REINSURANCE TREATIES

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A reinsurance arrangement presumes a remarkable degree of cooperation between two separate, distinct companies each with its own special identity and corporate personality. As individual companies they can differ significantly in important characteristics, but in their reinsurance relationship they have to function almost as if they were one company. To a large extent this means that the reinsurer agrees to support the specific plans and objectives of the ceding company. Reinsured and reinsurer cooperate to execute the plans of the one for the benefit of the two.

The selection of a reinsurer or reinsurers by a ceding company is a complicated process. The ceding company will want to negotiate attractive financial terms, examine the range and quality of the services offered, and satisfy itself that the reinsurer is a competent and compatible partner, a partner who will help the ceding company attain its objectives.

Parallel to this process of the selection of a reinsurer by the ceding company, the reinsurer(s) under question also evaluates the ceding company in terms of its acceptability as a partner. The reinsurer, realizing its dependence upon the judgment and general business performance of the ceding company, must satisfy itself that it believes the ceding company functions in a sufficiently prudent manner. If a reinsurer is satisfied on these points, an agreement is possible.

The form this agreement takes is a reinsurance contract, agreement or, as it is commonly called, a treaty. This is a multi-purpose document which not only embodies the essence of the relationship but also most of the important details of how the relationship will work. It attempts to define what business is reinsured, allocation of liabilities between the parties on reinsured business, how and when the liabilities are incurred, the interests, rights and obligations of both parties, the financial terms of the arrangement, and at least a broad description of the reporting, accounting and administrative procedures to be followed. Provision is also made for any disputes arising under the agreement to be settled through arbitration procedures.

The treaty is a useful work document defining the terms of the arrangement in a convenient, relatively concise form for all involved in the reinsurance transactions. This is particularly useful for those who may not have been directly involved in the negotiations that preceded the preparation of the contract. It also functions as a statement of the initial understanding between the two contracting parties and as a communication of their expectations of one another. As such, it becomes the prime reference as to how questions and disputes should be settled as they arise over the course of the relationship. In general, it usually provides a satisfactory basis for the resolution of such problems. A critical aspect of the sufficiency of the contract language in resolving questions, is the emphasis placed upon the basic nature of the agreement: that in addition to being a legal document it is a *gentlemen's agreement*. This means that good will and the underlying intentions of the parties are of prime importance in the resolution of issues not specifically addressed by the treaty.

Historically, higher expectations of good will have been imposed upon the reinsurer than upon the ceding company in undefined or ill-defined situations. Most reinsurers have agreed that they should be more flexible and less demanding than the ceding company, which produces the business. But reinsurers, like all commercial entities, realize a need to limit their liabilities to intended ones. The result has been that in recent years, many reinsurers have shown an increased concern about being more precise in defining the liabilities they are assuming, as well as the rights they are reserving and the obligations of the ceding company.

This trend is due in part to changes that have taken place in the insurance industry itself, such as the erosion of the protection offered by the language of conditional receipts and the emergence of punitive damages as possible claim settlement problems. Also, it is a reflection of the greater divergence of philosophies and methods of operating among insurance companies. Reinsurers cannot presume, to the degree they once did, that they and their clients will agree on issues of common concern. By carefully defining what the reinsurer will or will not cover, a wider difference of perspective can be tolerated between the reinsurer and the ceding company without jeopardy to their relationship.

A further reason for the change toward more closely defined treaties is that reinsurance relationships are not as durable as they had been in the past. Formerly, ceding companies changed reinsurers infrequently, but this is no longer the case. For example, with most reinsurance allocated to various reinsurers by plan of insurance, the new business relationship may not survive beyond the market lifetime of the plan reinsured. In the past it was easier for a reinsurer to concede an issue gratuitously on the assumption that any loss incurred could be covered by future profits from the account. Today, the reinsurer may not retain the account long enough to amortize gratuitous losses from future profits. The drastically reduced profit margins currently used in reinsurance pricing only accentuate this problem.

Current treaties, nonetheless, continue to provide generous terms, investing considerable confidence and authority in the ceding company. It would be difficult to find other commerical relationships which are comparable to a reinsurance relationship where one party, the ceding company, can commit the other party, the reinsurer, to such extensive liability exposures with such a free hand. The system works because of the trust the reinsurer places in the ceding company and because of the respect the ceding company has for the interests of its partner, the reinsurer. If either element is missing in a particular relationship, ultimately that relationship won't work.

Let us now examine some of the more important features of a life reinsurance treaty.

