



Katrina and Rita on Our Minds

by R. Michael Cass, J.D., CPCU



■ **R. Michael Cass, J.D., CPCU**, is president and principal consultant for R.M. Cass Associates, an independent consulting firm located in Chicago. Formed in 1987, the practice emphasizes reinsurance and related matters. A graduate of Penn State University and Temple University School of Law, Cass is a member of the New York Bar; the American Arbitration Association's Panel of Neutrals; and a certified arbitrator for ARIAS-U.S. He is past chairman of the CPCU Society's Risk Management Section Committee; a former member of the Excess/Surplus/Specialty Lines Section Committee; and currently serves as chairman of the Reinsurance Section Committee.

As this edition of the RISE newsletter goes into distribution, the hurricanes known as Katrina and Rita are many weeks behind us. However, for those in the Gulf Coast region where these two catastrophic events wreaked havoc, their impact on lives and property will remain for years. The rebuilding has begun and our thoughts and prayers are with all those involved.

As professionals in the insurance and reinsurance industry, many of us will be applying our skills and abilities to deal with the multitude of problems related to these storms. Today there remain many humanitarian issues from the more than half a million displaced individuals and families. I was personally heartened to hear of many stories about our sisters and brothers in the industry who took time out of their lives to help those in immediate need.

It may be months and perhaps years before those working in the reinsurance sector need to deal with the professional issues created by these catastrophic events. For underwriters there may well be year-end disruptions in capacity and pricing. For claims and operations personnel, there will be significant issues in coordinating the reporting and collection efforts of ceding companies as the tremendous volume of claims is assimilated.

Your Reinsurance Section Committee is mindful of the need to consider and present programs and articles of interest that provide valuable information and professional tools in the management of reinsurance-related issues. We believe you will find that the seminars presented over the next year provide useful tools and ideas to be applied in solving the problems we face each day.

Reinsurance Section Programs

Thursday, February 2, 2006

Chicago, Illinois
Half-Day Workshop
"Reinsurance Update"

Thursday and Friday,

March 16–17, 2006

Philadelphia, Pennsylvania

Reinsurance Symposium

"Managing Reinsurance—Cycles, Catastrophes, and Things that Go Bump in the Night"

Tribute to Bruce D. Evans, CPCU, ARe, ARM

After many years of valuable service to our Reinsurance Section Committee, Bruce D. Evans, CPCU, ARe, ARM, has decided to retire from service to the CPCU Society. While I have been acquainted with Bruce for perhaps 25 years or so, it is only in the last five years while serving on the Reinsurance Section Committee that I now fully appreciate Bruce's many significant contributions to our industry. Bruce's commitment to excellence in education will be a standard to which I can only aspire. Thanks, Bruce, for all your help and support! The accolades of your colleagues contained in this issue more adequately express the appreciation that we all have for your many ideas and contributions! ■

“Follow-Form” or “Follow-The-Settlements”— The Annualization of Limits Dispute

by Andrew S. Boris

■ **Andrew S. Boris** is a partner in the Chicago office of Tressler, Soderstrom, Maloney & Priess. His practice is focused on litigation and arbitration of insurance coverage and reinsurance matters throughout the country, including general coverage, directors and officers liability, professional liability, environmental, and asbestos cases. Questions and responses to this article are welcome at aboris@tsmp.com.

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frequently receiving billings under a factually consistent allocation approach. Reinsurers often maintain that the intention of the parties to the reinsurance relationship was to not provide for annualization. In contrast, cedents have historically relied upon the “follow the settlements” doctrine to support an annualization argument. A recent decision by the First Circuit in two companion cases highlights some of the difficulties in addressing this issue. *Commercial Union Insurance Company v Swiss Reinsurance America Corporation*, __ F.3d __, 2005 WL 1503121 (1st Cir. 2005) and *American Employers’ Insurance Company v Swiss Reinsurance America Corporation*, __ F.3d __, 2005 WL 1503218 (1st Cir. 2005).

Succinctly stated, the First Circuit identified the primary issue as whether, under several three-year reinsurance contracts, Swiss Re was limited in the reinsurance provided a single per-occurrence limit on its liability for the three-year policy period or whether the limit applied separately for each policy year, thereby enlarging Swiss Re’s total exposure.

The facts of the case are relatively straightforward. W.R. Grace & Co. (“Grace”) maintained primary CGL coverage with Maryland Casualty Co. The excess liability coverage was maintained by Commercial Union’s predecessor in-interest (“Commercial Union”). The Commercial Union policies included a definition of “occurrence” and specifically “followed form” to the primary Maryland Casualty policies. Of importance, the “follow form” language provided that the terms of the Commercial Union policies would not be construed any more restrictive than the underlying primary coverage. Swiss Re provided facultative reinsurance to Commercial Union. Within the reinsurance contracts, there were “follow form” provisions, stating that except as “otherwise specifically provided” in the certificate, Swiss Re’s liability would “follow” or “be subject” to the “terms and conditions” of the Commercial Union policies. In addition, the reinsurance contracts contained “follow the settlement” clauses.

