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## **Message from the Chair**

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. Pavelko earned his J.D. from Washington University School of Law in St. Louis, Mo., and his bachelor's degree from Marquette University in Milwaukee, Wis. He is currently chair of the Reinsurance Interest Group Committee. In the past, he served on the board of the CPCU Society's Chicago-Northwest Suburban Chapter and was its president in 2006–2007.

**W**ow! As I am writing this, I have just received word that the CPCU Society and its Circle of Excellence Committee have awarded the Reinsurance Interest Group Gold Circle of Excellence Recognition! Besides confirming the terrific year that we have had, it also brings closer to my mind how quickly this fiscal year is moving. At the Annual Meeting and Seminars in Denver, I will have completed my first full year as chair of the Reinsurance Interest Group Committee.

It seems only yesterday that we were in Philadelphia for the 2008 Annual Meeting and Seminars. The remnants of Hurricane Ike whipped outside the Philadelphia Downtown Marriott as we planned for what we now know was an award-winning year. **Diane Houghton, CPCU, ARe**, accepted the position of webmaster and **Richard G. Waterman, CPCU, ARe**, agreed to continue as editor for *Reinsurance Encounters*, the wonderful periodical that you are now reading.

Also, **Eric F. Hubicki, CPCU ARe, AU, AFIS**; **Michael J. Lamplot, CPCU**; and **R. Michael Cass, CPCU, ARe, ARM**, agreed to plan a reinsurance workshop in Chicago. **Charles W. Haake, CPCU, ARe**, agreed to chair the Reinsurance Symposium in Philadelphia. **Nicholas J. Franzi, CPCU, ARe**, chose to plan our 2009 Annual Meeting seminar.

We also agreed to schedule the first annual Reinsurance Interest Group Lunch at the 2009 Annual Meeting and Seminars. Finally, in an effort to further connect to our members and allow them to connect with one another, we established a LinkedIn group for the CPCU Society Reinsurance Interest Group that is open to all CPCUs.

As you can see, the success of our interest group is truly a collaborative effort! I am so pleased to report that every one of the events we planned last fall has either

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# Message from the Chair

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already been presented or will come to fruition at the 2009 Annual Meeting and Seminars in Denver. We have published three quality issues of *Reinsurance Encounters*. Our Interest Group Web site is a beacon of information to our members and the Society, offering a wealth of knowledge on our upcoming events and other news.

The Chicago workshop in February was first-rate, and its quality confirmed that it is a must-attend event for reinsurance professionals in the Chicago area and throughout the Midwest. The workshop began with a Reinsurance Market Update, which was a panel discussion of the marketplace from the perspectives of reinsurers, brokers and buyers. Eric F. Hubicki, vice president, BMS Intermediaries Inc., moderated the panel, which consisted of **Timothy Hein**, senior vice president, Platinum Re; **Janet Katz**, senior vice president, American Agricultural Insurance Company; **Kelly Smith**, executive vice president, Aon Benfield; and **Meredith Williams**, vice president, Zurich Commercial North America. Then, **John Chaplin** and **Sandy Hauserman, J.D.**, managing members, Joint Resolution LLC, presented “Resolving Smaller Reinsurance Claims — One Size Does Not Fit All!”

What the Chicago workshop was for reinsurance professionals of the Midwest, the Philadelphia Symposium was for reinsurance professionals nationwide — clearly a must-attend event! Often referred to as the “crown jewel of CPCU educational events” outside the Annual Meeting and Seminars, this Philadelphia program spanned two days and included a special lunch ceremony to honor new ARe completers. **Norman A. Baglini, CPCU, Ph.D., CLU, ARe, AU**, professor of risk management, insurance and business ethics at Temple University, was the keynote speaker.

The educational program began with a panel discussion entitled, “Today’s Race for Tomorrow’s Talent.” The panel consisted of **Catherine Elwood**, officer of the Financial Leadership Rotational

Program for Nationwide Insurance; **Jodi Valenti**, of Guy Carpenter & Company, LLC; **Anita Z. Bourke, CPCU**, executive vice president of the American Institute for CPCU and Insurance Institute of America; and Norman A. Baglini, CPCU, Ph.D., CLU, ARe, AU.

Next, **Mary Seidel**, Federal Affairs, Reinsurance Association of America; **Eric C. Nordman, CPCU, CIE**, director of research, National Association of Insurance Commissioners; and **Neil Aldredge**, state affairs director, National Association of Mutual Insurance Companies, discussed “Industry and Governmental Changes and Trends.”

