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Content

In line with the task description paper & presentation deal with the following topics:

1. Types of Reinsurance and the Process of arranging Cover
2. Inconsistencies between Insurance and Reinsurance Coverage
3. Reasons that lead to Inconsistencies or Difference in Cover
4. International and jurisdictional Issues
5. Underwriting Considerations
6. Claims Examples involving Inconsistencies
7. Conclusion

1 Types of Reinsurance and the Process of arranging Cover

Facultative Reinsurance

1. The very basic form of reinsurance: cedant and reinsurer discuss each end every risk on the basis of risk characteristics and coverage they are prepared to grant prior to binding the risk with the insured.
2. Broker(s) may or may not be involved.
3. This procedure should avoid any problems and misunderstandings between the parties involved.
4. However: see loss examples....!

1 Types of Reinsurance and the Process of arranging Cover

Treaty Reinsurance

The process of underwriting a reinsurance treaty is described in detail in the paper. The main characteristics are:

1. The reinsurer is in a remote position from the risks (re)insured.
2. The reinsurer assumes liability for an – at least partially – unknown portfolio at the time of treaty inception.
3. There is no exchange of detailed risk data information. However, the cedant discloses his risk appetite, guidelines, tools etc..
4. In addition the performance of the port-folio is displayed on the basis of comprehensive statistical data.
5. It is all about ***Underwriting the underwriter*** on the basis of
6. ***Mutual trust (People's Business !!)***.

2 Inconsistencies between Insurance and Reinsurance Coverage

This section gives an overview of the topics which may be subject to inconsistencies:

1. The Treaty Period

- » Usually 12 months – whilst insurance policies may have periods from weeks up to several years.
- » 2 different working principles considered: Risks Attaching During (RaD) ⇔ Losses Occurring During (LoD)

2. Underwriting Capacity and Limits – *proportional Treaty*

- » The cedant has only a certain capacity per risk which is defined by the treaty.
- » Cession basis is either Sum Insured (SI) or PML.
- » Usually a limit is defined for the maximal recovery out of a **Nat Cat event** (often also one for the aggregate).
- » Separate limits may be applied for special cases such as e.g. TPL, DSU and/or other cover extensions.
- » Certain perils are subject to accumulation, e.g. nat. cat. and terrorism.

3. Amount of Cover and Limits – *non-proportional Treaty*

The capacity of a non-proportional (XoL) treaty is limited not only by the stretch of the layer(s) but also by the number of reinstatements. An increase in the loss activity in the cedant's portfolio may lead to the treaty being exhausted before the portfolio has naturally expired. Risks which are still live may become unprotected.

4. SI / PML Increase above the Treaty Capacity

- » Large construction projects are often subject to an increase of the SI and/or the PML.
- » The resulting value may exceed the capacity granted by the treaty.

2 Inconsistencies between Insurance and Reinsurance Coverage

5. Policy Cover Period

Treaties on RaD basis often stipulate a maximum length of the insurance period of a policy. Large construction projects may not only be subject to costs increases but also to time extensions beyond the maximum period granted by the treaty.

6. Exclusions in the Reinsurance Treaties

Each reinsurance treaty contains a list of exclusions. The underwriter of the cedant can only write business which is within these boundaries.

7. Payment Terms

- » Insurance policies may dictate claims payment terms which are faster than those defined in the reinsurance treaty between the cedant and the reinsurer.
- » In case of claim pools claims payments are not triggered by a loss happening and may be avoided by reinsurers.

8. Non-Renewal of Treaties which are not on RaD Basis

A reinsurance treaty may not be renewed for a certain reason. Risks which are still live may become unprotected.

9. Cedant's Entities

Sometimes an impressive list of legal entities can be found under the section "Reinsured" of a treaty – especially in the case of a very large cedant. It is important that this list is kept up-dated in case of e.g. reorganizations.

