Surplus Line
ASSOCIATION OF WASHINGTON

Casualty in Surplus Lines

1710 One Union Square • 600 University Street • Seattle, Washington 98101-1129 • (206) 682-3409 • FAX (206) 623-3326

CASUALTY IN SURPLUS LINES

Impossible amount of material to cover in a short class. Attachments are provided for some specialty classes to familiarize you with some of the coverages and classes commonly written in the Surplus Line area. Keep in mind, though, that many companies that write this same coverage may have a completely different set of conditions. Accordingly, you should pay attention to the general concepts and know the specifics are examples of what that one company does.

Remember there is no such thing as a standard form for coverage written in the surplus line market. These companies may use ISO and other standardized forms, but that is strictly because that is their choice. Even when they use the standard forms, they will endorse the policies to reflect their own-underwriting philosophies.

GENERAL LIABILITY

No handout attached. Most companies start with ISO forms, though some do have their own forms. Even then, though, they are almost always based on the ISO GL form with built-in alterations.

Some rather common changes made by surplus line companies to the GL form include:

- punitive damages exclusion
- defense inside the limit
- deductibles apply to defense costs as well as indemnity payments no medical payments coverage
- contractual is limited
- coverage limited to designated operations or locations

CLAIMS MADE

Coverage trigger is date claim is made against insured. vs. occurrence form, which is date injury or damage occurred.

Retro date

1. Found on most policies, though not all. Some policies, D&O for example, typically do not have Retro dates.
2. Refers to a date before which coverage does not respond. On GL policies, usually the date injury or damage occurred; on E&O policies, usually the date of the alleged act, error or omission.

Definition of claim can vary: written demand, any demand for money or relief, filing of suit, or lodging of a complaint with a regulatory body are all examples. Varies by coverage and company form.

When claim has to be made to Company relative to expiration date in policy: some just leave it as soon as practical. Quite often though, claim must be made and reported to the Company within the policy period. Can be very tight if claim is made against insured in last couple days of policy period.

Extended Discovery Coverage. i.e. tail coverage

1. Applies when claims made coverage ceases. Might be when switch to occurrence form, go bare or close a business Sometimes when moving to a new claims made coverage that has a later retro date than the prior policy.
2. Occurrence or error still has to occur after the retro date in policy.
3. Sometimes term and pricing in policy form but not always: can be up to discretion of underwriter at time application made for extended reporting.
4. May have a free mini-tail, such as 30 days in which to report claim.
5. Usually have to pay in advance and must take place within a short time frame. Non-cancelable once effected.

When switching to an occurrence form, potential gap from something that has already occurred or error made but no claim as yet. Besides Extended Discovery coverage from claims-made carrier, occasionally the new occurrence carrier will provide "nose coverage" for this gap.

Incident or Circumstance Reporting Provisions: some carriers allow insured to report something that might lead to a claim, even though claim not yet made. This provision allows the insured to report a subsequent claim under the current claims made policy, even if it has expired when the actual claim is made.

PROFESSIONAL LIABILITY

Some considerations:

- Usually cover defined professional services; adequacy of definition important.
- Often BI and PD excluded. When coverage is provided, it is for claims arising out of providing professional services: for many classes, such as accountants, real estate agents, et al, exposure covered is financial loss; medical malpractice, home inspectors, architects/engineers are examples of exceptions.
- Application usually becomes part of policy and: a warranty.
- Almost always claims made.
- Most coverages allow for the insured to refuse settlement, unlike other liability coverages; is to protect insured's reputation. Refusing settlement, though, means company will not pay a verdict in excess of what it could have been settled for.
- Plaintiff is usually the client.
- Limits are usually per claim ,with an annual aggregate.
- Deductibles usually per claim with multiple claims arising out of a single act, error omission considered a single claim.

Patent Infringement provides coverage for claims against the insured by someone who alleges the insured infringed on the plaintiffs patent. There is a product for firms that want to buy coverage in case they want to bring suit to uphold their patent rights. Allows them to pay steep costs of hiring an intellectual rights attorney and have paid by the insurer.

DIRECTORS & OFFICERS

Historically, 2 parts of coverage:

1. Corporate Indemnification-where company is able to indemnify the D&O's; most all bylaws allow for such indemnification unless D&O's operated recklessly, illegally or did something else really bad
2. D&O coverage; when corporation can not indemnify, cover D&O's directly; the deductible on this part is often much less than in part 1

Expect more claims to fall under Corporate Indemnification.

Coverage for entity itself happening more often especially non-profits and private companies.

In the past, policies usually were indemnification contracts, with insured expected to arrange for defense and company would indemnify later. Changing now to pay as they go.

Among exclusions, usually Punitive Damages, BI and PD.

Claimants include stockholders, customers, employees, vendors.

Fiduciary Coverage sometimes included

- Covers ERISA-based. Suits.
- Plaintiffs include participants and can be Department of Labor.
- Handling of 401K, pension, profit sharing, life and medical plans all can lead to claims not Employee Benefits Coverage, which only cover claims of an administrative nature.

EPLI

Almost all claims made with a few exceptions at this time. Many coverage forms provide full prior acts, sometimes by listing a retro date but having it refer to known claims, not the date an incident occurred.

Base coverages:

- Discrimination.
- Wrongful termination.
- Sexual harassment.