Automatic Reinsurance Facilities

An insurer's primary reinsurance outlets usually involve automatic reinsurance facilities under which the company may cede to the reinsurer amounts of reinsurance, up to specified limits, without seeking the reinsurer's agreement or concurrence. Such facilities are essential to enable a company to issue policies in excess of its retention promptly and economically. Most reinsurance is transacted on this basis.

The maximum amount of reinsurance that may be ceded automatically on a particular life is normally related to the ceding company's retention, usually being expressed as a multiple of that retention. In the past the most common multiple was four, with lower multiples being used with companies employing especially high retentions. In recent years, there had been a tendency by some reinsurers to go to higher automatic coverage; six, eight and even ten times retention were not uncommon. This trend, prompted by the dramatic increase in the average size policy being issued by many companies, seems to have slowed.

Automatic coverage may be expressed as stipulated dollar amounts rather than as a multiple of retention. In either event, the reinsurer looks for a reasonable relationship between the ceding company's own exposure on a risk and the exposure it can assign automatically to the reinsurer. It is assumed that this should give the reinsurer some guarantee that the ceding company will act prudently in underwriting a case if it must first bind itself.

Because of this concept, reinsurers require that their clients fill their own retentions before using automatic reinsurance facilities. In the past a minority of reinsurers did provide "limited retention automatic coverage" permitting insurers to split with the reinsurers on a 50/50 basis cases that were within the ceding company's retention but which had borderline features. The emphasis here is on the word "borderline". These facilities usually are no longer available with the problem of insurance applicants at high risk for AIDS.

Exceptions to Automatic Coverage

Typically treaties specify several exceptions to the automatic coverage provided. Many indicate that coverage is limited to residents of the United States and Canada.It is common to exclude group conversions, guaranteed issue business and other forms of coverage where normal evidence of insurability has not been secured. Such policies can be covered by the treaty but they usually require separate negotiations, especially with regard to price, to reflect the higher mortality costs anticipated.

Virtually all treaties employ a restriction commonly called the "jumbo limit." If the amount of insurance applied for plus the amount currently inforce with all companies exceeds this specified jumbo limit, the automatic reinsurance facilities cannot be used and the case must be submitted for facultative consideration. (This means the reinsurer exercises its own underwriting judgement and the reinsurance can be effected only with the reinsurer's approval and at the rating set by the reinsurer.) There are two reasons for this limitation.

When an applicant has a substantial amount of insurance inforce, there is some chance that the reinsurer may already have its own capacity to accept reinsurance filled by business ceded to it by other clients. By requiring facultative submission of the current application, the reinsurer can arrange retrocession coverage, that is, reinsurance coverage for the reinsurer, before it assumes this additional liability from its current ceding company.

Second, underwriting the financial aspects of a risk can be far more difficult than underwriting the physical aspects. When very large amounts of insurance are involved on a life, evaluation of the financial considerations of the risk can become very subtle. Reinsurers, dealing constantly with these cases, feel they develop more sophistication than the typical ceding company. Accordingly, the reinsurer desires to participate in the underwriting action taken on such cases by requiring facultative submissions for coverage.

Another feature often found in treaties today is that automatic coverage is terminated if the ceding company submits the case facultatively. Some reinsurers impose this limitation only if the case is submitted facultatively to other reinsurers, while others terminate the automatic coverage even if the facultative submission is made to them alone. Some reinsurance treaties do not specifically address this point, but most reinsurers would argue that, in the absence of a specific agreement to the contrary, automatic coverage on a life is forfeited once the reinsurance on that life is offered to another reinsurer.

The reasoning behind this position is that an automatic reinsurance relationship involves a bilateral agreement. The company agrees to cede certain defined classes of its business to the reinsurer. The reinsurer in turn agrees to accept the business automatically. One party agrees to cede, the other to accept. However, if the ceding company solicits facultative reinsurance offers from one or more other reinsurers on a particular case, it clearly has withdrawn its agreement to cede that case to its automatic reinsurer and thereby frees the reinsurer from its commitment to accept that case automatically.

Unfortunately, these two limitations are sometimes overlooked by underwriters, both lay and medical, as they assume liabilities beyond their retention. With respect to the jumbo limit, if it is discovered at claim time that there was no automatic coverage at issue time, there is the danger the reinsurer will may disavow liability if it disagrees with the underwriting of the case or if it encounters problems with its own retrocession coverage.