3 Reasons that lead to Inconsistencies or Difference in Cover During the Underwriting Process

1. Covered Business

Sometimes standard covers – e.g. CAR – include extensions which are excluded by the treaty. Such extensions may be required by local market practice (example: employers liability).

2. Exclusions and Clauses

- » Are all the relevant clauses clear to the underwriter of the cedant?
- » E.g. NMA1975 – this clause may be tricky to understand if not used on a regular basis.
- » Definitions may not always be clear - e.g. “Wet Risks”?

3. Capacity and Limits (can be either SI or PML based)

- » How is the PML determined (cover extensions, 100% DSU, etc.)?
- » Cession of TPL (part of scenario or in the same proportion)?
- » Other limits: e.g. CBI (depending on type, sometimes even excluded), policy period limitation, etc.

4. Miscalculation of the PML

In case of a large loss the cover provided by the treaty may not be sufficient:

- » Very clear in case of a XoL treaty: amounts in excess of the ceiling are on behalf of the cedant.
- » In case of a pro-rata treaty at least a dispute may be triggered about the sharing.

3 Reasons that lead to Inconsistencies or Difference in Cover During the Policy Period (Treaty on RaD Basis)

RaD based treaties have the advantage of granting cover for a risk during its entire life span. Nevertheless, “fire and forget” is not a reasonable practice:

1. Most typical Problems

- » Risk Exposure: SI / PML of a risk may increase substantially (delays, project changes, ...) beyond limits.
- » Policy Period: may increase beyond limits granted by the treaty for the same reasons.

2. Possible solutions

- » Special acceptance.
- » Purchase of facultative coverage.

3. Additional Restrictions by Reinsurers

Even though reinsurance conditions provided by a treaty on RaD basis remain stable until expiry of the last risk, there are exceptions. Reinsurers may be forced by law to impose additional restrictions with immediate effect, *sanctions* for example.

Simply buy fac. ??

4. Considerations about fac. Purchase

- » Shall the fac. part be placed retro-actively as from policy inception? How about losses already happened?
- » “Filling” up the treaty before buying fac.? How about a surplus treaty (=> cession rate)?
- » Fac. on non-prop basis? => How would this be done in case of a pro-rata treaty

3 Reasons that lead to Inconsistencies or Difference in Cover During the Policy Period (Treaty on LoD Basis)

LoD based treaties provide coverage during (usually) 1 year for the entire live portfolio, no matter of the underwriting years of these risks. Whilst long-term project policies remain unchanged over the time, reinsurance conditions may change. This requires attention by the underwriter and the reinsurance manager of the cedant.

1. Change of SI or PML

A (relative) change of the SI or PML (compared with the treaty capacity) can happen due to either an increase of the project value or a reduction of the treaty capacity.

2. Changes of limitations for NatCat, SRCC/Terrorism and other Cover Extensions

Same as above: all these limitations could be changed from year to year.

3. Additional Restrictions by Reinsurers

The terms of the reinsurance treaty can be changed from year to year. It can happen that live risks fall out of scope which have been underwritten completely inline with the treaty conditions of the time of underwriting.

4. Management of Special Acceptances

- » Spec. acc. are usually granted for one treaty period unless stipulated otherwise.
- » Long-term project risks under a spec. acc. must be submitted each year to reinsurers.
- » If a spec. acc. has been granted for the full life time of the risk, the spec. acc. must still be reported to reinsurers as there may be a change in the panel and a new reinsurer must be aware of such risks (he might even have decided otherwise had he known that such risks are part of the portfolio...).

5. Discontinuation of the Treaty

Non-renewal of the treaty may result in some risks remaining with no reinsurance coverage. Possibilities:

- » In-built run-off option of the treaty to be triggered (if any).
- » Run-off facility with some reinsurers.
- » Fac. purchase

4 International and jurisdictional Issues

A survey under some insurers and reinsurers has been made regarding the following topics:

1. Law and Court Jurisdiction / Litigation

- » No serious systemic problems found.
- » *Governing Law Clause* and *Jurisdiction Clause* are a must for a RI treaty. Otherwise a court may have to apply the law which it would normally not use.
- » Facultative reinsurance often subject to UK law and jurisdiction.
- » A *Follow the Fortunes Clause* is desirable from the standpoint of the cedants.