State of the art now to include all kinds of discrimination, including local laws & may extend to workplace torts, i.e. invasion of privacy, humiliation, etc.

- Intentional Acts Exclusion sometimes found here and in most professional forms innocent party sometimes covered and sometimes not.
- Severability of interest.
- Does exclusion for intentional acts refer to "an" or "the" insured?

POLLUTION

Coverages

- May just cover third party claims or cleanup costs or both; also may cover just off premises, on premises or a combination of both.
- Many of the products refer to specific sites, not blanket.
- More and more occurrence forms: "deemer" clause will limit continuous pollution to a specific time, usually when the pollution first began, so as not to trigger multiple policy years.

Contractors can be those involved with tanks, lead, asbestos or even a plumber, excavator or GC.

Professional coverage for people who also do testing or environmental surveys.

Combination forms available that include GL, professional and pollution; quite often the only part that is claims made is the professional.

Coverage required by Washington State Law; RCW 70.148 for:

- Anyone with an underground tank.
- Not affect above ground tanks.
- Limits required $500,000 to $1,000,000 depending on volume of the tanks.
- Required coverage include BI PD, cleanup costs and must include defense by statute.
- State provides reinsurance if purchase in program they sponsor.

MISCELLANEOUS COVERAGES

Loggers PD

- Used to be a ton written in London: now under $1,000.00 premium in this country as more admitted companies become involved.
- Coverage includes fire fighting expense and trespass, care custody. & control.

Railroad Protective

- Is an OCP policy written with the railroad as named insured: no protection for the contractor who has to buy it.
- Written when contractor works in the railroad's' right of way, even if not cross tracks or do so above or below the tracks.
- Reason for this is the exclusion in the Contractual coverage found in the GL policy includes BI/PD as well as damage to railroad property.

Kidnap & Ransom and Product Recall both written in the London market heavily.

Warranty Coverage

- Cars, appliances, etc.
- When buy extended warranty for multiple years often this laid off to an insurance company.

Riggers

- On hook coverage
- Alternative is to be covered on first party basis by installation floater but then lose defense and loss of use coverage.

UMBRELLAS AND EXCESS LIABILITY

Excess coverage is a follow form policy that warrants the Underlying policies' conditions, though almost always have some additional endorsements.

Umbrella is a separate policy with its own set of coverage conditions.

- If picking up a claim here that is not covered in underlying policy then usually a self-insured retention applies; most common figure $10,000.

Most people think of umbrellas as being broader but not necessarily so; broad underlying with restrictive umbrella would result in the opposite; always chances of gaps.

Umbrellas often include following form endorsements, which mean they will not cover anything beyond what the underlying carrier does in the affected coverage; for example following form Personal injury would mean the carrier is making sure their form does not go beyond the primary policy's coverage.

REINSURANCE

Heavy use in the Surplus Line arena.

Bordereaux: used in surplus line area with MGA' s also; usually monthly reports of what written, certain terms and usually separate claims bordereaux.

Would suggest becoming familiar with some of the basic terms including quota share, excess of loss, treaty, facultative, gross and net lines, retrocession.

Stop Loss

> One example is the medical and provider area; in this state started as a Casualty coverage though also now a health coverage. In medical, reinsure a self-insured employer for health insurance provided their employees; can be over specific claims or an aggregate amount of claims. For the provider, insures a hospital or other health care entity who receive flat amounts of revenue per patient against large costs.

RISK RETENTION ACT

Applies to Casualty coverages, including auto only: not property

States not allowed to inhibit (though they often try).

Still have to make filings and pay taxes and fees; special affidavit gets used.

EXCESS LIABILITY vs. UMBRELLA

I. Umbrella Liability

   A. Increases limits of liability afforded to policy holder by
      1. Provides Excess over scheduled underlying policies
         a. Usually on following form basis.
         b. If not following form, umbrella definitions and conditions apply regardless of terms on underlying.

      2. Provides Excess over liabilities not scheduled on underlying policies and not otherwise excluded.
         a. Rarely cover any known exposures.
         b. May be subject to a self insured retention.
         c. Umbrella definitions and conditions determine scope of coverage.

   B. If Marine coverages are included it is known as Bumpershoot coverage.

II. Excess Liability

   A. Increases Limits of Liability
      1. For only specified coverages usually identified by underlying policies.
      2. May be excess over an SIR but this is usually a significant amount unlike the SIR for unknown coverages in an umbrella.

   B. When preferred
      1. Where certain known exposures are not covered in the underlying policies.
      2. When conflicting definitions or other terms could afford coverage under an umbrella where it does not exist in the underlying policies.

A Glossary of Reinsurance Terms

Bordereau (plural Bordereaux): A form providing premium or loss data with respect to identified specific risks which is furnished the reinsurer by the reinsured.

Burning Cost: A term most frequently used in spread loss property reinsurance to express pure loss cost or more specifically the ratio of incurred losses within a specified amount in excess of the ceding company's retention to its gross premiums over a stipulated number of years.

Cede: When a company reinsured its liability with another, it "'cedes" business. Ceding Company: The original or primary insurer; the insurance company which purchases reinsurance.

Cession: The unit of insurance passed to the reinsurer by the ceding company; it corresponds with the policy units of any insurance company. A cession may accordingly be the whole or a portion of (a) single risks or (b) defined policies or (c) defined divisions of a policy as agreed.