In the late 1990s, Grace and Commercial Union settled a coverage dispute

As the insurance industry has experienced a proliferation of long-tail claims, there has also been an increase in the number of challenging coverage questions. One coverage question that has a significant impact on reinsurance is how to apply the limits in a multi-year policy to a continuous injury claim. More specifically, the query involves a situation involving multi-year excess or umbrella policies and the determination of whether the excess insurer should be responding on an annualized basis with new limits for each year or treat the claim as one occurrence spanning the years of the policy. The difference can mean a significant sum, which is not lost on reinsurers. With settlements of large underlying claims allocated on an annualized basis, reinsurers are



concerning some of Grace's underlying environmental liabilities. A fundamental component to the settlement was that each per-occurrence limit should be viewed as applying to each policy year, i.e. annualization. In turn, Swiss Re refused to indemnify Commercial Union for the billed amount (based upon an annualization allocation approach), contending that the reinsurance contracts protected it from an annualization calculation.

Presented with opposing motions for summary judgment, the district court ruled in favor of Swiss Re. The court ruled: (1) the annualization calculations were improper; and (2) one occurrence limit should apply over each multi-year policy period. The district court found the "follow form" and "follow the settlements" arguments unpersuasive.

■ ***One coverage question that has a significant impact on reinsurance is how to apply the limits in a multi-year policy to a continuous injury claim.***

The First Circuit Court of Appeals vacated the district court's decision and remanded the matter for further proceedings. As an initial matter, the First Circuit was convinced that the question of how many occurrences were at issue was best determined by evaluating the language of the primary Maryland Casualty policies. Since there was no "occurrence" definition in the reinsurance contract, the court concluded that the analysis of the issue could not be confined to reviewing the reinsurance certificates. Of importance to the court, the Commercial Union policies also followed form to the Maryland Casualty policies and could not contain more restrictive language than was included in such policies. Since the primary Maryland Casualty policies specifically called for the limits of the multi-year-policies to apply on an annual basis, Commercial Union was obligated to utilize an annualization calculation. Thus, the



First Circuit concluded that the follow-form language contained in both the reinsurance contract and the Commercial Union excess policies supported an annualization of the limits.

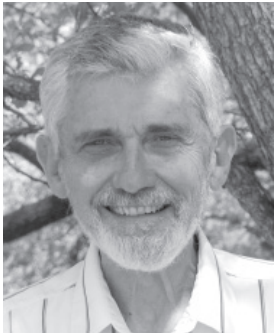
Second, the court also found support in application of the "follow the settlements" provision to the question of whether Swiss Re was obligated to follow an annualization approach. The First Circuit noted Commercial Union's coverage counsel had opined in connection with the Grace coverage dispute that a court would likely find in favor of annualization, if the issue were litigated. In addition, the court noted that the annualization of limits was a fundamental component of the settlement between Grace and Commercial Union. Since there had been nothing provided to support that the settlement was not made in good faith, the court concluded that the follow the settlements provision also supported a conclusion involving annualization.

Of significant importance, the First Circuit specifically noted that if the limits of certificate were sufficiently clear, they would control over an ordinary "follow" clause. In the instant case, the court found the balance was tipped in favor of requiring Swiss Re to indemnify Commercial Union on an annualized

basis since the contracts did not more clearly address the questions presented by the facts of the case. However, the court also commented that the court's decision should not be controlling where a dispute was better illuminated with the use of extrinsic evidence such as premium comparisons, expert testimony, or other evidence relating to pertinent negotiations.

Undoubtedly, the First Circuit's decision will be trumpeted as a major victory by those cedents that have encountered significant difficulties in having their annualization calculations approved by their reinsurers. In addition, many cedents are likely to use this case, as part of litigation and arbitration with their reinsurers, as evidence of support for the strength of the "follow the settlements" provision and its application to allocation disputes. In contrast, reinsurers are certainly going to narrow the application of the instant case since the First Circuit placed significant emphasis on: the "follow form" language at issue in the relevant contracts; the applicability of clear limits within a reinsurance contract, and the specific notation that extrinsic evidence could have changed the result of the case. ■

Tributes to Professor Bruce D. Evans, CPCU, ARe, ARM



■ Bruce D. Evans, CPCU, ARe, ARM

"I have known **Bruce D. Evans, CPCU, ARe, ARM**, for longer than I can remember. We first met before he became an academician while with Transport. I had the pleasure of serving with Bruce on the first Reinsurance Section Committee. He made such an important contribution in those early days. The idea of interest sections was not embraced by many in the CPCU Society at that time. There were three initial pilot sections—Risk Management, Claims, and Reinsurance. We were never sure that the CPCU Society would adopt the idea of sections, and vote us a permanent status. Bruce's creation of *RISE* was a critical step in getting final approval of the Reinsurance Section.