2. Arbitration

- » No adverse experiences detected.
- » It may be hard to find qualified arbitrators/umpires.

3. Ex gratia Payments

- » Loss scenario: nat. cat. event, followed by looting => the latter may not be covered by the treaty. Are claims handlers and IT systems capable to manage this differentiation?
- » It has been commented that the definition of “Ex Gratia Payments” may not always be clear.
- » Total exclusion ⇔ prevention of court proceedings.

4. Language Problems

- » Translation of a wording is always a problem, but usually a prevailing language is stipulated.
- » Beware of automated translation tools!
- » Standard London market clauses => local language => back to (bad) English language...

4 International and jurisdictional Issues

5. Regulation

- » No bad experiences have been reported.
- » Cedant and reinsurer may be subject to different regulators.
- » A cedant subject to Solvency II rules may have difficulties with a reinsurer which is not.
- » In case of sanctions the reinsurer(s) could be subject to stricter guidelines than the cedant.

5 Underwriting Considerations – Cedant's Underwriter

The topics picked up by this section of the paper have already been touched in the previous sections. There may also be some repetitions; but it is the intention to only comment on issues which are relevant in the context of the paper.

It is not the intention to provide general underwriting guidelines for insurance underwriting.

1. PML Assessment

- » Common understanding between cedant and reinsurer of how the PML is calculated is crucial.
- » Avoid full utilization of the treaty capacity!

2. Long-term Risks

- » Periods may be extended beyond time limits granted by the treaty.
- » Also in case of RaD based treaties it has to be ensured that RI cover is always in place: a reinsurer may cease to exist...

3. Sanctions

- » Sanction laws precede (re)insurance conditions.
- » Cedants should monitor the portfolio and discuss potential issues with the insured and the reinsurer.

4. Nat Cat

- » Exposures to be tracked and accumulated.
- » Be aware of limitations provided by the treaties: RaD ⇔ LoD / interlocking.

5 Underwriting Considerations – *Cedant's Underwriter*

5. Difficult Clauses – Terrorism as an Example

- » Widely used London market or Munich Re clauses may not be in line with requirements of local legislations.
- » E.g. the Turkish law stipulates that a military rising may be understood as an act of terrorism. Property losses caused by this event had to be covered by insurance policies and reinsurance coverage turned out being insufficient for this.

6. Special Acceptances

- » Usually granted for one insurance period but may also be taken out subject to automatic renewal.
- » It is crucial to monitor risks reinsured under a special acceptance.
- » LoD based treaties: changing treaty conditions may require special acceptances for already live risks.

5 Underwriting Considerations – *Reinsurance Underwriter*

The reinsurer is in a rather remote position from the individual risks. Besides the actuarial assessment of the figures provided by the cedant, the reinsurer also want to discuss generic aspects in order to get a high degree of comfort:

1. Overall Strategy of the Cedant
 - » Top line ⇔ bottom line
 - » Importance of the engineering LoB: independent ⇔ only support to other LoBs (opportunistic)
2. Organization of the Engineering Department
 - » Key people: knowing them personally / background
 - » Reporting lines
3. Guidelines
 - » Risk appetite: types of industries/risks/covers/ regions
 - » Processes: referrals,
4. Tools
 - » Pricing
 - » Nat Cat: accumulation, modelling
 - » Risk grading
5. Common Understanding of Treaty Items with the Cedant
 - » E.g. PML setting
 - » E.g. background of treaty changes requested by the cedant
 - » E.g. cession of DSU losses

6 Claims Examples – *Hydroelectric Power Plant in LatAm*

1. The Risk

- » Very large project. The policy affected was issued for initial phase: a dam and a tunnel.
- » Sum Insured: \$ 200 mio.