Commutation Clause: A clause usually found in Lloyd's treaties, which provides for estimation, payment and complete discharge of all future obligations for reinsurance losses incurred regardless of the continuing nature of certain losses such as unlimited medical and lifetime benefits for Workmen's Compensation.

Contingent Commission (or Profit Commission): An allowance payable to the ceding company in addition to the normal ceding commission allowance. It is a predetermined percentage of the reinsurer's net profits after a charge for the reinsurer's overhead derived from the subject treaty.

Cover Note: A document issued by an agent or a broker which tells the insured that the agent or broker has effected the insurance described therein. Since there are often delays in issuing, a cover note gives the insured a description of what insurance the agent or broker has put in effect. A cover note is similar to a binder although a binder has greater validity, being a document issued by a company or its agent instead of one given by the broker to his customer.

Excess of Loss Reinsurance: A form of reinsurance which indemnifies the ceding company for that portion of the loss (arising out of a loss occurrence) which is in excess of a stipulated sum or primary retention of the ceding company. Excess of Loss is the normal form of reinsurance of liability risks, but it also has special applications in all branches. It should never be confused with Surplus, which in reinsurance always refers to a pro rata distribution of the original coverage when it exceeds specified amounts.

Ex Gratia Payment: A payment made for which the company is not liable under the terms of its policy. Usually made in lieu of incurring greater legal expenses in defending a claim. Rarely encountered in reinsurance as the reinsurer by custom and for practical reasons follows the fortunes of the ceding company.

Facultative: Facultative reinsurance means reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the "faculty" to accept or reject each risk offered.

Following the Fortunes: The clause stipulating that once a risk has been ceded by the reinsured, the reinsurer is bound by the same fate thereon as experienced by the ceding company.

Gross Line: The amount of insurance the company has on a risk including the amount is has reinsured. Net lines plus reinsurance ceded equal gross lines.

Net Line: (1) The amount of insurance the company carries on a risk after deducting reinsurance from its gross line; (2) The maximum amount of loss on a particular risk to which an insurer or reinsurer exposes itself without reinsurance.

Over-Line: A commitment by an insurer or reinsurer above and beyond its normal facilities or capacity.

Overriding Commission: An agent or a general agent may have the sole privilege to represent a company in a certain territory and have a contract whereby he is entitled to a commission on any business which a company may write in his territory or through one of his sub-agents. That portion of the commission which the general agent or supervising agent keeps is termed the "overriding commission." The terms Overriding Commission and Overwriting Commission are interchangeable. In reinsurance, the broker who receives a commission for placing a retrocession of a reinsurer through yet another broker receives an overriding commission.

Per Risk Excess Reinsurance: Retention and amount of reinsurance apply "per risk" rather than on a per accident or event or aggregate basis.

Pool: An organization of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, and expenses shared in agreed ratios.

Portfolio Reinsurance: In transactions of reinsurance, it refers to all the risks of the reinsurance transaction. For example, if one company reinsures all of another's outstanding Automobile business, the reinsuring company is said to assume the "portfolio" of Automobile business and it is paid the total of the unearned premium on all risks so reinsured (less some agreed commission).

Quota Share: The basic form of participating treaty whereby the reinsurer accepts a stated percentage of each and every risk within a defined category of business on a pro rata basis. Participation in each risk is fixed and certain.

Reinstatement Clause: When the amount of reinsurance coverage provided under a treaty is reduced by the payment of a reinsurance loss as the result of one catastrophe, the reinsurance cover is automatically reinstated usually by the payment of a reinstatement premium.

Reinstatement Premium: A pro rata reinsurance premium is charged for the reinstatement of the amount of reinsurance coverage that was reduced as the result of a reinsurance loss payment under a catastrophe cover.

Reinsurance: The practice whereby one party called the Reinsurer in consideration of a premium paid to him agrees to indemnify another party, called the Reinsured, for part of all of the liability assumed by the latter party under a policy or policies of insurance which it has issued. The reinsured may be referred to as the Original or Primary Insurer, or Direct Writing Company, or the Ceding Company.

Retention: The net amount of risk which the ceding company or the reinsurer keeps for its own account or that of specified others.

Retrocession: A reinsurance of reinsurance. Example: Company "B" has accepted reinsurance from Company "A", and then obtains for itself, on such business assumed, reinsurance from Company "C". This secondary reinsurance is called Retrocession.

Self-Insurance: Setting aside of funds by an individual or organization to meet his or its losses, and to absorb fluctuations in the amount of loss, the losses being charged against the funds so set aside or accumulated.

Slip: The piece of paper submitted by the broker to the underwriters at the "boxes" in the "room" at Lloyd's of London on which the Syndicates accepting the risk are identified and the extent of their participation is noted.

Stop Loss Reinsurance: A form of reinsurance whereunder the reinsurer reimburses the ceding company for the amount, if any. by which the latter's incurred losses during any calendar year for a specified class of business exceeded a specific loss ratio. Used particularly in classes of insurance with wide fluctuations in losses from year to year, such as hail insurance.

Surplus Line: A term originating in property insurance, commonly used to describe any risk or part thereof for which there was no available market to the original broker or agent. Now generally translated to mean business, which would otherwise be subject to regulation as to rate or coverage, placed in non-admitted markets on an unregulated basis in accordance with the Surplus or Excess Line provisions of state insurance laws.