"Bruce encouraged (and needled) me to write articles for *RISE*. His critique of the drafts, and helpful suggestions, made the articles worthy of publication. Whenever we met (usually at the CPCU Society's Annual Meeting and Seminars), Bruce was always interested in what I was doing. His camaraderie and friendship were highly appreciated, and important to me both professionally, as a colleague, and more important, as a friend. Thank you, Bruce, for your friendship and dedication to the reinsurance profession. The CPCU Society, the Reinsurance Section, and I owe you a debt of gratitude."

**George M. Gottheimer Jr.,
Ph.D., CPCU, CLU**
President and CEO
Kernan Associates, Inc.

"Bruce Evans is one of my favorite industry professionals whom I came to know and respect during my involvement on the Reinsurance Section Committee. To my way of thinking, Bruce was *RISE*, and *RISE* was Bruce, and his shoes will be very difficult to fill. Bruce, or 'Professor Evans' as I like to call him, is very much a student of our industry, and an invaluable resource for intelligent commentary on issues of topical importance, which he gathered and published in *RISE*.

"More personally, his editorial critique, as applied to the articles, which I submitted to *RISE*, has been extremely helpful in developing my own analytical style, which I have applied to my editor's role for the *Journal of Reinsurance*. Additionally, Bruce's engaging personality and willingness to discuss any and all issues put before him, are traits that I have highly valued during the course of our professional relationship, which I hope will continue for many years to come."

Paul Walther, CPCU, ARe
CEO and Principal Consultant
Reinsurance Directions, Inc.

"I've only known Bruce Evans since 1999, when I first joined the Reinsurance Section Committee. I say 'only' because by today's standards, and considering how long both Bruce and I have been in the industry, this is a mere nanosecond. But in that short time I have experienced many of the admirable traits Bruce brought to the table. I enjoyed his editorial panache as he critiqued articles I had submitted to *RISE* (always in a positive and non-adversarial light). I marveled at his ever-inquisitive intellect, always asking questions, not unlike a Plato dialectic, constantly seeking the best answer or course of action. There is no better example of this than when he led the Reinsurance Section Committee's questioning of the ARe curriculum changes. He was adamant that the quality of the curriculum remain at the highest level. His intellectual integrity was unsurpassed.

"I also had the pleasure of participating as a panelist at one of Bruce's reinsurance seminars at the University of Dallas. His skills as a moderator and discussion facilitator would rival Tim Russert on *Meet the Press*. And then there was the historical perspective that he brought to every Reinsurance Section Committee meeting, which I sometimes kidded him encompassed the entire era dating back to the Galveston Hurricane of 1900. Our committee was blessed to have this tool at its disposal.

"But most of all, I benefited from his warm and genuine friendship. I am a better person and better professional because Bruce Evans touched my life. His are indeed large shoes to fill, and he will be sorely missed."

Richard Thomas Blaum, CPCU
Supervising Claim Consultant
Swiss Reinsurance Group

"In my four years on the Reinsurance Section Committee, I have learned much, laughed often, and been challenged to be a better reinsurance professional and author—mostly at the hands of Professor Bruce Evans. He has been a remarkable asset to the committee and to me personally as a mentor and friend. Although Bruce often begged his fellow committee members to submit written material for *RISE*, I only submitted a few recaps of Annual Meeting or workshop sessions. While Bruce was a tough taskmaster with regard to content, timetables, and format, he was also an extremely fair and accurate editor. I have never seen someone who could cull out a phrase, sentence, or paragraph as confusing or unclear and almost simultaneously read my mind to know exactly what I meant to say and phrase it precisely in the way I should have.

"My greatest pleasure on this committee was being a panelist with Professor Evans and Kevin Brawley at the 2002 CPCU Society's Annual Meeting and Seminars in Orlando, where we presented a session entitled 'Top 10 Things About Reinsurance That Are Misunderstood.'

It was based on Bruce's Reinsurance Basics seminar, spiced up with 10 humorous 'zingers' (as he called them) that we wrote for the occasion and sprinkled throughout the program. Several of the top 10 items were puns that warranted more of a groan than a laugh—but the audience truly enjoyed the presentation! In fact, one audience member came up to me afterwards and said that was the best seminar she had ever attended. I knew then and now that almost all the credit belonged to Bruce—he has a stage presence and a gift for humor that are peerless."