Following the ARe luncheon ceremony, another panel, consisting of **Joseph Murphy**, regional executive, MidAtlantic Region, Zurich North America; **Kirk Larsen**, president, MidAtlantic Region, The Travelers Companies Inc.; **Peter Austen**, president and CEO, Willis of Pennsylvania Inc.; **Michael C. Sapnar**, executive vice president, Transatlantic Reinsurance Co.; and moderator **Susan Kearney, CPCU, ARM, AU, AAI**, senior director of knowledge resources, American Institute for CPCU and Insurance Institute of America, discussed current issues facing the reinsurance industry from executives’ perspectives.

**Brad Kading, CPCU, ARe**, president and executive director, Association of Bermuda Insurers and Reinsurers, spoke on the status of the Bermuda markets; and **Ali Majidi, Ph.D.**, a consultant with Munich Re, enlightened the group on the “Role of Reinsurance in an ERM Framework: A Practical View from Solvency II Perspective.”

On the final day of the symposium, **Laline Carvalho** of Standard & Poor’s and **Mark J. Murray**, senior financial analyst with AM Best Company, provided the “Rating Agency Overview” of the state of the market. Finally, **Andrew Boris, J.D.**, partner, Tressler Soderstrom Maloney & Priess LLP; and **Rhonda D. Orin, J.D.**, partner, Anderson Kill & Olick PC, provided a “Mini State of the Union of

Insurance and Reinsurance Claims — Occurrence Triggers and Allocation.”

I can’t wait for our upcoming Annual Meeting and Seminars events! I hope to see you all there. Be sure to register for our first annual luncheon, which will be held on Sunday, Aug. 30, from 11:30 a.m. to 1 p.m. Besides the networking opportunity, we are excited to have **Philip J. Klotzbach, Ph.D.**, as our featured speaker.

Klotzbach is a research scientist with Colorado State University’s Tropical Meteorology Project (TMP). Under the leadership of **William M. Gray, Ph.D.**, professor emeritus of Colorado State’s Department of Atmospheric Science, the TMP has been issuing annual predictions of Atlantic hurricane numbers and severity since 1984.

Klotzbach has assumed primary responsibility for issuing the TMP’s periodic forecasts of Atlantic seasonal hurricane activity and landfall strike probability, which are often cited in media and trade publications. Our meeting comes just days before the TMP team announces its September update to its hurricane forecast. Who knows? Maybe Dr. Klotzbach will provide us with a sneak peek at the update!

Our Annual Meeting and Seminars educational offering will be “Reinsurance — State of the Art,” a panel discussion by executive-level talent representing reinsurance providers, customers and brokers. It will take place on Sunday, Aug. 30, from 2:45 to 4:45 p.m. This panel will address major issues pertaining to reinsurance and their impact on the insurance and reinsurance industries.

**Franklin W. Nutter, J.D.**, president of the Reinsurance Association of America, will moderate. The panel will include **Patrick J. Denzer**, Guy Carpenter & Company LLC; **Larry Spoolstra**, Transatlantic Reinsurance Corporation; and **Philipp Wassenberg, Ph.D.**, Munich Re.

Finally, if you are a member of LinkedIn, look for our group there! It provides a great opportunity for us to keep in touch! ■

# 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 more than 10 years.

**A**s editor of *Reinsurance Encounters*, I am continually inspired by the opportunity to work with authors of articles related to new and emerging topics affecting the reinsurance industry. The collection of articles in this edition demonstrates emphatically the expanding role of risk management and reinsurance strategies to mitigate the impact of unexpected large losses and catastrophe events.

Our lead article, titled "Casualty Clash and Casualty Catastrophe Reinsurance Risks," written by [Emil Metropoulos](#), senior vice president, Guy Carpenter & Company, clarifies the meaning of the terms "casualty clash" and "casualty catastrophe" risks. The author also explains how clash reinsurance protections are among the techniques employed by insurance companies to manage casualty clash and catastrophe risks that involve losses to multiple policies or insureds from a single event. Although heretofore casualty clash losses were relatively infrequent, with the advent of higher net retentions and the interconnectedness of product manufacturing and rendering of professional services, casualty clash losses are much less remote. Those of us who work with enterprise risk management strategies will be especially interested in learning more about casualty catastrophes and determining how clash reinsurance may provide needed protection for unanticipated large casualty catastrophe losses.

