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Past Chairman's Corner

by Richard T. "Rick" Blaum, CPCU, ARe

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He graduated with a bachelor's degree in history from Mt. St. Mary's College in Emmitsburg, Md., in 1972.

Editor's note: Rick Blaum, CPCU, ARe, resigned the chairman's post in May 2008. Thomas M. Pavelko, CPCU, J.D., ARe, was elected by the Reinsurance Interest Group Committee members to replace him. Blaum will stay on the committee to help provide value to its members.

Getting the Reinsurance Interest Group Committee Back on Track

We all know how the landscape has changed over our careers in the insurance and reinsurance industries, a change that has accelerated exponentially during the very recent past. Mergers, acquisitions, synergies, redundancies, restacking, "lean and mean," doing more with less, getting a larger share of the wallet, "on call 24/7," have become an all too familiar part of the vernacular in our industry and our jobs. It is clearly no longer "your father's" reinsurance industry. Add to the equation the responsibilities we all have to our families and communities, and what we face on a day-to-day basis often looks overwhelming.

As a microcosm of the industry at large, the CPCU Society, and by extension the various interest groups and their committees, have also felt these pressures and constraints. Membership is down, and partly because of aging, getting and keeping people engaged are becoming increasingly more difficult; this includes attracting attendees to various educational events.

As corporate budgets for training and education shrink, the competition to put on exceptional seminars and symposia is increasing. At the very least, it is imperative to attract audiences large enough to "break even" financially. It is even more difficult to succeed in attracting talented people to volunteer to commit even more of their time to plan such

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events, recruit speakers, and work out all the logistical details necessary to put forth a truly professional and valuable seminar.

The Reinsurance Interest Group and its committee have not been immune from these factors over the past year. Quite honestly, during 2007 we had several efforts "die on the vine" for various reasons; however, when we met at the Annual Meeting and Seminars in Hawaii last year, we left with a renewed commitment to get things back on track and regain some of the luster we had lost. While it hasn't been easy, I believe we are succeeding.

In February, we co-sponsored the REACH Workshop in Chicago, which was quite successful, despite severe weather problems. After a one-year hiatus, we also succeeded in bringing back our Reinsurance Symposium in Philadelphia. This 1½-day event kicked off with an executive panel representing a primary carrier, a direct writer reinsurer, a reinsurance broker and a brokered reinsurer. A lively discussion covered the latest issues facing our industry. Other topics included: an update on mass torts, the latest in CAT modeling, a discussion on reinsurers' ECO obligations vis-à-vis a ceding company's E&O policy, the Bermuda markets, CAT bonds and contingent capital markets. We also included a ceremony for the recent ARe completers. This event was well attended, well received, and, we believe, quite successful.

In short — "We're back!" And we're also proud to be able to put together such worthwhile educational events, including the "Reinsurance—State of the Art" seminar we presented at the 2008 Annual Meeting and Seminars. I want to take this opportunity to thank all of the committee members who worked so hard and contributed so much to make these last three events so successful. And we plan to keep going … and going … and going! ■

Editor's Comments

by Richard G. Waterman, CPCU, ARe

Richard G. Waterman, CPCU, ARe, is president of Northwest Reinsurance Inc., a Minnesota-based management consulting firm specializing in the fields of insurance, reinsurance, and alternative dispute resolution. In addition to working with both ceding and assuming companies in his consulting practice, he has served as an arbitrator or umpire on more than 110 panels to resolve industry disputes as well as a neutral mediator, facilitator and fact-finder assisting parties to work out differences in a confidential setting. Waterman has been a member of the CPCU Society since 1978, and has served on the Reinsurance Interest Group Committee for nearly 10 years.

Let's celebrate for a moment. The Reinsurance Interest Group was awarded Gold Circle of Excellence by the CPCU Society for 2007–2008. Recognition in the Society's Circle of Excellence Program is earned by engaging in activities that benefit our industry and communities while promoting the CPCU designation. Congratulations to the Reinsurance Interest Group Committee as well as all other members of the Reinsurance Interest Group who contributed to this remarkable achievement.

Receiving Circle of Excellence recognition serves to remind us of the hard work and dedication of committee members who organize, conduct or participate in industry seminars, symposia and workshops or write articles for Web sites, newsletters, magazines or other publications. It is a longstanding goal of the Reinsurance Interest Group to organize and present creative and innovative value-added educational programs that serve the diverse interests of our interdisciplinary interest group membership.

In pursuit of those objectives, once again this year, the Reinsurance Interest Group sponsored a number of excellent educational and recognition events:

- A reinsurance workshop in conjunction with the Chicago-area CPCU chapters and Reinsurance Education and Communication Hotline (REACH) in February.
- A 1½-day reinsurance symposium in Philadelphia in March that featured a luncheon and an awards ceremony honoring recent completers of the Insurance Institute of America's Associate in Reinsurance (ARe) program.
- A successful webinar pertaining to enterprise risk management in June.
- Finally, on Monday, Sept. 8, at the CPCU Society's Annual Meeting and Seminars in Philadelphia, the Reinsurance Interest Group presented Reinsurance—State of the Art, a panel consisting of leading industry executives who discussed opportunities and challenges in today's reinsurance industry environment.

In this issue of *RISE* is an interesting lead article written by **Steven M. McElhiney, CPCU, ARe, AIAF,** entitled "Capital Markets and Reinsurance," which describes how private equity, hedge funds, catastrophe bonds, and industry loss warrants, along with other forms of capital markets, are emerging to provide for growth in available reinsurance capacity. This issue also includes the comprehensive article "Mediating Reinsurance Disputes," written by **Peter A. Scarpato, J.D.,** who explains how mediation can be an effective and efficient means to resolve certain types of reinsurance disputes. Given the increased costs and complexities associated with arbitration and litigation, more and more parties are using mediation to resolve reinsurance disputes. Peter is an exceptionally experienced and qualified mediator, so I'm confident that you will find his insight about the mediation process to be particularly interesting.