Thomas M. Pavelko, J.D., CPCU, ARe
Contracts and Regulatory Attorney
American Agricultural Insurance Company

"*Reader's Digest* occasionally will carry stories from people writing about 'someone memorable they have met.' Bruce certainly qualifies as one of the most memorable people I have met; and probably he has left that impression with most of the people who have met him. What makes Bruce so different is his genuine enthusiasm for life, and oddly, the study of insurance and reinsurance (for those of you who aren't insurance professionals this probably makes him appear strange). For anyone in the business, talking to Bruce is like watching the History Channel of Insurance. He has thousands of stories, anecdotes about people in the industry, and background on why things are the way they are today. Those of us who have had the privilege of knowing Bruce and serving with him on the Reinsurance Section Committee will miss him and the limitless support he provided to both the section and CPCU Society."

Nicholas J. Franzi, CPCU, ARe
Vice President-Underwriting
American RE

"Bruce Evans has been my guide and friend since I started on the Reinsurance Committee nine years ago. At that time, I was new to CPCU participation, and I was very happy to have someone to cheer me on. Bruce always made me feel my contributions to the committee were important, and helped me to gain the confidence to become even more active in the CPCU Society. This included serving as the president of the New York Chapter, which was a wonderful experience! With Bruce's editorial help, I also wrote several *RISE* articles that would not have been nearly as interesting without him. Thank you, Bruce!"

Diane Naomi Houghton, CPCU
Account Executive
St. Paul Travelers

"The first time I met Bruce I was a young reinsurance underwriter for Nationwide Insurance. He was in Columbus to conduct his famous 'Reinsurance Basics' seminar under the auspices of NAMIC. He had a mixed audience of about 40 people—ranging from experienced managers of small mutuals to new hires at brokers (notably Balis) and large companies. I will always remember his explanation of surplus treaty mechanics. It was the best I ever heard. It certainly helped me analyze surplus treaty submissions, as well as forming a basis for me to train new hires in my own department.

"Bruce's experience as a reinsurance practitioner has enabled him to relate to industry problems and to build upon them as he worked in the academic world. He has weaved stories from his 'company days' into parables that helped bridge the gap from theories to practice. I suspect most senior officers representing buyers and sellers of reinsurance have had the pleasure of participating in one (or more) of Bruce's seminars. Undoubtedly all have benefited from his editorship of *RISE*. His dedication to reinsurance is unsurpassed by anyone I know."

David B. Grant, J.D., CPCU, ARe
Vice President
American Agricultural Insurance Company

"It has been an honor to know and work with Professor Bruce Evans for more than 30 years, especially during the past eight years as we served together on the CPCU Society's Reinsurance Section Committee. Bruce has experienced a great deal during his career; he has learned a lot about the reinsurance business and he knows many people. Everyone along the way has professionally admired and genuinely liked him. And he brought his vast store of experience and knowledge, along with great credibility and visibility to the CPCU Society and Reinsurance Section Committee. We had been fortunate to have such an outstanding colleague on the Reinsurance Section Committee. We will miss his thoughtfulness, his intellectual gravitas, and his leadership in approaching industry subjects with academic rigor.

"The baton has now been handed off. So while we congratulate and thank Bruce Evans for his vision, leadership, and contributions to the Reinsurance Section Committee, we are appropriately challenged to continue the traditions and commitment to excellence that he worked so hard to protect."

Richard G. Waterman, CPCU, ARe
President
Northwest Reinsurance, Inc.

Reinsurance Coverage for Uncollectible Deductibles and SIRs

by William A. Brauer, CPCU, ARe, AIC, SCLA

■ **William A. Brauer, CPCU, ARe, AIC, SCLA**, is a claim director at GE Insurance Solutions, based in Barrington, Illinois.

What happens in cases where the insurer funds or is unable to collect a deductible or self-insured retention (SIR)? Are these payments part of the insurer's "ultimate net loss" in its reinsurance recovery and, therefore, payable by the reinsurer? For many years, SIRs and deductibles have been used as tools by risk managers to reduce their insurance costs, and also by insurers in general to provide their policies with some buffering and/or to reduce loss frequency. These features are becoming more common on longer-tail casualty business, where claims often arise and are ultimately resolved some time after the expiration of the policy.

A self-insured retention is essentially a dollar threshold below which the insured retains all the duties and concomitant financial responsibility arising from a loss. Often, the insured will perform all the duties and functions normally handled by the insurer on claims valued within the SIR. Though the terms are often used interchangeably, a "deductible" is different. In a typical casualty deductible situation, the insurance carrier will respond to a loss and provide investigation, defense, and indemnification as necessary, seeking from the insured reimbursement of the deductible amount specified in the policy.

