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Reinsurance Contracts: *Clause and Effect*

Session #607
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Overview

- **Agenda**
  - Introductions

- **Treaty Inception and Accounting Basis Comparison**
  - Underwriting Year/Risks Attaching
  - Losses Occurring/Accident Year
  - Losses Incurred/Calendar Year

- **Reinsurance Contract Articles**
  - Purpose
  - Things to consider
Treaty Inception and Accounting Basis

- Underwriting Year/Risks Attaching
- Losses Occurring/Accident Year
- Losses Incurred/Calendar Year
Underwriting Year/Risks Attaching
- allocates premiums and losses to the UW year in effect when the policy incepts, regardless of when the loss occurs or the premiums are earned.

- **Loss** allocated to the yr policy incepted (Year 1)
- Premium allocated to yr policy incepted (Year 1)
- Reinsurance typically incepts on **new and renewal** basis and terminates on runoff basis
- Usually, no UEP or losses transferred from yr to yr
**Losses Occurring/Accident Year**

- incurred losses include all claims arising from accidents which **occurred** during the accident year, whether they have been **paid or still open**. Premiums are usually tied to the year in which they are earned, and **losses are tied to the year in which they occur** (these may not necessarily be the same year).

- **Loss** allocated to yr when it **occurred** (Year 2)
- EP from inception of policy to end of Year 1 of reinsurance is accounted for in Year 1. Remaining UEP is accounted for in year it is earned (Year 2)
- Reinsurance typically incepts on in force, new and renewal basis and terminates on cutoff basis
- UEP is usually transferred from yr to yr

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**Treaty Inception and Accounting Basis**
**Treaty Inception and Accounting Basis**

- **Losses Incurred/Calendar Year**
  - generally, **premiums are tied to the year in which they are earned** (in the same manner as in accident year accounting), and **losses are tied to the year in which they are paid**. Unpaid losses are carried from yr to yr as a loss reserve.

  - **Loss** occurs in Year 2, and in this example is **paid** in Year 3, so accounted for in Year 3
  - **EP** from inception of policy to end of Year 1 of reinsurance is accounted for in Year 1. Remaining UEP is accounted for in year it is earned (Year 2)
  - UEP and outstanding loss reserves are usually transferred from yr to yr
Say what?

Huh?!?

What did you say?

read the CONTRACT!
Classes of Business

- Purpose
  - lines or classes
  - insurance and/or reinsurance
  - written or renewed on or after the effective date
  - in force, written or renewed
  - proportional or excess of loss basis
  - automatic or semi-automatic

- Things to Consider
Exclusions

- Purpose
  - perils, lines of business and activities excluded
  - exceptions to the exclusion, which add back coverage
  - intense negotiations
- Common -- war risks exclusion, pools, associations and syndicates exclusion, pollution exclusion, nuclear incident exclusion

- Things to Consider
Commencement and Termination

- **Purpose**
  - **Continuous contract**: when *begins* and when/by whom/how it may be *terminated*
    - anniversary date or another date
    - written notice/number of days prior
  - **Term contract**: specifies an *inception date* and an *expiration date*
  - **basis for attachment** of coverage, similar to:
    - **losses occurring contracts** - “losses occurring” or “losses arising out of occurrences commencing”
    - **risks attaching contracts** - “losses arising under policies allocated to underwriting years commencing”
    - **claims-made contracts** - “claims made against and/or reported to the company”
    - **losses incurred contracts** - “losses incurred” or “claims incurred”
Commencement and Termination continued……

- Purpose cont…
  - basis of termination
    - Runoff: reinsurer’s liability for business in force at the effective time and date of termination remains in place for a specified period of time
    - Cutoff: reinsurer’s liability ceases with respect to new losses after the effective time and date of termination

- Things to Consider

Read the Contract!
Special Termination

- Purpose
  - **early termination** if a specific event occurs
    - either party’s option or solely at the option of **cedent**
  - common **triggers**: 1) change of ownership by the other party; 2) a rating downgrade of the other party; 3) cessation of writing business; 4) insolvency of the other party; or 5) a specific change in policyholders’ surplus
  - **notice period** for terminating
  - **basis** (usually cutoff)
  - **impact** of termination on:
    - premium and loss previously paid
    - premium scheduled to be paid
    - minimum premium
    - reinstatement premium

- Things to Consider
Retirement and Limit

• Purpose

• **Excess of Loss Contracts**
  - Ultimate Net Loss (“UNL”) **retained** before recovery
  - per risk, per policy, per person, per loss occurrence
  - any **deductible** ceding company must pay prior to application of retention
  - any **sub-limit** or **annual aggregate limit** to reinsurer’s liability
  - **underlying policy limits**

• **Pro Rata Contracts**
  - **percentage** of net liability the ceding company will retain and percentage it will cede to reinsurer (cession percentage)

• Things to Consider
Retention and Limit continued………

• Cession % versus Co-Participation % (placement %)
  ➢ Don’t confuse cession % (quota share cession %) with the co-participation % (term used if contract partially placed)

80% quota share 80% placed?
(64% of ceding co’s liability ceded)

OR

Is it intended to be 80% QS, 100% placed?
(or 100% QS, 80% placed)
Reinsurance Contract Articles cont....