Surplus Relief: The use of admitted reinsurance on a portfolio basis to offset unusual drains against policyholders' surplus. The ceding company recaptures equity in unearned premium reserves on the business ceded through the ceding commission allowed by the reinsurer against the gross premiums ceded.

Surplus Share: A form of proportional reinsurance where the reinsurer assumes pro rata responsibility for only that portion of any risk which exceeds the company's established retentions.

Treaty: A general reinsurance agreement which is obligatory between the ceding company and the reinsurer containing the contractual terms applying to the reinsurance of some class or classes of business, in contrast to a reinsurance agreement covering an individual risk. For different forms see Quota Share, Excess of Loss, First Surplus, Second Surplus, Spread Loss, Stop Loss, and Catastrophe.

Ultimate Net Loss: This term usually means the total sum which the assured, or any company as his insurer, or both, become obligated to pay either through adjudication or compromise, and usually includes hospital, medical and funeral charges and all sums paid as salaries, wages, compensation, fees, charges and low costs, premiums on attachment or appeal bonds, interest, expenses for doctors, lawyers, nurses, and investigators and other persons, and for litigation, settlement, adjustment and investigation of claims and suits which are paid as a consequence of the insure loss, excluding only the salaries of the assured's or of any underlying insurer's permanent employees.

Underlying: In respect to Excess of Loss coverages, refers to that amount of risk which attaches before the next higher layer of insurance or reinsurance.

Working Layer: An area of excess reinsurance in which loss frequency is anticipated. The rating approach to such a layer is usually on a retrospective basis.

Comparison of Risk Retention Groups and Purchasing Groups

Issue	Risk Retention Groups	Purchasing Groups
Formation of entity	RRGs form as liability companies which retain risk	PGs are groups of insurance buyers who retain no risk; PGs purchase liability insurance from admitted insurers, surplus lines insurers or RRGs
Homogeneity	Members of RRGs must be engaged in similar businesses or activities that expose them to similar liability exposures	Same for PGs
Type of coverage permitted By LRRA	LRRA provides for third party commercial liability i.e., general liability, product liability, professional liability, etc.; LRRA excludes workers comp, property and personal lines	Same for PGs
Membership requirements	Members of RRGs are owners/insureds	Members of PGs typically have no ownership interest in entity
Capitalization of entity	RRGs are capitalized by member/insureds	PGs require no capitalization by members
Policy issuance	RRGs issue policies to member/insureds	PGs do not issue policies; policies are issued by the PGs insurer
Reinsurance	RRGs typically cede a portion of risk to reinsurers	PGs are typically not concerned with reinsurance
Fictitious Group Laws	States are prohibited from applying fictitious group laws to RRGs	Same for PGs
Countersignature laws	States are prohibited from requiring RRGs to comply with countersignature laws	Same for PGs
Licensing by domiciliary state	RRGs must be licensed under the laws of one state known as their domiciliary or chartering state	PGs must identify their state of domicile but are not licensed
Registration with non-domiciliary states	RRGs must file their plan of operation or feasibility study with all states in which they intend to operate	PGs do not file plans of operation but must register with all states in which they intend to operate, providing specified information to state insurance departments
Use of Agents/Brokers	Some RRGs make direct placements through officers, directors, or full time employees of the RRG while other RRGs use licensed agents and brokers; LRRA prohibits discrimination against nonresident agents/brokers	LRRA permits states to require use of licensed agents and brokers but prohibits discrimination against nonresidents. Most states issue nonresident surplus lines licenses (or the equivalent) for placement of coverage in PGs insured by surplus lines insurers
Guaranty Fund Protection	RRGs do not participate in state guaranty funds. Most states require that RRGs place a notice on their policies in 10 point type advising policyholders of this fact	Where a PG is insured by an insurer admitted in the state guaranty fund projections are typically the same as for non-PG situations. Many states require nonadmitted insurers of PGs to place a notice on the policy in 10 point type advising that guaranty fund protection is not available
Payment of Premium Tax	States can require RRGs to pay premium tax on risks written in the state at either the admitted carrier rate or the surplus lines rate	States can require payment of premium tax on risks written in the state at either the admitted carrier rate or the surplus lines rate
Discrimination	States are prohibited from discriminating against RRGs	Same for PGs
Name of Entity	LRRA requires all RRGs to incorporate the words “Risk Retention Group” in name their name	There is no legal requirement for PGs to use words “Purchasing Group” in name their name

Loggers Broad Form Property Damage

This is a property damage coverage form specifically designed for the unique needs of the logging and lumbering industry. Originally a Lloyd's coverage form and a number of standard carriers now offer an endorsement to their CGL policy to address these needs. In some cases the endorsement form is not as broad as the Lloyd's form.

Unique coverage extensions are:

Coverage for Fire Fighting Expense arising from insured's negligence.

Care, Custody and Control provided for:
- Timberlands and Timber whether standing or felled
- Trucks, Trailers RR cars while being loaded

Railroad Protective Liability

This coverage is an O&CP liability form. It is designed to cover the indemnity requirements of a railroad company when work is being performed for the railroad or within the railroad right of way.

The CGL form limits contractual liability from work done within 50' of a railroad. This policy is how that exposure is addressed.