In addition, we are fortunate to once again include an article authored by **Andrew S. Boris, J.D.,** a partner with the law firm Tressler Soderstrom Maloney & Priess, that presents a comprehensive analysis of the conflict between the services of suit and arbitration clauses that are found in most reinsurance agreements. You probably have enjoyed reading his discerning articles related to an array of industry topics in previous editions of *RISE*. We always look forward to receiving Andrew's insightful submissions.

And finally, I hope you will enjoy reading my article, "Making Decisions in the Face of Uncertainty," which briefly introduces a fascinating and provocative book entitled, *Why Most Things Fail*, written by economist Paul Ormerod, who delves into the pervasive nature of failure, how patterns of failure are similar in biology and human organizations, and how failure can be highly beneficial.

We invite you to join the Reinsurance Interest Group Committee to be part of a vibrant group of industry professionals. Membership on the Reinsurance Interest Group Committee provides an opportunity for you to apply your professional knowledge to organizing national education programs, writing featured articles for RISE, and demonstrating inclusive leadership and service. For more information about committee membership, visit www.cpcusociety.org or contact the Reinsurance Interest Group Committee Chairman, **Thomas Pavelko, CPCU, J.D., ARe,** by e-mail at tpavelko@aaic.com or by calling (847) 969-2947. ■

Capital Markets and Reinsurance

by Steven M. McElhiney, CPCU, ARe, AIAF

Steven M. McElhiney, CPCU, ARe, AIAF, is the president of the reinsurance brokerage firm EWI Risk Services Inc., based in Dallas and a subsidiary of NL Industries. Spanning over two decades, his insurance industry experience includes senior management roles in leading insurance groups such as Fireman's Fund, Argonaut Group and Overseas Partners Re. McElhiney has served in the role of chief financial officer, corporate treasurer and reinsurance executive. He earned a master's degree in business administration and a Bachelor of Science degree, cum laude, from the University of Southern California; he holds the CPCU, Associate in Reinsurance (ARe), and the Associate in Insurance Accounting and Finance (AIAF) designations. McElhiney serves on the CPCU Society's Board of Governors and three not-for-profit boards in Texas. He can be reached at smcelhiney@ewirisk.com.

During the 1990s, the insurance industry was preoccupied with the anticipated convergence of the insurance and banking industries and how the insurance company business model would need to evolve as a result. In hindsight, the more relevant discussion would have been concerned with the impending convergence of the capital markets and insurance industries, and the transformation it would cause. Currently, there is industry discussion concerning the *pending* convergence of capital markets and reinsurance; in reality, it is a "past tense" event — the convergence has, in fact, occurred and is beginning to radically transform the traditional global insurance carrier and broker distribution models.

2005 was a seminal year relative to this convergence. The unanticipated and unprecedented events of Hurricanes Katrina, Rita and Wilma ("KRW"), with their total $60 billion in insured losses, caused a sudden and material strain on the traditional property catastrophe retrocessional market. This spate of hurricanes, the so-called "frequency of severity," demonstrated the inherent limitations of traditional sources of market capacity and that new solutions, involving capital markets providers, were quickly required. Simultaneously, the capital markets universe was seeing a continued growth in assets and the resultant vehicles available to meet this need. In effect, heightened demand for a new product met an increased supply of capital that was readily available. Thus, when the last hurricane made landfall in 2005, the insurance world was forever transformed.

It is important to clarify the meaning of the term "capital markets." There are several key products of the capital markets industry that are aligned in many common ways but are very different in terms of their focus and intent.

The key areas to be discussed in this paper are:

- Hedge funds.
- Private equity.
- CAT bonds.
- Industry Loss Warrants (ILW).

Hedge Funds and Sidecars

The general concept of institutional investors merits some discussion. Essentially, the world is awash in capital provided from invested funds in various pension, trust, endowment and sovereign equity funds. Much of this has been fueled by demographic trends, particularly in the United States, as the baby boomers have been in their peak asset-accumulation years.

Clearly, much of this overall investment asset segment is deployed in traditional equity and fixed-income investments throughout the major exchanges around the globe. Each of these funds is managed against a benchmark; success or failure in the management of these funds is determined by exceeding the market returns (or applicable benchmarks) over a holding period. This excess return is referred to as "alpha" by Wall Street. The pursuit of alpha has led many of these investment managers and fiduciaries to seek alternate investment vehicles.

One of the key alternate investment vehicles that exists for both institutional investors and high-net-worth individuals is the concept of a hedge fund. While the term has become part of the common vernacular, there is a lot of misunderstanding concerning the precise function of a hedge fund.

The traditional institutional investment mandate has utilized a "long" investment position in equities and fixed-income holdings; that is, the investment intent is to achieve capital appreciation and current income over time, resulting from holding or trading the securities. Such a mandate is highly effective during those periods when capital assets are appreciating.

Alternative investment assets and hedge funds, however, can provide for uncorrelated returns to these traditional "long" stock and bond holdings. In other words, if the stock market is declining due to a general economic contraction, investments in foreign currencies or commodities may actually be increasing. Accordingly, the overall portfolio return available from holding traditional and alternative investments is improved vis-à-vis the return benchmarks that would be the case by being purely invested "long" in securities. Therefore, alpha (superior returns) relative to the benchmarks is achieved. It is this incentive for alpha that has led to the incredible growth in hedge funds.

Hedge funds take several shapes and forms. On a global basis, there are over 8,000 hedge funds of various sizes and complexities. In many ways, this is a much less regulated investment universe than traditional investment managers. Some of the particular investment strategies and mandates of hedge funds include:

- Foreign currencies.
- Commodities.
- "Short mandates" (that is, selling particular financial instruments short with the anticipation of a falling stock valuation).
- "Activist" hedge funds that make strategic investments in companies with the intent of lodging a proxy fight or forcing other strategic changes with a particular investment that unleashes shareholder value.

Increasingly, some hedge funds are emerging that have more characteristics of becoming company "operators" for a longer holding period. Some of these entities have taken major positions in such stalwart companies as Sears Holdings, KMART, GMAC, and other such entities, with the intent of improving the operating results over a long-term holding period for a substantial capital gain upon sale. Thus, some hedge funds are evolving into more of business operators than simply opportunistic investors.

As a general matter, hedge funds tend to be extremely opportunistic, and look for short-term disruptions in the marketplace. While traditional institutional funds seek to minimize volatility, hedge funds are focused upon volatility because it can create very pronounced short-term profits.