One of the basic strengths of an automatic treaty is that the reinsurer becomes liable simultaneously with its client. However, as we have seen, when a ceding company solicits facultative bids from other reinsurers, it forfeits that benefit. This creates a hiatus in reinsurance coverage until such time as the facultative coverage can be established. This introduces a serious problem with respect to prepaid applications where the insurer may be liable for the insurance under a conditional receipt or temporary insurance agreement. This problem is only heightened in those jurisdictions that ignore the conditional aspects of premium receipts. If a company decides to shop a case facultatively, it is prudent to first terminate any premium receipt liability it has by returning to the applicant any prepaid premium. Otherwise, in the event of a fast claim, the company may find it has no reinsurance in place.

It is, therefore, of prime importance that medical and lay underwriters be aware of these limitations to their reinsurance coverage to avoid committing their companies to liabilities in excess of their retentions without benefit of indisputable reinsurance.

Facultative Reinsurance Facilities

Virtually all automatic treaties also provide facultative facilities for cases that cannot be ceded automatically and for cases where the ceding company wishes to seek the underwriting assistance of the reinsurer. This assistance is often viewed as one of the prime benefits of the reinsurance relationship. In fact, the help a particular reinsurer offers through its facultative services may be the very reason why that reinsurer was chosen as an automatic reinsurer.

While the automatic reinsurer is commonly viewed as a company's primary facultative outlet, insurers often have additional facultative only outlets, expecially when the insurer has only one automatic reinsurer.

Typically, facultative only relationships are not as close or as full as automatic ones. The treaties are often entered into without the full mutual assessment that precedes an automatic relationship, since the commitment is more casual and more contingent. The reinsurance premium basis may be less attractive to the ceding company if the facultative reinsurer tries to reflect the higher expense costs associated with a facultative only account. The rate differential will be even greater if the reinsurer tries to reflect the anti-selection that can be involved where the facultative reinsurer receives the case only when he is the lowest of several bidders.

Facultative arrangements can effectively increase placement rates for ceding companies and improve agent acceptance of underwriting performance. However, facultative reinsurance relationships tend to have the least meaning when the ceding company has a large number of facultative outlets. Sometimes these "shopping" arrangements ultimately prove unworkable from the reinsurer's point of view; because of the large number of competing parties, even the most competitive bidder can end up with a low reinsurance placement or paid-for ratio. Because of the high costs reinsurers incur in facultative evaluations, it is not uncommon for individual reinsurers ultimately to drop out of specific shopping programs. Facultative submissions are similarly expensive for ceding companies and they often drop from their shopping programs reinsurers who infrequently submit the best offer.

On the other hand, facultative only relationships can prove to be very meaningful ones, especially where the ceding company is not merely engaged in a widespread shopping program looking only for the lowest possible rating on a case, but is looking for guidance in its own underwriting direction from its facultative submissions to all reinsurers, automatic and facultative alike.

A facultative relationship is less of a commitment for a ceding company and can permit it to sample how it is to deal with an otherwise untried reinsurer. Also, corporate relationships develop unevenly; sometimes an underwriter may be prepared to work with a particular reinsurer before his actuary is, or vice versa, and the facultative relationship permits a partial association that may ultimately grow to a fuller one.

Commencement & Termination of Liability

A key provision in any reinsurance agreement is the one defining when the reinsurer's liability begins and ends.

With respect to automatic reinsurance, the reinsurer's liability commences simultaneously with that of the ceding company. This is important because it means that the ceding company can entertain applications in excess of its retention, and proceed with underwriting and issuance of its policy without any need to consult its reinsurer. And, as we have noted, if the insurer incurs any pre-issue liabilities through premium receipts it does so with its full automatic reinsurance coverage in place.

When we come to commencement of liability under facultative reinsurance, we find some confusion. It is common for underwriters to speak of facultative "acceptances" suggesting that the reinsurer becomes liable when it communicates to its client that the risk is acceptable to it at the underwriting classification it specifies. In years past when it was usual to submit facultative cases solely to the automatic reinsurer for its facultative consideration, this was a proper characterization. The ceding company "offered" the case to the reinsurer and the reinsurer "accepted" the case. Today it is typical for facultative cases to be submitted to several reinsurers for comptetive bids. In this situation, the insurer is not making an offer but is soliciting offers. There is no reinsurance coverage until the ceding company accepts one of these offers. Many reinsurance treaties don't address this issue directly but ceding companies should be prepared for reinsurers asserting this position.