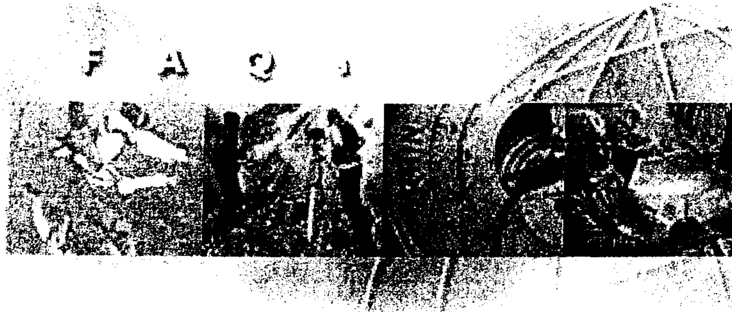
Key features of the policy are:

Named Insured: The Railroad Company

Coverage Limitation: Applies only to contract designated

Covers acts of: Railroad, Contractor and sub contractors

Provides: Broad contractual liability
Covers acts or railroad employees in a supervisory role for the work being performed.
Covers CCC under a separate coverage form specifically for property of the railroad to include tracks, cars, signal lights, etc.



Governance/Regulation
Financial Strength
Operations/Participation

Governance/Regulation

How is INEX governed?
INEX is governed by the INEX Board of Trustees under the management of an Executive Committee. The Executive Committee is comprised of three(3) public trustees. Among other responsibilities, the Board and the Executive Committee establish the qualifications and requirements for INEX underwriting participants and INEX brokers.

Financial Strength

How is the financial security of INEX participants regulated?
INEX offers underwriting freedoms not found elsewhere in the states, but it is regulated much the same as traditional insurance operations-with some additional built in safeguards.

All participants file financial statements and actuarial certifications with the Illinois Insurance Department, just as other licensed insurance companies do. In addition, participants are subject to reserve and surplus ratio regulations as mandated by the Board.

All participants also contribute to the INEX Insurance Exchange Guaranty Fund, a non-statutory guaranty fund maintained to pay certain claims in the event of syndicate insolvencies.

Operations/Participation

What types of underwriting facilities are best suited for INEX?
Facilities seeking easy, efficient entry to excess and surplus lines capabilities in a large number of states are ideal. INEX is also optimal for investors seeking integrated insurance-financial risk structures that until INEX, could only be transacted offshore.

What is the criteria for approval as an underwriting participant on INEX?
Potential participants must have experienced management,

documented business plans, and adequate capitalization. Capitalization requirements range from a minimum of $30,000 to $15 million for applicants interested in writing multi-line E and S business consistent with The NAIC Surplus Lines Model Act. Also, the applications of all qualified candidates are subject to the approval of the Board of Trustees and the Executive Committee.

How much does it cost to apply and to participate at INEX?
After a non-refundable $1,500 application fee, listed participants pay an annual fixed operating assessment fee of $150,000, plus a percentage of gross premiums written.

In addition, all participants are required to establish a $1 million custodial account for the INEX Insurance Exchange Guaranty Fund, a non-statutory guaranty fund maintained to pay certain claims in the event of syndicate insolvencies. This deposit may be included in the participant's surplus.

Special assessments may also be levied in extraordinary circumstances at the discretion of the INEX Board of Trustees.

How do investors become underwriting participants?
Interested investors should complete the Application for Admission As An Underwriting Participant. The Board typically acts on each completed application within 30 days.

Can any broker take advantage of INEX?
Yes, any Illinois licensed insurance broker can place business with INEX.

What is the maximum liability as an underwriting participant at INEX?
Participants assume liability solely based on the risks they choose to underwrite. Individual participants are not liable for the risks of other participants. However, a participant's Guaranty Fund account is exposed to liability equal to $500,000 per insolvency, up to a maximum limit of $1 million.

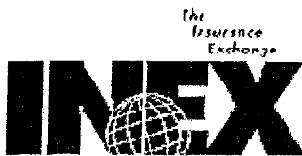
What if I want to stop participating as an underwriting member?
An underwriting participant may cease underwriting and become an inactive member responsible for payment of the fixed operating assessment only; or file a petition to withdraw with the INEX Board of Trustees and pay the appropriate withdrawal fees outlined in the INEX Regulations.

Does the INEX Guaranty Fund protect only Illinois insureds?
No. The Guaranty Fund protects policyholders in all states in which INEX has authority to transact business, up to an

aggregate limit of $15 million per one insolvency, $300,000 per claimant and $10,000 for unearned premium.

What are the competitive advantages to membership on INEX?

- Lower cost of capital
- Capitalization
  $30,000 - Limited Syndicate
  15,000,000 - E & S Syndicate
- Flexibility of application process - Ease of market entry
- Operations of the Exchange are under the control of its Board of Trustees
- The application process is determined and conducted internally
- Underwriting and management agreement terms are determined internally
- Freedom of form and rate
- There exists no requirement for regulatory review or approval of form or rate
- Admitted status in Illinois
- Premium Tax Benefit - There are no premium taxes for business placed in Illinois
- No residual market charges
- Control of leverage ratios
- Operational requirements such as premium to surplus ratios, retained risk minimums and maximums, are controlled internally
- Determination of accredited reinsurance
- There are no excise taxes on reinsurance
- Internal control over expenses of marketplace
- Operational expenses are determined internally



216 West Jackson Boulevard
Suite 975
Chicago, IL 60606

1-800-525-8471

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A LOOK AT REINSURANCE AND HOW IT AFFECTS YOUR INSURANCE PROGRAM

In this Letter, we take a look at reinsurance and why it is important to your insurance program.