Thus, the hedge fund community was quick to embrace the opportunity that was presented post-KRW; the insurance community required catastrophe capacity and the traditional sources of that capacity were limited due to net losses that had surfaced on the reinsurer's own net accounts. Many of the traditional reinsurers in Bermuda, London and the United States were required to access additional capital to shore up their surplus positions subsequent to the massive losses from KRW. Their ability to provide extra capacity, despite the significantly higher pricing that was evident, was limited.

Therefore, during this general time frame, the "sidecar" was created in concert with the hedge fund community. A sidecar is a special purpose investment vehicle that provides quota share reinsurance protection to the sponsor of the vehicle. The insured perils in the sidecar vary and have included multiperil accounts, Florida catastrophe business, Gulf energy risks and other such perils. Sidecars provide limited protection for a short holding period (generally up to three years), at which time they are closed out and profits are distributed. The potential losses are limited to the amount of capital allocated to the sidecar.

While 2005 is noted for the dire impact of KRW upon the industry, the subsequent storm seasons of 2006 and, to a lesser extent, 2007 were fairly benign. A key confluence thus occurred: a substantial amount of new capital was allocated to sidecars (over $5 billion in 2006 alone) in a short period and, concomitant with that, due to the limited storm activity, unprecedented market returns ensued for the investors. The sidecar phenomenon is here to stay.

The key risks of a sidecar investment include the size and capabilities of the sponsor, as well as the tail risk of the exposure, compared to the limited time frame of the investment. In other words, if the sidecar has a three-year life and exposures do not clearly fit into those time parameters, there could be a residual exposure to the cedent. As an industry, we are now more than two years past hurricane Katrina, and those losses continue to be in various stages of adjustment and adjudication (the so-called evolution of property into a "long-tailed" line of business).

Finally, the capital providers for sidecars (primarily hedge funds) are highly opportunistic, and long-term capital support via these mechanisms may not be always available in less appealing pricing environments.

Private Equity and Insurance

Another key element of the capital markets universe is the general term "private equity." Private equity represents a global supply of more than $1 trillion in capital that is available to make strategic investments in companies with the intent of a three- to 10-year liquidity event when those assets are sold, recapitalized, or brought public via an initial public offering.

Typically, a public company is acquired through a private equity offering and taken "private" by substituting one group of owners (public common stock shareholders) with a private equity group. Private equity groups raise funds from a combination of institutional investors (pensions, banks and others) as well as high-net-worth individuals. During 2007 alone, $300 billion was raised by private equity firms. Recently, a few of the larger private equity firms have undergone

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initial public offerings to access the public capital markets (in what may seem to be a bit of a counterintuitive move).

Private equity has impacted the insurance industry in a few ways. Events over the past 15 years have required sudden, material infusions of capital into the industry to allow for reinsurers and primary carriers to recoup underwriting losses and to provide the additional capacity necessary for growth.

Subsequent to 1992 (Hurricane Andrew), the first group of Bermuda-based carriers was launched. While the next five years brought some notable wind activity, these investments proved to be highly successful and profitable to the capital markets investors. Thus, the first major coordinated foray into property-casualty investing by institutional investors was both profitable and operationally successful as the new companies succeeded and quickly grew in the marketplace (although some of the companies eventually merged into other entities). In essence, a new insurance carrier business model was developed in Bermuda with a new set of investors than those who had traditionally backed insurance carrier formations and capital raises.

After the tragic events of the World Trade Center attacks, a second class of reinsurers was formed in Bermuda as billions of new capital was put into new companies, unburdened with legacy liabilities, to allow them to capture the improved pricing environment of a hardening market. Again, institutional investors provided the seed money for these new ventures and, again, this "class" of reinsurers proved to be both profitable and operationally successful.

After the events of KRW, a third class of Bermuda reinsurers was formed to capture opportunistic market conditions. The returns this "class" of reinsurers will achieve are less compelling; it would appear they are achieving returns on equity of less than 10 percent and consolidation may be likely.

As a general matter, private equity is not a great fit with the property and casualty insurance model given the longer-term investment horizon required by the capital providers (up to 10 years or more) and the insurance pricing cycle variability that is likely over such a period. In other words, the timing when the private equity firm is looking to exit an investment via a liquidity event may or may not coincide with the timing of a hard market cycle.

There are some segments of the insurance industry that fit with the private equity model. First, several firms have made investments in run-off management companies as well as commercial run-off and windup ventures of reinsurance companies. Such firms utilize aggressive commutation strategies to wind up longer tailed reserves to free up residual surplus that can, ultimately, inure to the benefit of the investors.

Second, there is a marked interest in non-risk bearing acquisitions and consolidation roll-ups of intermediaries and brokers. This segment of the market tends to lend itself to cost efficiencies to be gleaned from combining operating platforms and also provide for less operational execution risk from legacy liabilities than is the case with a risk bearing entity merger. Distribution acquisitions tend to better support the leverage required in such a private equity buy-out than is the case with a risk bearing entity.

Third, some specialized niches have been the focus of private equity investments and acquisitions. These would include some life reinsurance platforms.

As a general matter, there is a high degree of operational risk that arises from an insurance acquisition. Unlike the banking industry, which tends to have a very common platform and operations that can be combined with little execution risk, the insurance model is very disparate from one carrier to another, and consolidations are risky undertakings. The expense savings that emerge from an insurance acquisition tend to be much less meaningful than would be the case in combining the back-office operations of two banks.

CAT Bonds

A catastrophe bond, or "CAT" bond, is a securitized form of reinsurance that is fully collateralized and involves three key parties. The first is the ceding company (or sponsor). In turn, it will pay premiums into a Special Purpose Reinsurance Vehicle ("SPV") that has been solely created for this transaction. That SPV will, in turn, hold a principal amount in trust that has been provided by external investors (the third party to the transaction). These investors will be paid a periodic return on the SPV investment, generally variable interest based on the London Interbank Offer Rate (LIBOR) and a risk spread. There is potentially a need for a fourth party in these transactions, known as a "swap counterparty" (usually a Wall Street firm) to address any fixed rate versus variable interest conversion issues.