Next, following the theme of large casualty exposures, regular *Reinsurance Encounters* contributor [Andrew S. Boris, J.D.](#), with the law firm Tressler, Soderstrom, Maloney & Priess, presents a cognitive description of how the number of accidents or occurrences can have far reaching effects on the availability of reinsurance coverage. Aptly referred to as the aggregation or accumulation question, some types of events require a determination of whether numerous underlying losses can be considered

one accident or occurrence pursuant to the language of a specific reinsurance contract. Boris's insightful observations and analysis brings into clear focus the importance of negotiating appropriate contract language to express the intent of the parties in addressing the aggregation or accumulation of losses considered one accident or one occurrence.

The threat of property catastrophe losses also poses a risk management dilemma. No one knows how many, if any, property catastrophes will occur in a given time frame, and no one knows whether property catastrophe losses will be large or small. We do know, however, that property catastrophes will happen. Placing property catastrophe reinsurance methods and techniques in perspective, [Susan Kearney, CPCU, ARM, AU, AAI](#), with the American Institute for CPCU and Insurance Institute of America, provides an overview of catastrophe reinsurance in her article, "Demystifying Catastrophe Reinsurance."

And finally, [Jonathan Tilman](#) and [Martin Davies](#), with Towers Perrin, have contributed a very timely article explaining why Solvency II will fundamentally change reinsurance purchasing and capital management strategies. While at first blush you may not have a strong interest in reading about changes affecting complex accounting procedures, a subject I often try to avoid as well, readers of this newsletter will likely benefit by understanding the genesis and regulatory impact of Solvency II in comparison with prior forms of risk protections and solvency provisions.

With summertime rapidly coming to an end, I hope you will enjoy reading the informative articles contained in this edition as you prepare for reinsurance encounters in the months and years ahead. On behalf of the Reinsurance Interest Group Committee, we welcome your comments, suggestions and especially your submissions for publication. ■

# Casualty Clash and Casualty Catastrophe Reinsurance Risks

by Emil Metropoulos



**Emil Metropoulos** is a senior vice president with Guy Carpenter & Company LLC.

**C**asualty insurers are starting to prepare for the worst of all possible scenarios. When an event causes large losses involving multiple policies, lines or insureds, the likelihood that claims will compound increases, putting carriers at greater risk. In some cases, this “clashing of covers” can reach catastrophic proportions. As we have seen in recent years, the threat of a casualty clash — or a larger “casualty catastrophe” — is quite real. Even though the market for casualty clash cover is still small, larger carriers are taking a closer look at this form of protection.

The importance of managing casualty clash and catastrophe risks has long been linked to solvency. An event of profound severity could decimate a casualty insurer’s capital, leaving it unable to support its portfolio of risks.

Remoteness has been used to downplay the threat, causing carriers to overlook a more immediate, though less menacing, concern. A substantial loss may not imperil company operations, but it could lead to an unexpected earnings hit, the effects of which would be magnified for shareholders. Unanticipated large losses typically result in a disproportionate impact on market capitalization. Casualty clash and catastrophe protection, consequently, can be a vital tool in managing overall financial performance.

## Clashing and Catastrophic Casualty Events

Casualty clash reinsurance normally sits at the top of a casualty insurer’s reinsurance coverage tower and thus typically attaches at higher levels. In some cases, insurers can purchase clash cover attaching at a lower retention, covering multiple insureds and treaty retentions where there is no underlying single-line reinsurance in place. When this is the structure, the reinsurance is more challenging to underwrite because coverage is triggered more often and consequently the protection is more costly. Since an increasing number of carriers have been retaining larger nets on some lines of casualty business, clash reinsurance is becoming more cedent desirable. And from an enterprise risk management perspective, casualty insurers would like to have the reinsurance protecting these previously unsuspected casualty loss scenarios.

The terms “casualty clash” and “casualty catastrophe” may seem new, but the concepts certainly are not. An increasingly complex and interconnected global business community has made many large (and even small) companies quite efficient. Being fast and lean is no longer a genuine competitive advantage. Rather, it’s the price of admission to many global — and local — markets. Yet the ease of coordination and collaboration along today’s supply

chains also transmits risk as well as cost savings and operational efficiency. One company’s liability exposure could spread to its suppliers, partners and service providers. But, these weaknesses are not immediately evident. Instead, they sit dormant — and concealed — until a loss-triggering event occurs.

Casualty clash involves a loss to multiple policies or insureds from a single event. An event that leads to both directors and officers (D&O) and errors and omissions (E&O) claims, for example, could result in a casualty clash scenario. The insured losses would be higher than anticipated since several lines of business are involved. A casualty clash scenario that grows to disastrous proportions is called a “casualty catastrophe.” Insured losses can span companies, geographic borders, industries and lines of business. Though the insured losses sustained may be lower than those of property catastrophes, the economic damage is almost always much, much greater.