In recent years some confusion also existed with respect to when reinsurance terminated. Most treaties provide that, except for recapture following a retention increase, the reinsurance would continue as long as the reinsured policy continued in force. As the industry moved toward rapid product innovation and premium reductions, it became common for companies to replace their own inforce policies with their most current competitive product. The problem was that the current product was often reinsured with a company other than the one reinsuring the original policy. Initially there was some feeling that the ceding company should be able to transfer the reinsurance when they reissued the policy. In time, the industry recognized that the principle of the continuation of reinsurance, under which the reinsurer has no right to cancel reinsurance, also restricted the reinsured's right to cancel.Today treaties are commonly explicit on this point.

Administration

Usually the treaty includes at least a general description of how the reinsurance account is to be administered. Today most reinsurance is transacted on a self-administered paper bordereau basis. We are beginning to see the introduction of electronic data transfers which will no doubt be the rule in the future.

Arbitration

While a reinsurance treaty does attempt to define the rights and obligations of both parties, the tone of the document is not legalistic. Consistent with this, the treaty normally provides that any disagreements arising between the parties with respect to any transaction under the treaty will be settled by arbitration rather than being referred to a court of law.

The arbitration provision describes how the arbitrators are to be chosen (one by each part and a third by those two arbitrators), emphasizes the gentlemen's agreement nature of the treaty, normally states there shall be no appeal of the majority decision, and describes how expenses will be handled. Some treaties specify where any arbitration proceedings will be held and the laws of which state will govern the interpretation of the treaty.

Oversights

Epitomizing the special spirit of the reinsurance relationship is the Oversights Clause. This provides that if either party unintentionally makes an error, upon discovery of the error both parties will be restored to the position they would have held had no such error been made.

While this provision protects both parties, it offers especially important protection to the ceding company. If at claim time the ceding company discovers that it inadvertantly neglected to secure the reinsurance it required, this clause will retroactively provide that reinsurance subject to the payment of the back premiums. Absolute guarantees of this nature are rare in other commercial relationships.

Inspection of Records

Reinsurers try to minimize the data they require of their clients. They do, however, reserve the right to review the ceding company's records as they apply to the reinsurance ceded. It is quite common today for reinsurers to conduct underwriting and administrative audits. Generally these audits are welcomed since, if any problems or misunderstandings exist, both parties want to discover this before any claims arise when satisfactory remedies are less available.

Settlement of Claims

While reinsurers sometimes identify certain claim situations where they want to be consulted before the claim is settled, considerable authority to settle claims is usually granted the ceding company. The reinsurer is always prepared to help but tries to avoid dominating the settlement process in recognition of the insurer's more immediate relationship to the beneficiary and agent involved.

Recapture

Underlying many aspects of reinsurance treaties is the recognition that the ceding company has some interests that are superior to those of the reinsurer. One of these is the principle that the ceding company should, under most circumstances, be allowed to keep its full retention and only reinsure the excess over its retention. Reinsurers respond to this principle in the Recapture provisions.

Under the Recapture provision, the reinsurer agrees that, should the ceding company increase its retention, the ceding company should be able to cancel or "recapture" sufficient portions of inforce reinsurance on each individual reinsured life so that it fills its current retention on such lives. The reinsurer, in acceding to this right, usually imposes some conditions of its own.

The most fundamental limitation imposed by reinsurers is a minimum duration qualification for recapture. There are administrative costs for the reinsurer in placing any piece of reinsurance in force. Also, reinsurance financial terms often attempt to support the ceding company's initial expenses in issuing a policy. Further, a reinsurer may feel entitled to a specified profit on any business reinsured. All of these factors will suggest a minimum period for which the reinsurance must be maintained before recapture is permitted.

It should also be noted that if the ceding company wishes to recapture any cases, it must recapture all eligible business. To permit the ceding company to select certain cases or even classes of business obviously would create anti-selection conditions.

Parties to the Agreement

The usual reinsurance agreement is an indemnity type of treaty rather than an assumption agreement. Under an assumption agreement the reinsurer "assumes" the position of the original insurance company and is liable directly to the insured for policy benefits. Under an indemnity reinsurance treaty the reinsurer indemnifies the original insurance company for specified benefits. The reinsurer's obligations are to its ceding company, not to the insured life. Accordingly, the typical indemnity reinsurance treaty contains a statement to the effect that the parties to the agreement are the ceding company and the reinsurer and that the reinsurer has no relationship to the insured, the beneficiary or any other party.

The foregoing are some of the more important provisions typically included in contemporary reinsurance treaties. They repeatedly show the wide ranging authority granted the ceding company and demonstrate the reinsurer's confidence in and dependence on the competence and integrity of the ceding company.