDES) AND "FOLLOW THE FORTUNES"

Mitchell S. King



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“Uberrimae Fides” or the Duty of Utmost Good Faith and Fair Dealing:

- A heightened and reciprocal duty of care owed by and between a reinsured and its reinsurer based upon the reliance and dependence existing between the parties given the nature of the relationship;
- Derives from the “marine rule” of underwriting which requiring an affirmative duty on the party seeking insurance to disclose all information potentially material to the risk where the insured risk;

- ● ● | “Uberrimae Fides” or the Duty of Utmost Good Faith and Fair Dealing (cont.):

- In the reinsurance context the rule applies to all aspects of the relationship from contract formation and renewal to claims handling.
- A key element of the doctrine is that notwithstanding the existence of reinsurance, the cedent is obliged to act in the same manner as it would act if it had no reinsurance.



"Follow-the-Fortunes"

- Often expressly stated in the reinsurance agreement. Even where not expressly stated, it is generally recognized that it is inherent in the nature of the agreement.
- As a general rule, the follow-the-fortunes doctrine requires a reinsurer to indemnify a reinsured for any payments made by the reinsured for claims covered by the underlying policy, by settlement or adverse judgment, as long as those claims are not fraudulent, collusive or made in bad faith. *See, e.g., Commercial Union Ins. Co. v. Seven Provinces Ins. Co., Ltd.*, 9 F.Supp.2d 49 (D. Mass. 1998), *aff'd* 217 F.3d 33 (1st Cir. 2000); *Travelers Cas. & Surety Co. v. Gerling Global Reins. Corp.*, 2005 U.S. App. LEXIS 17526 (2d Cir. 2005); *North River Ins. Co. v. ACE Am. Reins, Co.*, 361 F.3d 134 (2d Cir. 2004)
 - Under this rule, a reinsurer cannot dispute the good faith determinations that a risk was covered under the underlying policy, or a good faith interpretation of the policy terms.

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Common Problems and Issues in Reinsurance

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Notice:

- Most reinsurance treaties and facultative certificates provide for some type of notice of claim. Older reinsurance contracts tended to be vague but more modern reinsurance contracts often have rather specific requirements as to precisely what sort of notice must be given and under what circumstances.
- As a general matter, those clauses containing express “condition precedent” language will be strictly construed.
- Reinsurers may raise a late notice defense as grounds for avoidance, particularly in connection with complex and large claims and particularly where there is a related right of disclosure and/or association.
- Late notice defenses become very contract- and fact-specific.



Right of Inspection:

- Virtually all reinsurance treaties provide that reinsurers have the right to inspect or audit the records of the reinsured business.
- The scope of the right and timing of inspection may become the subject of disputes.
- Some contracts provide for the right to “associate” in the defense. In practice this is rarely exercised and the reinsurer relies upon the cedent’s good faith obligation to handle the claim in an appropriate manner.



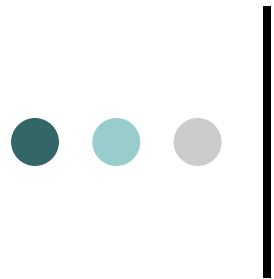
Non-Congruence of Insurance and Reinsurance Provisions and Exclusions:

- Disputes can also arise when there is a difference between the provisions of the insurance policy or policies on the one hand, and the reinsurance treaty or facultative certificate on the other.
- The differences in language between the insurance and reinsurance agreements can involve exclusions, definitions, the policy term, limits or other critical provisions.



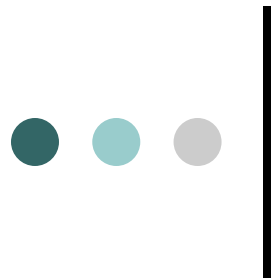
Non-Congruence of Insurance and Reinsurance Provisions and Exclusions (Cont):

- Disputes often arise as to whether a loss fits within a treaty period where the period of the underlying policy and the reinsurance agreement are not identical and where the terms of inception and termination are not identical.
 - An example is where there is a losses occurring versus claims made type contract.
 - Issues also arise where there are run-off or tail provisions in either of the agreements.
- Follow-the-fortunes does not trump an express limitation in the reinsurance agreement, but express follow-the-fortunes provisions may create a “presumption of concurrency” which will require the reinsurer to follow the cedent’s liability with respect to the underlying policy, unless there is clear language in the reinsurance agreement stating that the different provision in the reinsurance agreement controls.



Ex Gratia Payment and Bad Faith Liability

- Where it appears to a reinsurer that an "ex gratia" payment has been made, reinsurers will challenge their obligations under the reinsurance contract absent and express grant of coverage for "ex gratia" payments. The reinsurer's obligation, in general, is to indemnify the insurer for losses properly covered under the policy.
- Where judgments or settlements arguably arise from negligent claims handling, bad faith, etc., absent specific coverage grants in the reinsurance agreement, there likely is no coverage for bad faith payments or payments in excess of the underlying policy limits.