CATASTROPHES PILING UP

As we were in the process of writing this Letter about reinsurance, a 9.0 earthquake and deadly tsunami struck Japan. These events were followed by the near meltdown of several nuclear reactors. While the economic loss will be huge, most of the attention has rightly focused on the human tragedy from the flood as well as the dangers that the reactor breakdowns posed.

> The amount of insured loss is unclear, but Japanese domestic insurers, reinsurers, and the government clearly will bear the brunt of the insured loss to residential properties and small businesses. International reinsurers will likely bear much of the insured loss by larger businesses. (Catastrophe bonds might also play role.) A big hit to reinsurers would be a concern because they have incurred losses from a number of costly catastrophes lately.

For natural disaster losses, reinsurers typically pay between 25 percent and 30 percent of the gross losses on an aggregate basis. The larger the loss event, the greater the share that will likely be passed on to reinsurers. Reinsurers paid a reported 60 percent or more of the insured losses from the September 11 terrorist attacks and 61 percent of the 2005 losses from Hurricanes Katrina, Rita, and Wilma. In the 2010 earthquake in Chile, reinsurers incurred 95 percent of the insured loss. This year, reinsurers have been hit by several catastrophes.

> Among the uncertainties that could affect both the primary insurance and reinsurance markets in the months ahead, the potential for major catastrophes ranks pretty high. How long you continue to enjoy a soft insurance market will depend in part on how long insurers continue to enjoy a soft reinsurance market. Too many catastrophes of too great magnitude could harden reinsurance, and insurers will pass those costs on to you.

ROBERT MONTGOMERY, CPCU, AU, Editor • MEIKE OLIN, CPCU, CIC, CRM, Technical Editor • LINDSEY CROTEAU, Copy Editor •SUSANNE EDES DILLMAN, Marketing Manager • KELLY COTTER, Circulation Manager • NAKEESHA WARNER, Production Coordinator • ROBERT DAUER, Publisher Emeritus • JOHN C. CROSS, Esq., Publisher

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IMPORTANT TO YOUR INSURANCE PROGRAM

Your insurance program is pretty much dependent on the availability of reinsurance. Reinsurers give the insurance process capacity, financial stability, and underwriting flexibility.

> Many risk managers turn to reinsurers for excess coverage above some type of self-insured program - often for workers compensation obligations.

Typically, the insured absorbs or retains an initial loss up to some predetermined amount - e.g., $250,000 per occurrence or in the aggregate over the policy year - and buys a "stop-loss" policy to protect against catastrophic losses in excess of that amount. (Whether this is truly "reinsurance" or insurance with a retention depends on the program's details.)

A LOOK AT THE BASICS

Under a reinsurance agreement, a primary, or ceding, insurer transfers (cedes) some portion of its obligations under one or more insurance policies to a reinsurer. The reinsurer, in turn, may reinsure some portion of that risk with other reinsurers in a process known as retrocession. Those retrocessionaires may in turn retrocede a portion of their risk to others, and so forth.

> Ultimately, many insurance organizations all over the world may have a piece of your risk. For example, after a severe hurricane, as many as 200 or 300 insurers in 50 or more countries may participate in the loss. In this way, reinsurance stabilizes underwriting results by protecting insurers from shock losses or the aggregation of smaller losses that might otherwise jeopardize their capacity to operate effectively - or even their ability to remain solvent.

Reinsurance increases the flexibility of an insurer in the size and types of risk and the volume of business it can accept, consistent with its appetite for risk. An insurer has a limit on the amount of risk it retains, but it can underwrite a much larger limit of liability by reinsuring the amount over that retention. Reinsurance makes it possible for you to deal with smaller, newer, or perhaps more innovative insurers.

TREATY, FACULTATIVE, AND POOL

Under reinsurance treaties, the ceding insurer agrees to cede and the reinsurer agrees to accept a share of business as specified in the treaty. A property treaty might provide that the insurer cede a certain percentage of all commercial properties in a specified territory up to a certain limit. The treaty will exclude classes unacceptable to the reinsurer.

The insurer may go outside the treaty to arrange for separate reinsurance when the insured risk does not fit the parameters of the treaty; e.g., the risk is in an unacceptable class or the amount at risk exceeds the limits of the treaty. Otherwise, the ceding insurer must cede and the reinsurer must accept all risks that come under the treaty's terms.

Facultative reinsurance is negotiated individually for one specific policy of insurance. The ceding insurer has no obligation to offer the business, and the reinsurer is not obligated to accept it.

The facultative underwriter examines the risk and the terms and conditions of the insurance policy being reinsured. The underwriter then decides whether to accept a portion of the risk, under what terms and conditions, and for what price. This type of reinsurance is generally used for unique risks or for risks too large or too hazardous to be handled by a treaty. Sometimes facultative reinsurance is used to protect the treaty by removing the more volatile risks from the treaty portfolio. Of course, facultative reinsurance tends to be more expensive than treaty, in part because it is negotiated on a one-off basis.