These investments have grown significantly in acceptance and appetite — from $2.5 billion in such securitizations in 2005 to more than $13 billion in 2007. Investors in such bonds are, almost exclusively, global institutional investors and, to a lesser extent, high-net-worth individuals. The bonds are increasingly desired by investors due to their lack of correlation with the general stock markets and the favorable returns to date that have been provided.

The "triggers" for reimbursement of losses can vary with CAT bonds. The key triggers include industry indices; parametric (based on certain event characteristics such as a hurricane intensity or specific earthquake magnitude), or based on the indicated results of one of the key industry catastrophe models. Industry losses (such as the PCS index) can be problematic, as the specific losses of any one company may not correlate precisely with the industry losses (on a market-share basis). This introduces the concept of "basis risk" (a company's results are not well correlated with industry losses from an event), and is one of the key criticisms of this type of product. This risk can be mitigated through one of the other trigger mechanisms that more closely correlates with the cedent's actual exposures.

There are certain barriers to entry for such a solution, given investor appetites and the frictional costs associated with establishing such a bond offering. There is also an upfront commitment of management time and company resources necessary to bring such an offering to fruition. Thus, to date the larger insurance companies have tended to sponsor such bonds; although, there are opportunities for industry-type pools for certain regional companies (a bond for Texas wind exposures for various regional companies with such risks, for example).

The perils that can be addressed by CAT bonds are varied and international in scope. Recent offerings have included:

- U.S. Wind.
- U.S. Earthquake (various zones).
- Japanese Earthquake and Typhoon.
- Mexico Earthquake.
- U.K. Flood.

There are some compelling advantages of CAT bonds compared to traditional reinsurance. The credit risk (from uncollectible reinsurance) is negated with a bond that is fully collateralized. The timing of the recovery under a CAT bond that has been triggered can be much quicker than would be the case with traditional reinsurance. Thus, the time value of money needs to be incorporated in any cost analysis of a CAT bond compared to traditional reinsurance. (The general mind-set is that CAT bonds are always a more expensive risk solution; however, such analyses often disregard the soft costs such as time value of money and credit risk.)

Further, the correlation of the risk solution from a CAT bond may more closely align with the exposures themselves (i.e., model-based attachment points and expected losses). These products are often multi-year and can provide longer-term protection than a traditional treaty product.

To some extent, these products have not been fully tested by actual events. While no disruptions are anticipated, there conceivably could be an indication of a so called "cliff risk" when the size of the event leads to a complete loss of an investor's principal. The willingness for such investors to "re-invest" may be tested under such a circumstance.

Industry Loss Warrants (ILW)

ILWs are one of the older, more common forms of capital market solutions that have been in effect since the 1990s. In essence, ILWs are derivative contracts and are a generalized alternative to a Catastrophe Excess of Loss contract. Basis risk (company loss exposures do not correlate with the underlying recovery of the instrument) is common, and, accordingly, these products best fit only the largest entities with the broadest account diversity. This factor has lessened the appeal of the product, and since their initial introduction, growth has been very limited. As a positive factor, these solutions can be implemented very quickly and efficiently to provide generalized protection.

Initially, these products were offered on a nationwide basis and have since evolved into more of a regional peril focus. Hedge funds are very active in providing the capacity for these instruments and have found superior investment returns from this product.

Capital Markets — Other Products

Collateralized Debt Obligations ("CDO") have been an effective way for regional and smaller insurance companies to raise capital efficiently in a pooled fashion. In essence, a CDO is an asset-backed security that has been created by structured finance institutions. These hybrid debt instruments are designed to provide an additional bond-type product to investors, and have capitalized upon growth in various types of loan assets, such as credit card receivables and mortgages. The various pools are stratified, based on the perceived credit risk of each layer, or tranche, and are priced to fit investor appetite.

These insurance CDO pools have allowed many regional companies to access capital markets to expand their market capacity in ways that would be denied normally in the conventional corporate finance arena (due to size limitations). Some of the insurance pools have also utilized bank collateral to provide greater diversification to investors.

Insurance CDO pools have not given rise to any defaults historically; unfortunately, recent events arising from subprime mortgage CDO pools have affected the formation of new insurance-oriented pools (the overall class of security has been impacted by recent liquidity constraints). These insurance-oriented vehicles have outstanding attributes, and the liquidity issues should ease over the course of 2008 and new issuance should resume.

Another capital markets vehicle that has very good potential for growth is a contingent capital vehicle that allows for predetermined access to capital (through either a borrowing or a right-to-issue surplus notes), subsequent to a defined catastrophic event. There is no balance sheet impact until the option is exercised. Unlike a "shelf registration" to sell stock, there is usually no special disclosure with the SEC.

The advantage of these vehicles is the carrier can avoid the forced liquidation of investment holdings after a major catastrophic event, as the forced liquidation of securities by numerous insurance companies may serve to depress

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market prices in a "mega-CAT" event. These vehicles also allow the company to avoid the time requirements necessary for a follow-on stock offering, or convertible debt issuance subsequent to a major catastrophic event. In turn, management can better focus on the new business opportunities that have surfaced vis-à-vis their competition.

Finally, there is a substantial need in the industry for a securitization product for reinsurance recoverables, which represent the second largest asset in an insurance company's balance sheet. Banks tend to be much more efficient in increasing balance sheet velocity (the timing required to convert a recoverable asset into cash) than insurance companies.

The reinsurance recoverable asset is subject to two key risks: (1) credit risk (an inability to pay); and (2) disputes (an unwillingness to pay). The second feature creates a major impediment in terms of creating a securitization product for investors. Nonetheless, one major European-based company recently completed the first reinsurance securitization to transfer some of the non-disputed, non-affiliate recoverables to investors (thereby increasing their balance sheet velocity for superior shareholder returns). There is a considerable opportunity within the industry to provide such products to a variety of cedents.

In conclusion, the convergence of the insurance and capital markets realms presents the various insurance company stakeholders (managers, shareholders, business partners) with new ways of addressing risk and providing for growth in available capacity. We are only in the early innings of this game that will, in time, greatly transform the risk business. ■

Mediating Reinsurance Disputes

by Peter A. Scarpato, J.D.