Two Scenarios

It is not uncommon to find cases where the insured may be unable to fund its SIR or deductible. The insured may be defunct and out of business, or so financially impaired that it cannot meet its commitments. What happens in such situations? The following are two recent scenarios presented from a reinsurer's perspective:

- An auto accident with several serious injuries, one a paraplegic, settled for \$7.8 million. The \$1 million primary policy would not tender until the \$250,000 SIR was paid. The insured was in a precarious financial position. The umbrella carrier took control of the claim settlement, accepting a note for the entire SIR balance from the insured, and then funded the insured's share of the settlement. The note ultimately proved to be worthless. The \$250,000 was included in the billing to the umbrella carrier's excess of loss treaties as part of the overall indemnity payment made by the umbrella policy.
- A surplus lines insurer wrote an extensive contractors book, often over a \$5,000 or \$10,000 deductible. The book of business, much of it in California, has generated an alarming frequency of construction defect claims. In many cases the insurer is unable to collect the deductibles from the insured. Although a recovery from the insured may be pursued, often the carrier is forced to "eat" the deductible.

In both cases, the reinsureds ceded department simply rolled up the paid and billed their reinsurers for their share of the gross incurred loss. The inclusion of the insured's share of the loss may not seem controversial. It is undeniable that it made good business sense to dispose of the cases as described. The plaintiff attorney simply wants cash and does not care from whom. The insurer's failure to step in and take control would be ruinous. The ceded accounting department, in preparing the billings, is only proceeding based on what the company's claim system indicates has been paid.

If called upon to justify the inclusion of these or similar balances in its outward presentation, the reinsured would undoubtedly recite the reinsuring

agreement's "follow the settlements" of "follow the fortunes" clause, or contract language along similar lines as requiring the reinsurer to pay based on the indicated amount of paid loss and/or expense. The insurer will also cite the reasonableness of its funding actions, the possibility of a huge trial verdict, and an even more costly reinsurance claim if the unavailable funds were not fronted by the reinsured.

Despite the fact that the reinsured made a solid business decision to fund such a shortfall, both case law and an analysis of the reinsurance treaties themselves overwhelmingly support an assertion that coverage does not exist under the typical reinsurance treaty for these SIR or deductible amounts.

Legal Precedents

Even in this arcane area, several courts have considered cases involving reinsurance coverage for this sort of funding and ruled in favor of reinsurers. In *Calvert Fire Ins. Co. v Yosemite Ins. Co.* 573 F Supp 27 1983, Yosemite insured the Yellow Cab Co., which had a \$25,000 deductible under its policy. Calvert reinsured Yosemite and initiated a declaratory judgment action after its reinsured demanded that Calvert include the funding of the uncollectible deductibles in its ground-up loss to its treaty. The court held that the reinsurance agreement had to be read to mean that Calvert's liability followed that of Yosemite and that the reinsured's liability as specified in its policy began only after the SIR had been exhausted. In other words, the funding of the SIR is not an obligation of the reinsured policy.

Along similar lines, the court in *Michigan Millers v North American Re* 452 NW2d 841 held that the insured had no liability under its umbrella policy, which did not cover losses below a retained limit, and thus the insurer was not entitled to recover from its reinsurer for amounts it paid to make up a shortfall. This concept

that the reinsurer's obligation extends solely to the reinsured policy is reinforced in *Bellefonte Reinsurance v Aetna* 903 F2d 910. In this case, the court stated that the "reinsurer's liability followed the fortunes of the insurer only within the limits specified in the reinsurance certificate."

Underwriting Considerations

When examining this issue in the context of reinsurance treaty coverage, the agreement's ultimate net loss (UNL) definition, which prescribes what costs are recoverable within a claim made under the agreement, must be reviewed. A common definition of UNL is ". . . sums actually paid by the company in settlement of losses for which it is liable." The company or direct insurer is of course liable only to the extent of its policy obligations, which do not include any obligation to fund SIRs or deductibles—those are/were the insured's obligations.

"Classes of business reinsured" provisions as often seen in reinsurance treaty wordings refer to reinsurance of a company's net *liability* under its policies, contracts, and binders of insurance. Additionally, the reinsuring agreement may also contain a warranty as to underlying coverage as well. "Dropping down" as the insurer does in such funding cases could also be considered to be a breach of such warranty.