There are two types of clash scenarios: systemic and classic. Systemic clash involves the degree of regulation in an industry, the extent of common practices, and vulnerability to an economic downturn. Thus, an industry that is highly regulated and highly exposed to an economic downturn — with operating practices that are common among its companies — is exposed to substantial casualty clash and catastrophe risk. Classic clash, on the other hand, may result from a long supply chain (including service or advisory), the use or development of hazardous products, exposure to the general public or the engagement of large amounts of subcontractors. Casualty catastrophes can result from both systemic and classic clash elements.

## Age of Casualty Catastrophe Risks

The global financial crisis that has unleashed havoc on credit and equity

markets is the most recent casualty catastrophe (with both systemic and classic clash characteristics), and it may be the largest in recent memory ... but it certainly isn't the first. In fact, there have been many, and their frequency has increased over the past two decades, allowing financial markets little reprieve from one disaster to the next.

The stock market crash of Oct. 19, 1987, kicked off the modern casualty catastrophe age. The Dow Jones Industrial Average lost 22 percent of its value, earning the event the appellation "Black Monday." Since then, we have endured the initial public offering (IPO) laddering and equity analyst scandals associated with the "dot-com bubble," as well as accounting irregularities at Enron, Tyco, WorldCom, Adelphia and others. The loss of shareholders' wealth with each of these events was profound, but none has been as severe as the one that currently has the world's financial markets in its grasp.

What began with uncertainty in the subprime mortgage market has spread to broader credit and equity markets around the world. The total damage is expected to far exceed USD1 trillion and will affect businesses of every kind. The insurance industry has sustained a considerable loss of surplus (approximately 20 percent in the aggregate), and there have been some major casualties. The banking sector has fared much worse, with an aggregate loss of capital in excess of 30 percent — even with capital from the Troubled Assets Relief Program (TARP).

The situation could still worsen for casualty writers. In addition to losses from the impairment of investment assets, shareholder class action lawsuits may lead to large D&O and E&O claims, which would hit the liability side of the balance sheet and pinch casualty carrier capital. Outsized claims could cause earnings to drop, triggering a response from equity analysts and investors that would

push the insurers' share prices lower. Insufficient earnings tend to magnify losses of market capitalization, making the situation even worse.

Traditional portfolio management and risk transfer practices are insufficient to protect carrier balance sheets (and shareholders) from casualty clash and catastrophe risks. Professional and product liability coverage tends to focus on specific circumstances rather than the rapid transmission of liability through a portfolio. Even with careful risk-by-risk hedging, gaping holes are left unattended. Insurers' capital and shareholders' wealth continue to be imperiled.

## **Renewed Interest in Clash Reinsurance**

Perhaps because of market conditions last year — and a general increase in awareness — larger insurers paid more attention to casualty clash and catastrophe risk at the Jan. 1, 2009, reinsurance renewal. This followed several years in which they did not secure much protection. Even with the increase in interest in this form of cover, capacity was adequate, and pricing remained stable. Historically, product availability, terms and pricing prevented the widespread purchase of protection. Since many of these cedents now have larger net lines on their portfolios — and plenty of available reinsurance capacity — they are beginning to secure the protection they need. Changes in capital availability and terms have helped cedents.

Casualty clash and catastrophe cover is not as exotic as its name may imply. This protection consists simply of a per occurrence excess of loss (XOL) reinsurance contract, which protects the insurer from a specific event's losses that affect several lines of business or insureds. There are more than a dozen markets in the United States and Bermuda that offer casualty clash and catastrophe cover, with a typical market having capacity of up to

USD100 million — though some sources of capital can provide much more.

Casualty clash reinsurance rates were up 1.1 percent on average at the January renewal. (See Exhibit 1 on page 6.) Specific layers renewed at rates ranging from minus 12.3 percent to 17.5 percent, with changes based largely on loss history, changes to retentions and limits, and other program-specific considerations.

Most programs renewed at expiring or more favorable terms. (See Exhibit 2 on page 6.) Forty-five percent were able to secure decreases, with 25 percent staying steady. Thirty percent of layers sustained price increases. Despite the renewed interest among larger insurers, few changes were made this year. Only 6 percent of renewing programs increased retentions, and 23 percent lowered them. Fifteen percent increased limits, with only 8 percent going in the other direction. Seventy-two percent of programs did not change retentions at all, and 77 percent made no changes to limits.