A type of facultative reinsurance known as open cover or facultative obligatory compels the reinsurer to accept the portion of any business of a certain class offered by a ceding insurer or a ceding broker. (Business offered by a broker can include insurance written by a number of different ceding insurers.) However, neither the broker nor the ceding insurer has an obligation to offer business to the reinsurer.

In a pool arrangement, a number of primary insurers agree to place all business of a certain type into the "pool." Each member of the pool gets a prearranged percentage of the total premiums and pays an agreed percentage of all losses. Many reinsurance pools have been created to handle specific risks and classes of business: terrorism, marine, aviation, pollution, nuclear, and so forth.

HOW COVERAGE IS STRUCTURED

Regardless of the method used to arrange reinsurance, as discussed above, there are essentially two structures for reinsurance contracts: pro rata (proportional) and excess of loss (nonproportional).

Pro Rata – Shared Risk

Under a proportional, or pro rata, arrangement, the reinsurer pays a percentage of each loss covered by the reinsurance policy. In return, it receives the same percentage of the original premium – less a ceding commission.

The reinsurer may also pay a contingent commission based on the profit earned on the ceded portion of the risk. This is intended to provide the insurer with an additional incentive to produce a profitable book of business.

There are two types of pro rata reinsurance: quota share and surplus share. When reinsurance is written on a quota share basis, a fixed percentage of each risk accepted by the primary insurer and covered by the treaty is ceded to the reinsurer. For example, the reinsurer may agree to accept 80 percent of premium and losses for all policies covered by the treaty.

Exactly how much loss the ceding insurer retains depends on the size of each policy written and the design of the reinsurance program.

Note that a quota share treaty can be written to provide the insurer with variable retention percentages depending on the category of risk. For example, the treaty could provide that the insurer will retain 50 percent and cede 50 percent on policies with limits under $1 million. For larger risks, those percentages might change to 20 percent retained and 80 percent ceded. The key is that parameters and percentages are contracted up-front.

Surplus share pro rata insurance works in much the same way as quota share, except that variable portions of the reinsured policies are ceded. Unlike quota share reinsurance, the reinsurer does not share all risks. If the insured writes a policy with limits under a certain amount, the insurer assumes the entire risk. For risks where a portion of the risk is ceded to the reinsurer, the insurer and reinsurer share the entire risk on a proportional basis.

Under this approach, the primary insurer establishes its line for each risk. How much the insurer can reinsure on any one risk is spelled out in multiples of the retention. In a three-line surplus share treaty, for example, the treaty capacity would be three times the retention, subject to the treaty limit of liability. Under most contracts, the ceding insurer is required to maintain a minimum dollar amount.

Even though the retention is expressed as a dollar amount, it is converted to a percentage, and premium and losses are shared on a pro rata basis. For example, if the insurer retained $500,000 of a $1 million policy, the insurer would retain 50 percent of premiums earned and losses incurred in connection with that policy.In practice, insurers follow a line guide, which specifies how much the insurer will retain on certain types of business.

Excess of Loss Contracts

Under an excess of loss policy, the reinsurer pays only when losses incurred by the ceding insurer exceed some predetermined figure. There are several forms of excess of loss contracts: per risk, per occurrence, and stop loss or aggregate.

> When coverage applies on a per risk basis, the reinsurer pays the loss on an individual risk in excess of a predetermined amount up to a predetermined limit. If coverage is written on an occurrence basis, the reinsurer pays only when the cumulative loss from any one occurrence exceeds the predetermined retention of the reinsured.

One form of excess per occurrence reinsurance is known as clash cover or contingency cover. It affords catastrophe coverage for losses that involve a combination of multiple coverages - such as general liability, auto liability, and workers compensation - from a single event. The terrorism attacks of September 11 are an example of an event that would have triggered clash cover.

> When coverage is written on a stop loss or loss ratio basis, the reinsurer pays when the reinsured's aggregate net losses exceed a predetermined amount or proportion of premium income. For example, an insurer might arrange for reinsurance to cover 90 percent of its losses in excess of a 70 percent loss ratio, up to a 92 percent loss ratio. At that point, the insurer again pays 100 percent of losses. This is sometimes called a loss corridor cover.

Keep in mind that there are variations of both proportional and nonproportional reinsurance arrangements. Insurers and reinsurers can structure a contract in almost any manner to which they mutually agree.

CEDING COMMISSIONS

The reinsurance transaction can help an insurer ease temporary strains on its surplus. An insurer can run afoul of regulators and rating agencies when it writes more business than its surplus can support. Rather than give up business when this happens, the insurer can cede business to reinsurers to keep its net premiums in line with its surplus.

> Under statutory accounting, an insurer must recognize its acquisition expenses immediately, but receives credit for premium only as it becomes earned during the policy period, creating a temporary drain on surplus. To offset this accounting dilemma, the primary insurer can cede a portion of the risk to a reinsurer, receiving a ceding commission and thus enhancing surplus.

When they write business, reinsurers do not incur the same expenses that insurers incur, such as agent commissions and fees, the cost of issuing the policy, the cost of making inspections, and so forth. Therefore, reinsurers share in these expenses by paying the insurer a ceding commission.