Peter A. Scarpato, J.D., president of Conflict Resolved LLC, is an arbitrator, mediator and attorney with more than 25 years' experience in the adjudication, negotiation, arbitration and mediation of business and legal disputes. He is also a run-off specialist for all forms of property-casualty insurance and reinsurance, warranty, surety and other types of program business. Scarpato's many years as outside litigation counsel, in-house counsel, senior executive for domestic and international insurance and reinsurance companies, and chief negotiator have given him a unique blend of strategic and substantive experience and skills. You may contact Peter Scarpato at peter@conflictresolved.com.

Editor's note: This article is reprinted with permission. Peter Scarpato created this commentary from an article he wrote for issue 108 of *JTW News,* September 2006

For certain reinsurance disputes in the U.S., mediation is an available, effective but often misunderstood and underused process for companies seeking an efficient, cost-effective alternative to arbitration or litigation.

As the aggravation, expense and time required to arbitrate or litigate escalate, parties are beginning to opt, either by contract or ad hoc agreement, to mediate reinsurance disputes. For them, depending upon the case, LESS IS MORE; that is, compared to arbitration or litigation, mediation is a less aggressive, less costly, less damaging and less divisive alternative to tip the balance of POWER AND OPPORTUNITY in the parties' favor. A careful, experienced and patient mediator views disputes between parties not as a battle but as an OPPORTUNITY to give them the POWER to structure a resolution that best meets their respective short and long term needs.

Despite this trend, many still debunk mediation as unnecessary, expensive and unproductive — complaints based mostly upon its non-binding nature and prior "bad" experiences with ineffective mediators. From my discussions with many satisfied client and lawyer participants, and my own work mediating such cases, I have found that parties and their counsel can and do benefit in many ways — even absent an immediate settlement — from mediating their reinsurance dispute.

To illustrate how this works in practice, I will use the following facts from an actual reinsurance mediation I recently and successfully conducted. Some details were changed, and the names withheld for confidentiality purposes: Retrocedent seeks to collect $5MM in reinsurance losses ceded to Retrocessionaire under a retro treaty. The losses derived from three reinsurance claims made against Retrocedent by Reinsurer. The three claims emerged from a large block of reinsurance business Reinsurer had originally reinsured for and had ultimately assumed from Insurer, the quality of which Retrocedent represented in placing information provided to Retrocessionaire when it agreed to participate on the retro treaty. In its denial of the retroceded losses, Retrocessionaire raised errors in underwriting, delays in reporting and other issues arising in the underlying block of assumed business. The parties agreed to mediate rather than arbitrate the dispute.

The Essence of the Mediation Process

In its classic form, mediation enlists an impartial, trusted facilitator to help parties explore, respect and react to the narrow and broad objective, subjective and psychological factors creating conflict between them, promoting their ability to perceive and communicate positions leading to an inexpensive, voluntary resolution of the dispute on their own terms. Notice that the technical aspects of the specific factual and legal issues in dispute are not necessarily the most important elements of the process. In both joint meetings and private caucuses, parties (a) work with an experienced, professional mediator with no formal power to issue rulings (subject to parties' modification), (b) use an informal, confidential process (no rules of evidence or transcript) designed to suspend judgment and promote candor, and (c) identify and understand each side's interests and goals underlying the actual dispute. The meetings and caucuses ultimately give the parties the power to control the terms of a mutually acceptable settlement.

In this process, success is measured on various levels, in carefully timed, meaningful steps:

Step One: Before the actual mediation session, the mediator (a) obtains the parties' mediation statements, which contain documents and information revealing the salient facts and specific issues in dispute, and (b) most importantly, works with them

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individually by phone or in person to help "set" the precise problems to be addressed, which may go well beyond the narrow issues noted in their mediation statements. This step cannot be emphasized enough. If the mediator does his/her job, the parties and counsel walk into the mediation room understanding that the real problems may involve other factors, such as each side's as yet undisclosed, underlying needs and interests.

In the case noted above, in addition to mediation statements, I asked the parties to provide only me with a Confidential Settlement Statement, designed to elicit (a) the history and end point of any prior settlement discussions, (b) the underlying interests and needs they wished the mediation to address, and (c) ideas for acceptable alternative paths to settlement. While Retrocedent basically discussed initial, acceptable percentage discounts to the $5MM claim, Retrocessionaire requested that the mediation explore their concerns with the underlying assumed block of business (e.g., lack of underwriting, accommodation underwriting, sloppy claims handling).

Step Two: In the opening joint session, the mediator sets the stage by convincing each party to actively listen to, understand and acknowledge the other side's arguments. It is not enough that you nod your head. You must be able to repeat the other side's position back and believably communicate your appreciation and respect for such views (even if you disagree with them). This often overlooked — but incredibly powerful step — builds trust, breaks down barriers, and actually makes the other side less defensive and more candid, giving you and the mediator valuable information to use in the mediation process, information which, as noted in Step One, helps define the proper depth and scope of issues the participants must address and resolve.

Step Three: After hearing the parties' positions in joint session, the mediator meets separately with each side in private caucuses. Caucuses are used to encourage parties to suspend judgment and accept an environment where they can comfortably and critically evaluate the strengths and weaknesses of their positions, creatively explore options to resolve their differences, and ultimately use the mediator to develop proposals designed to get what they need, not what they want, from a mutually-acceptable settlement.

In the first caucus, Retrocessionaire expanded the discussion beyond the three claims and expressed grave concern over deviations between the qualities of claims handling and underwriting performed in the assumed block and representations Retrocedent had made in the placing information. If Retrocedent did not acknowledge and attempt to address these problems, Retrocessionaire was prepared to "walk" from the $5MM and file an arbitration seeking rescission.

Step Four: Applying the old adage that "diplomacy is the art of letting someone else have it your way," the mediator slowly and deftly helps parties develop, discuss and respond to successive financial and non-financial proposals and counterproposals, each supported by an articulated rationale which satisfy both the offering party's needs and the responding party's interests. Simply put, party A must offer party B something that party A knows will help party B convince his company to accept the deal. This is the heart of the process: an unscripted, evolving and changing dynamic which requires a perceptive, inventive and focused mediator; patient, calm and committed parties; and an open exchange of ever-broadening proposals that accentuate agreement and eliminate disagreement.