Reinsurance treaties often extend coverage for the reinsured's extra contractual obligations (ECO).¹ However, this extension of coverage within the reinsuring agreement is essentially errors and omissions coverage designed to cover damages arising out of the company's conduct in handling the underlying claim matters.² While it is true that ECO coverage applies to damages that are "extra," or outside the policy, the drop-down funding of the insured's portion of the loss is wholly unrelated to the insurer's conduct during the course of the claim. As it is wholly unrelated to any error, omission, or other conduct of the reinsured, it is clear that this coverage is not a basis for reimbursement.

Neither is the so-called excess policy limits (XPL) coverage, also commonly included in reinsurance treaties, a potential funding mechanism. Under typical treaty XPL coverage, the reinsurer explicitly agrees to reimburse its share of sums the reinsured is required to pay in excess of its policy limits. As with ECO coverage, it is the insurer's conduct—often in the form of failure to settle within limits or other behaviors such as waiver and estoppel—that in turn sets the stage for such additional liability on the part of the carrier. However, to be reimbursable under the XPL coverage, it is important to note that, notwithstanding the policy limit restriction, the damages must be otherwise covered under the policy.³ Again, neither the SIR nor the deductible is covered under the policy.

Loss adjustment expense is usually a covered expense under a treaty, whether it is defined to be a part of UNL or shared pro rata. The argument may be made that if the insurer funds the insured's obligations and such payments are directed to payment of loss expenses, why are they not then covered under the reinsuring agreement? The test must be that the insurer would not otherwise have been obligated under its policy to make such payments on behalf of the insured. It is the policy obligations that are reinsured. And, even though the payments would be bona fide loss adjustment expenses to the extent they were the insured's obligations and not the insurer's within the reinsured contract, they still fall outside the treaty coverage.

Conclusion

Ultimately, it is the reinsured's underwriter who is in the best position to evaluate the insured's financial strength. A suitable risk for a program with significant SIRs or deductible features must not only be underwritten based on the insured's loss history, but also on its financial abilities to meet self-funded obligations both now and into the future. Although reinsurers must consider each situation on a case-by-case basis, upon renewal they might be advised to clarify intent on the treatment of SIR or

deductible funding. Where the insured is no longer able to meet its obligations to pay its SIR or deductible (or simply refuses to), the proverbial buck stops with the insurer, which itself must bear the financial loss of such failure.

There are also measures the insurer may take to lessen the chance for default. We have observed that claim departments often wait until the claim is concluded before seeking reimbursement from the insured for the deductible, and this delay undoubtedly exasperates collection issues. The billing could be issued to the insured far sooner within the claim process. ■

Endnotes

1. Such a clause may not be common in non-U.S. covers.
2. In *Ott v All-Star Insurance Corporation*, Wis. 299 NW 2d 839, the court characterized the ECO coverage as insurance, regardless that the coverage appeared in a reinsuring agreement.
3. Michael Elliott, et.al. *Reinsurance Practices*, Volume 1, Insurance Institute of America, pages 85-86. 1990.

Reinsurance—State of the Art

by Nicholas J. Franzi, CPCU



■ **Nicholas J. Franzi, CPCU**, is a vice president with American Re-Insurance in Princeton, New Jersey. He is a graduate of Rutgers University with a B.A. in english. Prior to AmRe, Nick worked for Liberty Mutual, Howden Swann Ltd., and Atlantic Mutual. For the last 23 years, he has been employed by AmRe. His experience at AmRe includes work in claims, statistical, and treaty underwriting. For the past five years, Franzi has been assigned to development of business tools and systems used by AmRe and its parent, Munich Re. Franzi is a past president of the CPCU Society's Central Jersey Chapter, a member of the Reinsurance Section for the last four years, and was appointed editor of *RISE* in 2005.

Top insurance company, rating agency, broker, and reinsurance experts and executives participated in a panel discussion held at the CPCU Society's 2005 Annual Meeting and Seminars held in Atlanta, Georgia. The panel entitled, "Reinsurance—State of the Art," was moderated by **Franklin W. Nutter, J.D.**, President of RAA. The panel was comprised of **Laline Carvalho** (S&P), **Timothy P. Demetres, CPA** (Nonprofits' Insurance Alliance Group), **Mark S. James, J.D.** (Chubb & Son), **William Allen** (Guy Carpenter), and **Robert M. Solitro, CPA** (North American Specialty Co.).

The format of the session was informal, with questions being posed to the panel, and each panelist having the opportunity to respond. The questions posed to the panel were often framed with PowerPoint slides containing information provided by the RAA.