- **Ultimate Net Loss/Loss Adjustment Expenses**
  - **Purpose**
    - **Excess of Loss Contract:**
      - sets out all *losses* to which retention and limit are applied
      - *indemnity loss* (after deduction of salvage and recoveries for inuring reinsurance)
      - loss adjustment expense (vs being covered pro rata in addition to UNL)
      - extra contractual obligations, and/or losses in excess of policy limits
    - **Quota Share:** N/A (“net liability” is used)
  - **Things to Consider**
Loss Adjustment Expenses

- **Purpose**
  - allocable to the *investigation, defense and/or settlement* of specific claims, including *litigation expenses* and *interest on judgments*
  - *not including* office expenses or salaries of regular employees
  - may enumerate covered expenses such as:
    - *court costs*
    - *declaratory judgment expense*
    - *subrogation, salvage and recovery expense*
    - a pro rata share of *salaries and expenses* of *field employees* in accordance with the *time occupied* in adjusting
    - expenses of employees who may be *temporarily diverted* to field adjustment
Loss Adjustment Expenses (LAE) continued…..

• Purpose
  • Excess of Loss Contracts
    • Unless excluded, LAE are:
      • part of the ultimate net loss ("UNL"); or
      • pro rata basis in addition to UNL; or
      • hybrid possible, if some LAE reduce policy limit (that LAE covered part of UNL, rest can be pro rated) or if LAE treated differently between classes of business
  • Where?
    • definition of UNL IF part of, or
    • loss and LAE article specifies LAE is covered pro rata in addition to UNL

• Pro Rata Contracts
  • usually same % as indemnity losses
  • if a monetary cap on losses ceded, should specify whether LAE is included within cap

• Things to Consider
Extra Contractual Obligations/Excess of Policy Limits

- **Purpose**
  - Extra contractual obligations (ECO)
    - obligations incurred outside the coverage provided by policies
    - resulting from faulty handling or defense of claims ("bad faith")
  - property or liability contracts
  - Losses in excess of policy limits (XPL)
    - losses covered under the policy, but which exceed the policy’s limits

- ECO/XPL both:
  - may include a provision for coinsurance
  - severability language is typically included in this article ~ punitive damages

- Things to Consider
Loss Occurrence Definition

• Purpose
  • Casualty business:
    • a series of one or more occurrences, accidents or disasters arising out of or caused by one event
    • with products and completed ops or WC business, occurrence definition may need to be modified
  • Property business:
    • hourly limitations on length of occurrence usually used

• Things to Consider
### Loss Notices and Settlements

- **Purpose**
  - *reporting requirements* of ceding company to reinsurer
  - **Excess of Loss Contracts**
    - losses reported *individually*
    - typically, must report losses that *exceed retention*, or - 50% of retention, or - as otherwise agreed
    - claims cooperation
  - *payment* requirements in excess contracts
- **Pro Rata Contracts**
  - losses typically reported monthly or quarterly
  - often includes a *loss bordereau*
  - will also include reports and remittances article

### Things to Consider
Reinsurance Contract Articles cont....

- Other Reinsurance
  - Purpose
    - to ensure the accurate application of the reinsurance contract’s coverage
    - inuring coverages ~ what reduces the loss flowing through the contract
    - specifies the underlying coverages
    - stand-alone article/additional paragraph in the retention and limit article

- Things to Consider
- **Premium**
  - Purpose
  - **Excess of Loss Contracts**
    - flat percentage
      - $NWP/collection/NEP$
    - possible minimum
  - **deposit premium** amounts/remittance dates OR
  - **variable premium** ~ rate based on anticipated loss experience ~ a provisional premium is specified and is adjusted upward/downward based on losses
- **Pro Rata Contracts**
  - typically, the **cession percentage** of original WP for subject policies
  - often reflected in original conditions article

- Things to Consider
Commission

- Purpose
  - covers expense in getting business on books (i.e., policy acquisition costs)
  - flat ceding commission - pro rata contracts, or
  - sliding scale or profit sharing ~ affected by the premium and loss ceded
  - excess contract ~ less likely to have flat, may include profit sharing (contingent commission)
  - profit sharing, contingent commission and/or sliding scale commission
    - give ceding company incentive to seek UW profit and to cede profitable business to reinsurers
    - reinsurer’s margin and minimum profit built into the calculation
    - may include features to smooth results over several years (a deficit or credit carryforward, adjustment periods > one year, or IBNR factor to reduce dollar trading)

- Things to Consider

Trying to spice up contracts!
• Reports and Remittances
  • Purpose
    • **what** information to be reported (e.g., premiums, unearned premium, losses, loss reserves, etc.)
    • **frequency** of reporting
    • how remittances due either party will be **calculated** and **paid**
    • prevalent in pro rata contracts (excess contracts typically have premium article which addresses reporting/remitting of amounts due)
    • cession of premium in pro rata cover often handled via original conditions article (article usually does not specify when and how premium will be ceded, but only that the reinsurer is entitled to its exact proportion of premium. As a result, specifics as to **when cessions are made** are included in reporting article.
  • **annual statement**

• Things to Consider
Unauthorized Reinsurers (Funding)

- Purpose
  - If reinsurer not licensed or authorized
  - designed to reduce statutory penalty a ceding company may incur when transacting business with such reinsurer
  - requires funding for reinsurer’s liabilities through various means (at various levels)
  - UEP reserve, if applicable, plus outstanding loss and LAE reserves, plus incurred but not reported (IBNR) loss reserves
  - funding for IBNR sometimes omitted, particularly for alien reinsurers
  - specifies the requirements of LOC/trust account
  - how ceding company can draw upon funds

- Things to Consider
Reinsurance Contract Articles cont....