- In our case, through several caucuses and carefully timed steps, I was able to move the parties to accept the following terms that addressed (a) the Retrocessionaire's need to identify and resolve potential problems with the assumed block, (b) the Retrocedent's need to maintain its ongoing relationship with Reinsurer on other business and to collect balances legitimately ceded under the retro-treaty, and (c) their joint need to cooperate on steps designed to implement their settlement: First, to provide information both parties needed to assess the legitimacy of claims ceded to the retro treaty, Retrocedent and Retrocessionaire agreed to work together to design, conduct and share the expenses of an audit of Reinsurer's questionable block of assumed business. Second, based upon the results of the audit, Retrocessionaire will pay all or any unchallenged portions of legitimate losses and, through Retrocedent, challenge any illegitimate cessions. Third, if Reinsurer rebuffed such challenge and instituted arbitration or legal collections proceedings, Retrocessionaire would pay 50 percent of any resultant legal and arbitrator expenses, legal fees and costs.
- Having cooperated throughout this process, the parties were primed to return to productive discussions addressing the $5MM claim. While their cooperative mood allowed them to identify, discuss and produce documents to narrow the substantive issues and financial gap between them, certain process adjustments noted below were necessary to achieve a final settlement.

Bridging the Gap

Often, despite everyone's best efforts, a financial or non-financial gap leaves parties with a choice between an agreed settlement and a disappointing walk from the table. Here, the mediator must maintain a positive, trusting relationship with the parties and continue moving the parties to propose alternatives and reframe the problem. He/she must keep parties focused on re-evaluating barriers between them and brainstorming ways to eliminate them. Very often, new alternatives uncover new forms of "value" that lead to acceptable compromises and settlement.

In our case, two of the three retroceded claims made up most of the $5MM.

In the original joint session, the Retrocessionaire had alleged improper accommodation underwriting. Since the parties' prior achievements had built a spirit of cooperation and trust, Retrocedent agreed to immediately retrieve from both its and the Reinsurer's files additional underwriting and claims records which were shared with both me and Retrocessionaire. Through additional caucuses, I helped the parties and counsel translate the substantive assessment of such records into rational, realistic and reasonable adjustments to the $5MM claim, narrowing the once "$5MM vs. rescission" gap to within $500,000. And even if a financial gap remains, the mediator can propose final alternatives. Here are just a few examples:

(a) First, if a financial gap remains, the mediator can ask the parties if they wish to give him/her privately their best, final good faith offer and further agree that (i) if the numbers overlap, the mediator can split the difference within the overlap and announce a settlement; or (ii) if the numbers do not overlap, the mediator can split the remaining gap between them and announce a settlement; or (iii) if the parties like (ii) but fear the gap might be too large, they set a smaller dollar limit on the gap within which the parties' last, best offers must fall and agree that, if they do, the mediator may split the difference and announce a settlement. Under all scenarios, if no settlement is reached, the mediator does not disclose the offers to the parties.

In our case, the parties agreed to option (iii) and gave me their last, best offers which fell within the narrowed gap, allowing me to split the difference and announce a final settlement.

(b) Second, the mediator can ask if the parties wish him/her to "cross the line" and, in separate caucuses, provide his/her opinion on their case. Often, especially after hours of mediation, parties desire finality and, if they trust the mediator, welcome his/her opinion to help them mediate across the final gap.

(c) Third, in lieu of (b), the mediator can ask if the parties wish him/her to become an arbitrator and decide the dispute based upon the briefs, exhibits and parties' positions disclosed during the mediation. The difference between (b) and (c) is that in (b), the parties still must mediate to a settlement and can walk away; whereas in (c) the mediator now arbitrator issues a final and binding decision.

The Results of the Process

Since this process often lasts one or two days, its benefits are obvious, even if parties fail to reach agreement. Without the aggravation, time and expense of lengthy discovery, pleadings, motions, practice and legal and consulting fees, parties can work with a mediator experienced in the complexities and subtleties of reinsurance to:

(a) gain an informed, enlightened perspective on both their and their opponent's cases;

(b) acquire insights into the strengths and weaknesses of their substantive positions and the goals and interests of the other side;

(c) test each other's desire to settle and measure the qualitative and quantitative gaps between their "bottom lines";

(d) hear from and test the credibility of the other side's key witness in preparation for subsequent proceedings;

(e) set the stage to comfortably resume settlement discussions later if and when discovery enhances or erodes their respective positions. Statistically, parties who mediate, even unsuccessfully, have a greater chance of settling cases earlier, more knowledgeably and less expensively than those who do not.

Conclusion

For certain reinsurance disputes, the mediation process allows parties to maintain relationships, reduce hostilities, avoid unpredictable panel or court decisions, assert more control over the terms of their settlements and lower litigation costs. In a world dominated by increasing numbers of arbitrated disputes, mediation is certainly a viable, beneficial option. ■

Is There A Conflict Between the Service of Suit and Arbitration Clauses?

by Andrew S. Boris, J.D.

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

Historically, some parties have challenged the enforceability of an arbitration clause due to the presence of a service of suit clause in the same reinsurance contract. The argument is that the inclusion of a service of suit clause restricts or limits the ability of a party to require arbitration (as opposed to litigation in a court of law). A "service of suit clause" usually places specific obligations upon a reinsurer in a situation where the reinsurer fails to pay amounts due under the contract. By operation of the service of suit clause, the reinsurer is traditionally required to submit to the jurisdiction of any court of competent jurisdiction within the United States. The trend among courts addressing the theory that there is a conflict between the clauses is that the service of suit clause simply provides a path to enforcement of an arbitration award with no effect upon the operation of the arbitration clause. A recent decision by the Superior Court of Pennsylvania highlights the majority view that where a reinsurance agreement contains both a service of suit and an arbitration clause, the service of suit clause should be read in conjunction with the arbitration clause and not as an overriding force. See, *Gaffer Ins. Co. v Discover Reinsurance Co.*, 936 A.2d 1109, 2007 Pa. Super. 339 (Pa. Super 2007).