Declaratory Judgment Actions:

- Although many reinsurance contracts contain precise terms outlining the reinsurer's participation in defense costs and expenditures, loss adjustment costs, etc., older contracts are generally silent on the question of declaratory judgment costs and expenses relating to declaratory judgment actions.
 - Modern contracts often expressly address declaratory judgment expenses.
- Under older contracts, ceding insurers generally take the position that declaratory judgment expenses are covered under loss adjustment expense or other expense coverage under the contracts.
- Not surprisingly, many reinsurers point to the failure of the contracts to address declaratory judgment expenses as evidence of the intent not to cover such costs.

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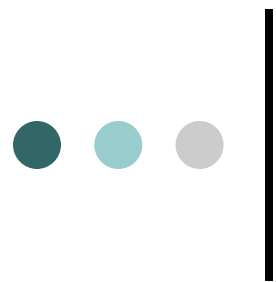


Some Unique Elements Affecting
Reinsurance Litigation:

ARBITRATION CLAUSES AND
CONFIDENTIALITY



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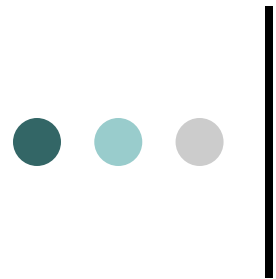
Agreements to Arbitrate and Confidential Proceedings

- The reinsurance industry has used arbitration as a dispute resolution mechanism for many years. The premise behind arbitration in lieu of litigation is that panels of industry experts will have a far better grasp of arcane reinsurance disputes than state or federal judges and juries; and that arbitration will be fairer, less formal and more efficient than litigation.



Agreements to Arbitrate and Confidential Proceedings (Cont.)

- The vast majority of reinsurance treaties contain mandatory arbitration clauses but many facultative agreements do not.
 - Most arbitrations are conducted pursuant to the Federal Arbitration Act but state Acts may govern in some instances.
 - Three-person arbitrations panels are commonly used.
 - So-called “honorable engagement” clauses are common and relieve the panels from following the strict rules of procedure or application of law.
 - Panels often do not issue reasoned awards.



Agreements to Arbitrate and Confidential Proceedings (Cont.)

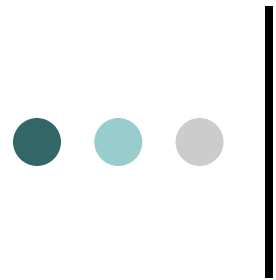
- Reinsurance arbitrations are generally viewed as confidential and it is common for parties to enter into express confidentiality agreements.
- Under the circumstances it is extremely rare for these decisions to be appealed (and even rarer for success on appeal) and arbitrations have little or no precedential value.
- Most published reinsurance case law involves substantive disputes under facultative agreements or procedural disputes under the FAA relating to the obligation to arbitrate, panel formation and powers, and confirmation or review under the FAA.

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On to Battle – Principles in Practice –Scenarios for Conflict

Panel



The Loss – Scenario A

- Mitchell's Never Inn, a popular night spot in New Orleans, is located next to the levee. A hurricane rips off a small section of the roof, causing damage to the upstairs private party room and minimal damage to the main bar area.
- Additionally, the heavy rains ultimately cause the levee to break flooding the streets, the bar, including the bar's basement stocked full of liquor.



The Loss (Cont.):

- Due to the extensive damage to the basement (all the refrigeration and other mechanical equipment is there), the bar is closed for three months to repair the damage to the basement and mechanical equipment. The damage to the party room and the main bar area are repaired in two weeks.
- The bar owner submits a claim for not only the damages to the bar and equipment, but also submits a business interruption claim for the entire three months the bar is shut down.
- Big Heart Insurance Company pays the entire claim under the Windstorm provision of the primary property contract. The claim submitted by the insured is \$1M.



The Reinsurance Claim

- Big Heart Insurance Company was reinsured on a facultative basis by the "Big or Small Deny them All Reinsurance Company" for all losses in excess of \$500,000.00.
- The certificate contains the wording "flood" under the exclusion section.
- The reinsurer utilizes the exclusion to deny payment to the Big Heart Insurance Company.



The Loss – Scenario B

- Fly By Nite Reinsurer provides cover for hurricane damage and excludes flood "as per original policies." Earl Scruggles prevails in a lawsuit deciding that the policy must cover both flood and water damage because both are caused by poor engineering and negligent maintenance of the levees, not flood.
- Must Fly By Nite Reinsurer follow the lawsuit ruling?
- Same facts: The reinsurance contains a "follow the settlements" clause and excludes ex gratia payments. An insured submits a claim for property damage due to flooding, a claim that would ordinarily be outside coverage. However the insured asserts that the insurer has waived its right to rely on the exclusions of flooding from the cover because it advised that the claim was covered. The insurer decides to pay to avoid a bad faith claim. Can it recover under its reinsurance?