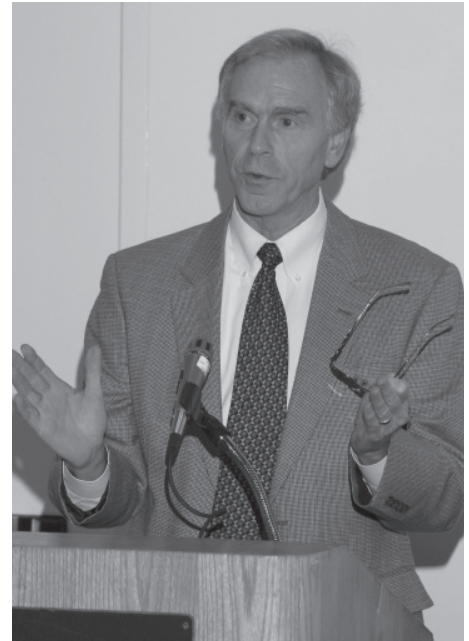
The first part of the discussion focused upon Hurricane Katrina, and that hurricane's effect on the Reinsurance market. The audience learned that six of the 10 largest U.S. catastrophes occurred in the last 10 months, and that seven of the 10 largest cats occurred in the last four years. The panel was asked, "Is this a pattern or an aberration?"

The panel indicated that the reinsurance industry would most likely approach renewals as if this trend were not a phenomenon. We were told that companies are "re-thinking their long-term strategies with regard to writing first-party business," and that they "must begin accounting for the high frequency of events by reexamining their business writings, especially with regard to the lines of business being covered."

RAA information was provided giving current estimates for the damage caused by Katrina. Although the estimates for insured losses still vary widely, it is already believed that the National Flood Insurance Program's losses from Katrina will exceed the total of all losses paid by the program since inception. The figures in Table 1 provided reflected the following distribution.

Table 1

Bermuda	8,700	1.1%
U.S. Primary	8,990	2.1%
Europe	4,400	15.7%
U.S. Reinsurers	3,000	10.7%
Lloyds	2,550	9.1%
Other	324	1.2%
Total	27,964	



■ **Franklin W. Nutter, J.D.**, moderated the panel and provided statistics compiled by the Reinsurance Association of America.

If history is an accurate indicator of what to expect, the current reported losses will certainly be higher. Expectations are that the total insured losses could climb to between \$40 billion to \$60 billion. The panel was asked, "Can the industry handle these losses?"

The insurance industry has shown significant improvement in managing catastrophe exposure since Hurricane Andrew. It is believed that the industry can handle the Katrina losses, and (with the exception of smaller companies writing in only one state) insolvency is not expected to be an issue. The reason the industry is better prepared today is because most primary companies' reinsurance programs are better designed, and recoverables will not be an issue since reinsurance capacity is greater.

Concerns that are being raised as a result of Katrina involve the combination of "blown" cat covers, and the possibility of another U.S. catastrophe prior to year's end. Some of these concerns are:

- The acknowledgement that cat models still have "shortcomings" with regard

to estimating flood and business interruption claims. The panel expects cat models to be recalibrated, and that the “new” versions may result in projected exposures being doubled.

- The potential for political involvement attempting to expand coverage where there is none (i.e. flood versus wind loss). If coverage is expanded, the resulting impact may limit or out-price coverage for many going forward.
- The reversion of risk back to primary insurers if another catastrophe “hits” before year-end due to exhaustion of cat covers. The result of this happening will adversely effect profitability, and, of more concern, the solvency of the companies affected.
- The impact of the high cost and lack of availability related to the purchase of third event covers.
- The impact of the high cost and lack of availability related to the purchase of cat cover during the next renewal.

With many questions still unanswered, the overall effect of Katrina on the insurance and reinsurance marketplace is not fully understood as the panelists spoke.

The next topic covered was TRIA, the Terrorism Risk & Insurance Act. The immediate concern raised was the availability of TRIA after year’s end. It is the opinion of the panel that TRIA will be extended by Congress before the



■ Robert M. Solitro, CPA, and William Allen provided the underwriter’s and broker’s perspective.

end of the year; however, it is expected that the deductibles and triggers will be adjusted to higher levels. The panel voiced the opinion that although the exposures covered by TRIA can be modeled, the responsibility for coverage should be with the federal government, and not the private sector.

Hedge funds were discussed by the panel. Currently, hedge funds make up a small part of the market; however, it is thought that more primary companies will explore the use of hedge funds to solve their cat exposure problems. It was the opinion of one panelist that since hedge funds are a “one and done” deal, and do not provide reinstatements, primary companies may be better served by purchasing cat

coverage having broader terms, and leveraging the long-term relationships with their reinsurers.

Finite Re was the next topic of discussion. The audience was informed about the NAIC’s recent approved recommendations for stricter disclosure requirements, and the implementation of new formulas for determining whether risk transfer is adequate. The panel was asked, “Is finite re a problem, and is there still a market for it?”