In *Gaffer*, the Superior Court of Pennsylvania was faced with the question of whether a service of suit clause overrides an arbitration clause. The appellate court found that in reading the contract as a whole, the two clauses complement each other and the arbitration clause mandated that the parties address disputes within an arbitral setting. The facts of the case are relatively straightforward. Gaffer Insurance Company ("Gaffer") entered into a captive reinsurance agreement with Discover Reinsurance Company ("Discover") through which Gaffer reinsured policies issued by Discover. As part of the reinsurance agreement, Gaffer was required to produce collateral (in this instance an irrevocable letter of credit) to Discover in order to secure its reinsurance obligations.

Gaffer terminated its relationship with Discover but was required to keep an appropriate amount of collateral in force to cover outstanding claims. As the outstanding claims were paid, settled or otherwise resolved, Gaffer believed the amount of collateral should likewise decrease. To that end, Gaffer requested Discover release some of its letters of credit to reflect its decreased obligations, to which Discover refused.

Gaffer filed suit in the Pennsylvania Court of Common Pleas against Discover, alleging breach of contract and unjust enrichment. Discover filed preliminary objections arguing that the court lacked jurisdiction over the matter based on an arbitration clause contained in the reinsurance agreement requiring that the parties arbitrate their disputes. The relevant language provided that, "[a]ny dispute between the parties to this Agreement will be submitted for decision of a board of arbitration composed of two arbitrators and an umpire, meeting in Farmington, CT, unless otherwise agreed to by us and you."

Gaffer argued that the insertion of language at the end of the arbitration clause allowed for the service of suit clause to govern the forum for the dispute, "unless otherwise agreed to by [Discover] and [Gaffer.]." In other words, Gaffer maintained that the parties incorporation of the service of suit clause [which allowed for the parties to "commence an action in any court of competent jurisdiction in the United States"] served as a separate condition to which the parties "otherwise agreed." The trial court agreed with Gaffer, finding that the service of suit clause prevailed over the arbitration clause based on the insertion of unique qualifying language.

On appeal, the court found that the contract must be interpreted as a whole, giving effect to all of the contract's provisions. Turning to the language of the arbitration clause, the court found that the phrases "any dispute" and "will be submitted for decision of a board of arbitration … unless otherwise agreed to by us and you" to be of critical relevance. According to the court, this language was not only extremely broad in scope, but mandatory in form. The court rejected Gaffer's interpretation because it diminished the force of the arbitration provision, which was intentionally mandatory. Gaffer's reading would have created a permissive form, allowing the parties to arbitrate only if they both mutually agreed, which according to the court, "renders the arbitration provision purposeless, meaningless, and superfluous."

Further, the court found that Gaffer's reading of the reinsurance agreement violated a basic principle of contract interpretation — to consider the contract as a whole and give effect to every provision if possible. The two provisions should be read in conjunction with one another. In doing so, the parties would first arbitrate their disputes under the arbitration clause, and then turn to "any court of competent jurisdiction in the United States" under the service of suit clause if, for example, awards were not complied with or the parties mutually agreed not to arbitrate.

The court also rejected Gaffer's alternative argument that the provision, "[n]othing in the Article constitutes … a waiver of [Gaffer's] rights to commence an action in any court of competent jurisdiction in the United States" allowed Gaffer to disregard the arbitration provision and seek judicial resolution of any dispute with Discover. The court found the waiver language unambiguously related solely to the service of suit clause and did not apply to limitations found in other portions of the reinsurance contract, namely, the arbitration clause. Gaffer's broad reading of the sentence was inconsistent with the plain meaning of the text and was therefore "firmly rejected" by the court.

Although other courts have relied upon different reasoning, many addressing this issue have reached a similar conclusion. See e.g., *Security Life Ins. Co. of America v Hannover Life Reassurance Co.*, 167 F.Supp. 2d 1086 (D. Minn. 2001), (granting motion to stay litigation in favor of arbitration when court stated that the service of suit clause was intended to address potential problems of obtaining jurisdiction over the parties and was not meant to address the arbitrability of claims); *Transit Casualty Co. v Certain Underwriters at Lloyd's*, 963 S.W.2d 392 (Mo. App. W.D. 1998) (finding that the service of suit clause was inconsistent with the arbitration clause rendering the contracts ambiguous. Further, finding that the drafters of the provisions in question were the reinsurers, the cedent was given the choice of litigating or arbitrating).

For a variety of reasons, certain parties prefer to have their disputes decided in a court of law rather than in an arbitration setting. In turn, there will always be battles as to the proper forum to hear a dispute between a cedent and reinsurer and the potential conflict between the service of suit and arbitration clauses is one such battle. Undoubtedly, additional disputes will occur concerning the operation of the service of suit and arbitration clauses, but the trend continues support the application of the arbitration clause. ■

Making Decisions in the Face of Uncertainty

by Richard G. Waterman, CPCU, ARe

Risk managers, insurers and reinsurers make decisions every day that affect the future well-being of the companies that employ them. We make these decisions with the intent and purpose of achieving specific goals to make profits and prosper. Nonetheless, our understanding of the consequences of the decisions we make today is very limited, and we often fail to achieve our desired goals.

In his book *Why Most Things Fail*, **Paul Ormerod** examines the "Iron Law of Failure" as it applies to business and government, and delves into the reasons for failure and explains what can be done about it. He asserts that "failure is all around us." The often quoted phrase "the best-laid plans of mice and men often go awry," taken from the poem *To a Mouse*, by **Robert Burns**, reminds us that no matter how carefully a project is planned, something may still go wrong. Most likely all of us are familiar with the sentiment and have experienced unforeseen, and unpredictable consequences affecting personal and business decisions.

The ability to make decisions in the face of uncertainty is guided by the way in which knowledge is organized in memory, and so determines how information about uncertainty can be retrieved from memory quickly and easily. Memory is generalizations of past experiences, which are neither logical nor scientific. Nonetheless, our interpretation of thoughts and feelings influences how we will think, feel and act in making decisions in the face of uncertainty. For instance, we often construct models of successful business activities, rich in detail, that make the strategy seem highly plausible, yet, according to the laws of probability, less and less likely to come true.