- **Reinstatement**
  - **Purpose**
    - most often in property *catastrophe* excess of loss contracts
    - reinstatement of reinsurer’s limit when part of limit is *exhausted* due to loss
    - negotiate the **number of** reinstatements available and **cost**
    - can be **free**, but usually calculated based on the **percentage** of limit reinstated and the premium earned (unexpired term of the contract can also be factored in ~ outdated)
    - reinstated immediately after a loss

- **Things to Consider**
Salvage and Subrogation

- **Purpose**
  - how salvage, subrogation, recoveries *shared* with reinsurer
  - **Pro Rata Contract**: reinsurer’s proportionate share under the contract
  - **Excess of Loss Contract**: reverse order of their priority according to participation
  - ceding company’s obligation to **pursue all reasonable** avenues of recovery relating to any loss
  - may provide the ceding company is not required to pursue if it deems it is **not economically practical**

- **Things to Consider**
Commutation

• Purpose
  • provides for cessation of any liability owed by one party to the other party
  • usually seen on long-tail business
  • payment from the reinsurer to the ceding company in exchange for commuting the reinsurer’s liabilities for future losses
  • may specify method for determining value of outstanding losses
  • specify whether the decision to commute must be mutual

• Things to Consider
Sunset

• Purpose
  • time limit for reporting losses to reinsurer
  • losses reported after sunset period are not covered under contract
  • casualty contracts
  • five, seven or ten years….
  • allow the reinsurer to control the “tail” of casualty claims

Things to Consider
Interlocking

- Purpose
  - **prorate** retained loss/reinsurance occurrence limit over more than one underwriting year
  - Example: a contract under which policies are allocated to **different annual periods** based upon their effective or renewal dates, and under which the reinsurance limit is a single amount that applies to each occurrence, regardless of the number of policies involved.

For accounting purposes, each individual policy loss arising out of the same occurrence is allocated to the same annual period as the policy. However, when an occurrence involves **policies allocated to more than one** underwriting year, this provision **prorates** the loss according to **different underwriting years involved**, although the dollar amount of the retention and limit do not change.

- Things to Consider
Federal Excise Tax

- Purpose
  - applies only to those reinsurers subject to the federal (U.S.) excise tax (FET)
  - reinsurer will allow premium to be withheld for FET
  - tax can be recovered where there is a return of premium
  - FET is levied on alien reinsurers, the ceding company is liable for its collection
  - cascading tax to non-exempt retrocessionaires ~ challenged in 2013

- Things to Consider
Reinsurance Contract Articles cont....

- Currency
  - Purpose
    - currency agreed to
    - provides conversion specifics for amounts received in any other currency
  - Things to Consider
Reinsurance Contract Articles cont....

- Insolvency
  - Purpose
    - specifies protocol if ceding company “insolvent”
    - reinsurer will pay amounts due to the ceding company or its liquidator
    - reinsurer must pay all claims allowed against the ceding company, rather than paying only that portion of claims actually paid by the ceding company
    - provides for notice to reinsurer
    - gives the reinsurer the right to investigate and to join in the defense of a claim at its own expense

- Things to Consider
Reinsurance Contract Articles cont....

- Original Conditions

  - Purpose
    - often referred to as “follow the fortunes”
    - historically in pro rata contracts ~ now in some excess contracts
    - reinsurer’s liability is automatic and follows that of ceding company
    - reinsurer and the ceding company each will share in the loss or liability according to its participation under the reinsurance contract (intended even if there are questions related to liability/coverage)

  - **Pro Rata Contract**: may also provide for the basis of the cession of premium (usually same % for premium and liability)

- Things to Consider
Arbitration

• Purpose
  • agree disputes will be submitted to arbitration
  • how arbiters are chosen
  • timelines for the arbitration
  • location of the arbitration proceedings / law governing
  • joining of multiple reinsurers as plaintiffs or defendants
  • expenses of the arbitration
  • “honorable engagement”
  • arbiters need not follow the strict rule of law
  • decision of the arbiters is binding on the parties
  • answers ~ arbitration panel permitted to impose punitive damages and provide for injunctive relief

• Things to Consider
Reinsurance Contract Articles cont....

- **Agency**
  - **Purpose**
    - used when more than one cedent
    - specifies which company is the authorized representative of the other(s) for all notices and monies due the parties under the contract
    - may set forth specific responsibilities of each ceding company

- **Things to Consider**
Q & A

p.s. read the contract ..............

What was that?
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