Due to the recent negativity associated with finite re, there is currently less desire to purchase finite re in the United States; although that does not seem to be the case elsewhere in the world. In the short term, it is believed that finite re will continue to be used in the U.S. marketplace; however, it is expected that new contracts will demonstrate greater risk transfer at a higher price. The panel expressed an opinion that there are currently no U.S. companies that will be “downgraded” as a result of their using finite re. This opinion is based upon the belief that there will be little financial impact to those companies required to re-state results. The negative consequence expected to befall these companies is believed to be both the drain on resources needed to handle and address perceived



■ Mark S. James, J.D., Timothy P. Demetres, CPA, and Laline Carvalho respond to a question regarding adequacy of current catastrophe modeling tools.

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Reinsurance—State of the Art

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accounting problems, and the significant risk of losing senior people as a result. These potential consequences are seen as being more disruptive and damaging to the companies, than any expected change to the company's results.

With all of the changes being discussed, it was only natural that the panel was asked, "Is the business model for reinsurance changing?" Overall, the panel believes that the model had already changed, and that it will continue to change. The United States is not the center of the

universe. Locations, such as Bermuda and Ireland, that provide attractive tax incentives and flexible regulation will continue to cause a shift in where business and capital are centered. These market dynamics have been evolving since 1997. Today, 49 percent of all U.S. reinsurance premium is assumed outside of the United States. If we were to take into account those U.S. reinsurers controlled by companies outside of the United States, that figure would be closer to 79 percent.

The "State of the Art" session wound down and came full circle with a final reference to U.S. catastrophes. U.S. losses represent a disproportionate percentage of the premium collected worldwide. Reinsurers will require "global" diversity as a means of protecting results, and as a result, reinsurers will view the United States as a "piece" of the overall marketplace. Global markets will continue the trend toward diversity, and capital will continue to move around the globe as a result. ■

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Regulators Say Insurance Industry Is Prepared for Hurricane Katrina's Cost



In a release dated September 2, 2005, the National Association of Insurance Commissioners (NAIC) says that while the damages from Hurricane Katrina may set record losses, the property and casualty industry maintains the adequate capital and liquidity required to withstand claims arising from one of the most devastating natural disasters in U.S. history.

Presently, the U.S. property and casualty industry maintains policyholders' surplus of roughly \$390 billion, and holds assets in excess of \$1.3 trillion. State insurance regulators require insurers to maintain minimum levels of surplus to absorb the volatility inherent in property and liability policy coverages. More than 75 percent of the industry's assets are held in marketable securities.

Helping assure the solvency of the insurance industry is a primary focus of state insurance regulators. As with past disasters, state financial analysts are well underway to assess the financial and operational impact of insurers affected by Hurricane Katrina. Working through the NAIC, states will be sharing assessments of financial strength of individual insurers, and coordinating the appropriate actions to help ensure claims are paid

in accordance with the contracts that insurers have issued.

"These financial results demonstrate that insurers are up to the task of making good on the promises that they have made to American businesses and consumers through their insurance policies," said Diane Koken, NAIC president and Pennsylvania insurance commissioner. "Some smaller insurance companies may experience financial distress, but the overall condition of the industry should remain healthy."

Advancements in computer catastrophe simulation modeling used in recent years have assisted insurers in evaluating expected loss costs from major natural catastrophes like earthquakes, hurricanes, and tornadoes. "Over the last decade, insurers have become more sophisticated in their ratemaking techniques," said Tim Wagner, NAIC chair of the Property and Casualty Insurance Committee and Nebraska insurance director. "In place of historical claims data that insurers traditionally used to price for catastrophic events, computer simulation models are used to develop estimated loss costs associated with catastrophic events, including hurricanes.

Rates are determined using a state's historical loss data for most perils covered by homeowners or other property insurance products with a factor added for catastrophic losses. As a result, most states should not see homeowners and other property insurance rates rise substantially as a direct result of Hurricane Katrina.

Early estimates place insured losses attributable to Katrina in excess of 1992's Hurricane Andrew, greater than any other U.S. hurricane event. These losses will be averaged over a long period of time (typically 30 to 50 years for property insurance) and reflect estimated catastrophe costs. Since insurance rates already include a factor that reflect losses from catastrophes, like Hurricane Katrina, the NAIC does not expect property insurance rates to be significantly affected. It should be noted, however, that loss information from Hurricane Katrina would be added to the bank of knowledge used by catastrophe modelers. This might cause a change in expected loss costs for the gulf coast states. ■

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Save the Date!

Thursday, March 16, 2006 (full day)

Friday, March 17, 2006 (half day)

Reinsurance Section Symposium

featuring Associate in Reinsurance (ARe)
designation ceremony

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Call John Kelly, CPCU, for more information
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