In this way our minds suppress uncertainty and make action possible. Unfortunately, we tend to look at the world through our lens of knowledge, beliefs, opinions and prejudices while remembering past instances of efficiency better than instances of inefficiency. In remembering, we are apt to distort and interpret information from the past so as to make it fit what we know or believe, and sometimes we add new information. In fact, studies have shown that intellect is more prone to error than our senses.

Real World Decision Making

Paul Ormerod explains in his book that it is not possible to process information in an optimal fashion when we do not have complete information and lack the cognitive ability to arrive at the "best" decision. He points out that in most real-world situations, it is simply not possible to find the optimal choice. Reality is far too complicated. However, in situations where incomplete information is limited, referred to as bounded rationality, experts in a field may be able to determine the best or optimal decision.

The game of chess offers a familiar illustration of bounded rationality. Chess is a game where there are a relatively small number of unequivocal rules and the position in the game is completely transparent at any point in time. The popular notion of a superior chess player is someone who has a logical mind and makes deductions on the basis of each move, planning many moves ahead. It is well established, however, that this is not how a chess player's mind works. An expert player's memory is not general-purpose, nor is an expert chess player usually an all-around genius outside the game itself.

An expert player thinks only a few moves ahead, just like a novice does. What makes the expert so formidable is the immense number of schemas specific to chess that are stored in memory, organized in such a way that an appropriate move can be retrieved instantly. An expert beats a novice because the expert can quickly recognize the pattern of pieces on the board, matching it to the same or a similar pattern stored in memory to which is attached a memory of a suitable move. Yet in most situations in a chess game, even the expert player will not know the single "best" move.

The game of chess can be learned. It functions in a fixed environment with rules that do not change over time. Information about the opponent is transparent. The moves of each player are known with certainty once they are made. Yet no one knows the best strategy to play the game, and no optimal end-game strategy has been discovered. Many of the features of the real world that make predictions of outcomes even more uncertain for personal and business decision makers are not present in the game of chess. In reality, the environment is not fixed with inflexible rules. Existing players are free to invent new moves, new players are able to enter the game, and knowledge about the opponents may be difficult or impossible to obtain.

Every day, for example, experts on the stock market come up with at least one plausible explanation of why the index went up or down on the previous day, with definite causes neatly producing logical effects. Yet, if there is an underlying order to the gyrations of the stock market, no one has been able to discover it. Some economists speculate that the stock market is neither rational nor irrational, but inscrutable. Similar to the reality of predicting hurricanes, a vast number of small elements contribute to the behavior of the whole. It is fruitless to chase after neat explanations for the ups and downs of the stock market, just like new theories of turbulence in weather systems and ocean temperatures are not enough to explain what sets in motion a chain of events that result in a Caribbean hurricane.

Why Most Things Fail is a fascinating book that presents provocative patterns and themes to explain why species fail and become extinct, brands fail, companies fail, and why public policies fail. The author suggests that by first understanding the pervasive existence of failure, we will recognize the criteria for success. If you are interested in knowing more about the factors that often lead to outcomes which are either unexpected or undesired, you will enjoy reading Paul Ormerod's analysis of the limits of cognitive discussion-making. ■

Reinsurance Interest Group Workshop Recap

by Thomas M. Pavelko, CPCU, J.D., ARe

Thomas M. Pavelko, CPCU, J.D., ARe, is assistant general counsel, contracts and regulatory, for American Agricultural Insurance Company (AAIC), where he has worked for 11 years. Previously, he ran an active law practice for 15 years, with emphasis in appellate practice, litigation and insurance defense. Pavelko earned his J.D. from Washington University School of Law in St. Louis, Mo., and his bachelor's degree from Marquette University. In addition to serving on the Reinsurance Interest Group Committee, he has served on the board of the Chicago-Northwest Suburban CPCU Chapter and was its president in 2006–2007.

On February 7, 2008, the CPCU Society and its Reinsurance Interest Group, in conjunction with the Chicago and the Chicago-Northwest Suburban chapters, hosted a reinsurance program entitled, "Reinsurance Update: What You Need to Know in Today's Marketplace." More than 50 attendees braved the worst snowstorm of Chicago's winter to attend this half-day workshop at the offices of DLA Piper in downtown Chicago.

The program began with "Reinsurance: State of the Art," a panel discussion moderated by **Richard G. Waterman, CPCU, ARe,** president of Northwest Reinsurance Inc. The panelists were **John Aquino, FCAS,** executive vice president, Benfield Inc.; **Susan Kelly,** vice president, CNA; and **Bruce Kukowski,** vice president, GMAC Re. These reinsurance professionals, representing the reinsurance broker, reinsurance buyer and reinsurance provider, fielded questions from the moderator and from the audience on the current state of the market. Issues included market conditions and whether we are in a soft or softening market and what issues or threats keep reinsurers awake at night.

Due to the inclement weather, the presenter for the second portion of the program was unable to attend. The hosts hope that she will be able to return in the near future to make her presentation regarding enterprise risk management (ERM) in the reinsurance environment. In its place, Richard Waterman led a "town hall" meeting among all attendees discussing current issues in reinsurance. (Editor's note: the speaker and her team presented a webinar on ERM in June 2008.)

Immediately following the workshop, most attendees remained for the quarterly lunch meeting of the Reinsurance Education and Communication Hotline (REACH). The topic "Terrorism Risk Insurance: Where Do We Go From Here?" was presented by **Mike Stinziano, Ph.D., WCP, CWCP,** senior vice president, Benfield Inc. ■

Mark Your Calendar for the 2009 Reinsurance Interest Group Symposium

The CPCU Society's Reinsurance Interest Group celebrates each new class of ARe completers at its annual Reinsurance Symposium. The next Reinsurance Symposium is being held on March 26-27, 2009 at the Loews Hotel in Philadelphia, Pa.

The program will follow the traditional format — a full day program on Thursday, March 26 that includes the ARe conferment at lunch and a cocktail reception in the evening; and a half day program on Friday, March 27. Program details will follow as they become available. This symposium is highly regarded for the great information it provides from top-class reinsurance professionals.

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