2. Loss

- » Collapse of ca. 360 m³ during excavation of the head race tunnel.
- » Repair costs: \$ 5'750'000. Amount accepted by L/A: \$ 3'771'231 before policy cond.

3. Problem

- » 5 reinsurers under a London Market Slip + another reinsurer under a different slip.
- » Different covers specified by these slips!
 - London Market Slip provided coverage for Sue & Labor; no coverage under the other slip. This coverage, however, was relevant in the context of freeing the TBM.
 - London Market Slip did not limit debris removal to 10% of the loss whilst the other slip did so.
- » Parties involved were unaware of the differences until the L/A submitted his report.

4. Adjustment (100% figures after deductibles)

- » Adjusted value London slip: \$ 1'209'574
- » Adjusted value other slip: \$ 484'397

6 Claims Examples – *Operational Power Plant in LatAm*

1. The Risk

Thermal power plant with several boilers fired by heavy fuel oil.

2. Loss

» One steam turbine generator failed by over-speed and caused a fire. The fire affected the whole plant and destroyed most of the process control system (PCS). Some generators have been replaced (destroyed or damaged beyond economic repair). The reinstatement of this PCS was a major delay factor.

» MD loss: \$ 40 mio

» BI loss: ca. \$ 26 mio

3. Problem

» Local policy => 9 R/I slips with varying conditions, placed through 3 different broker.

» Local policy was different from all the slips, wider in cover.

» Some slips excluded MB !

» Differences in deductibles and limits.

4. Adjustment

» No unity could be reached between all reinsurers involved => several adjustments on the basis of the different covers resulting in a *shortfall of \$ 4 mio against the local policy.*

» The local insurer could not afford to cover this gap.

6 Claims Examples – *Road Construction Project in Oman*

1. The Risk

A new road was to be built in a flood prone area and crossing several wadis which were known being exposed to floods.

2. Loss

A severe flood has severely damaged 8 sections of the road.

3. Problem

- » The cedant presented a L/A report to reinsurers requesting payment in full.
- » However, the R/I slip was very clear: coverage based on Munich Re standards with Sections Clause 106 (referring to 3 sections à 500m).
- » On the other hand, the local policy included an “amended” Clause 106 where the reference to road works had been deleted => it did not suit the circumstances and provided coverage for the full loss (8 sections).

4. Adjustment

- » Reinsurers did not accept loss adjustment on the basis of the local policy.
- » The cedant paid 100% of the admissible claim.
- » The basis of recovery paid by reinsurers was *10% of the admissible claim* only.

6 Claims Examples – *Power Plant Construction in CIS*

1. The Risk

New HEPP to be built in one of the CIS countries.

2. Loss

- » An unexpected heavy flood event in spring time caused damage to the dam under construction.
- » Loss according to L/A: between \$ 1 mio and \$ 1.5 mio.

3. Problem

- » Local currency basis for both, the original policy and the R/I slip. Both had a currency clause. However, they referred to differed dates for the RoE:
 - Primary policy: date of claim settlement
 - RI slip: date of loss
- » Considerable RoE fluctuations during loss settlements.

4. Adjustment

Claims settlement on the basis of the primary policy was higher than on the basis of the R/I slip.

7 Conclusions

In facultative reinsurance arrangements serious problems often arise when placing brokers do not properly mirror insurance conditions in the R/I slip. This situation may be aggravated where more than one broker and more than one RI slip are involved.

It should be the responsibility of the cedant that slips are compatible with the insurance conditions. Furthermore, the broker(s) must be held accountable for any differences between the R/I slip and the insurance policy.

In treaty reinsurance there are several potential inconsistencies to be taken into consideration by the cedant underwriter. The underwriter should have a long-term view on his portfolio regarding the development of long-tail risks. The purchase of fac. capacity should be avoided in the course of the policy period.

All in all, however, it did not appear that the industry is suffering from a systemic problem.



QUESTIONS ??