Importantly, the insurer can enter the ceding commission immediately as an asset on its balance sheet. For example, assume that an insurer with an initial surplus of $10 million writes $20 million of premium, with a 25 percent acquisition cost of $5 million. Because that premium initially is unearned, the insurer creates an unearned premium reserve of $20 million, reducing its surplus to $5 million:

  $10 million surplus
+ $20 million written premium
- $5 million expenses
-$20 million unearned premium reserve
= $5 million new surplus

Now, let's say the insurer cedes 50 percent of that premium under a pro rata reinsurance agreement, subject to a 25 percent ceding commission. Because the insurer can recognize the $2.5 million ceding commission immediately on its balance sheet, this transaction results in a surplus of $7.5 million. Here's the math:

  $10.0 million surplus
+ $20.0 million written premium
- $5.0 million expenses
-$10.0 million ceded pro rata premium
+ $2.5 million ceding commission
-$10.0 million unearned premium reserve
= $7.5 million new surplus

Note that the terms of ceding commission arrangements are completely negotiable; the amount of ceding commission doesn't have to match the insurer's acquisition expenses as it did in our example. They vary considerably from one treaty to another and are used to make adjustments to the "price" of the reinsurance.

HOW REINSURANCE IS REGULATED

Since the point of reinsurance is to relieve the primary insurer of having to pay more than a portion of the policy limit, it receives an appropriate credit on its annual statement for the amount of loss ceded to reinsurers.

Note that reinsurance does not relieve your insurer of its liability under the policy. It is ultimately responsible for the entire amount of covered losses, whether it can collect on its reinsurance or not.

Therefore, to receive this credit, the insurer must either place its reinsurance with reinsurers licensed or accredited in the insurer's state of domicile. Alien reinsurers must provide acceptable collateral in the form of cash, a letter of credit, or a trust fund.

> If a reinsurer does not meet these requirements, the insurer does not receive a credit to its liabilities on its annual statement. Among other benefits, these requirements provide a strong incentive for insurers to choose their reinsurers with care.

When claims occur, reinsurers are expected to pay their obligations to their reinsureds. Insurers are penalized on their balance sheet for reinsurance recoverables more than 90 days past due.

WHAT HAPPENS TO THE REINSURANCE IF THE INSURER FAILS

One major concern of policyholders is what happens to reinsurance proceeds if an insurer becomes insolvent. When that happens, a court or the insurance commissioner of the state in which the insurer is chartered generally appoints a liquidator or conservator to supervise the insurer's remaining assets.

> Among other things, the liquidator or conservator must establish the percentage of claims that policyholders and other claimants will receive. For example, if the liquidator mandates that claims will be paid at the rate of 20 percent of the adjusted value, the insured would recover $10,000 of an approved $50,000 claim.

How does the reinsurer fit into the picture? Let's say the insolvent insurer had a 50 percent quota share contract. Is the reinsurer liable for 50 percent of the actual claim ($25,000) or 50 percent of the sum actually paid ($5,000)?

> Reinsurers argued that their intent, under a pro rata contract, was to pay only for a pro rata share of the amount actually paid by the ceding insurer to the original insured. Reinsurance contracts are considered contracts of indemnity, as are most underlying insurance policies. This means the contract is intended to respond to actual loss sustained. Many reinsurers took the position that reinsurance should respond only to pay their share of a claim after the insurer has paid the insured - to indemnify only the ceding insurer. If the insurer pays less than "face value" for whatever reason, the reinsurance should respond accordingly.

However, most states generally require reinsurance contracts to incorporate an insolvency clause. These clauses make the full reinsurance payable, regardless of the insolvency of the reinsured. Note that you - as the policyholder - do not have direct access to reinsurance funds, but must stand in line with other creditors.

A CUT-THROUGH CLAUSE GENERALLY DOESN'T CUT IT

Reinsurers sometimes establish a form of direct contractual relationship with a policyholder with a cut-through clause in the reinsurance contract. A cut-through clause or assumption certificate is an agreement between the reinsurer and the primary or ceding insurer.

> It spells out the circumstances (e.g., "in the event that the insurer shall go into the hands of a receiver, assignee, trustee or successor for the purpose of liquidation, or on account of insolvency ...") under which the reinsurer will pay to a third party, other than the reinsured insurer, any amounts that the reinsurer may become liable to pay under the contract of reinsurance.

As a practical matter, a specific cut-through clause permitting direct recourse by a policyholder is rarely found in reinsurance contracts, with the exception of those drawn between members of a group under the same controlling ownership. More typically, reinsurance agreements do not operate in favor of the original insured. They are merely contracts of indemnity, and there is no privity between the insured and the reinsurer, only between the insurer and the reinsurer.

> Cut-through endorsements are not easily obtained – particularly when they are most needed: in the case of an insurer of questionable financial stability. Keep in mind, too, that a cut-through endorsement is only as good as the quality, reputation, and financial stability of the reinsurer and its financial commitment to you. Here's another point: You have to be sure the reinsurance affords coverage for the same perils under the same conditions as the policy in question.

Some courts have invalidated cut-through endorsements as against public policy because they create a privileged class of creditors.

> Cut-though endorsements are mainly used in connection with facultative reinsurance. Here, the reinsurance is being arranged for the policyholder. In such cases, it seems more appropriate for the policyholder to have direct access to the reinsurance.

A FINAL NOTE

Even though you probably don't deal with reinsurers directly, the availability of reinsurance is critical to your insurance program. The best way to address the adequacy of reinsurance and reinsurers is to buy insurance only from financially strong insurers in the first place.

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