So, prices generally have remained steady. And, cedents are exploring this market with fresh vigor. The remote threats to solvency aside, casualty insurers need to address the more likely risks associated with the impairment of earnings that result from unexpected large losses. Publicly traded carriers stand to lose market capitalization at a rate disproportionate with the earnings effect, suggesting that the true value of casualty clash and catastrophe risk management stretches far beyond the balance sheet.

## **Casualty Clash and Catastrophe Renaissance**

We are surrounded by casualty clash and catastrophe risk. Especially in today's interconnected and turbulent business environment, these threats can pervade a large insurer's portfolio, imperiling

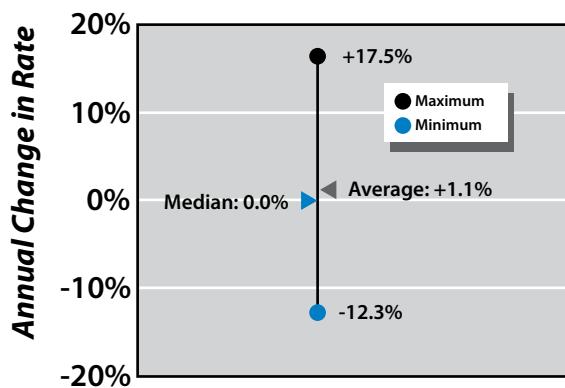
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# Casualty Clash and Casualty Catastrophe Reinsurance Risks

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## Exhibit 1

### Annual Rate Change

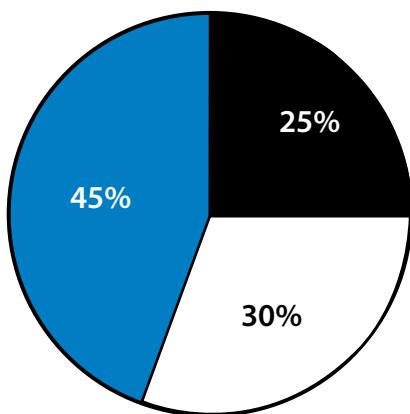


Source: Guy Carpenter & Company, LLC

Note: Analyzes like layers renewing in 2008 and 2009

## Exhibit 2

### Layers Renewing Jan. 1, 2009



■ % Layers Renewing as Expiring

□ % Layers Renewing with a Rate Increase

■ % Layers Renewing with a Rate Decrease

Source: Guy Carpenter & Company, LLC

Note: Analyzes like layers renewing in 2008 and 2009

balance sheet strength and shareholder returns. For the past 20 years, we have seen the rapid escalation of casualty clash and catastrophe risk, and the trend is unlikely to abate. If anything, it will gather more momentum. Consequently, we may be on the brink of a casualty clash and catastrophe renaissance, to be fueled by the capital management agendas of large casualty writers that need to address a lingering, concealed exposure that has long been elusive.

The market is still small, but its importance is growing. At the Jan. 1, 2009, renewal, larger casualty insurers eyed casualty clash and catastrophe pricing with interest. As the risks become more menacing, reinsurance buys will likely follow. The availability of sufficient cover at reasonable terms will contribute to the renewed interest in this form of protection, but the major drivers will be broader market conditions and access to the tools that make action more meaningful.

Regardless of pricing and terms, the

market dictates the likelihood of a casualty catastrophe and thus the need for cover. Precipitous equity market drops, mounting fraud allegations, and a general desperation to pin blame somewhere suggest that the foreseeable future will be packed with litigation (and probably claims). The contagion will spread quickly — as it already has — and few will not be touched. Fortunately, the time it will take for these factors to result in insured losses favors carriers. There's still time to examine portfolios, identify clash and catastrophe exposures, and take action to protect capital.

Where does it end? A casualty insurer that sustains unanticipated large losses can expect to be punished severely by investors and analysts. The magnifying glass used to measure performance widens the effects, leaving only risk management foresight and discipline to protect shareholder value. As this perspective gains ground relative to the traditional solvency concern, larger carriers will be more likely to address the casualty and catastrophe risks in their portfolios. The increased

frequency of events will become a near-constant reminder of what's at stake.

Prudent execution will become a differentiator among casualty insurers. Those securing casualty clash and catastrophe protections will withstand future shocks more confidently and more easily. Share prices will likely show the results. ■

# How Many Times Does the Reinsurer Pay — Multiple Accidents or Occurrences?

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](mailto:aboris@tsmp.com).

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**A**ny number of claim issues can lead to a dispute between a cedent and a reinsurer, but questions involving aggregation/accumulation for reinsurance purposes can be especially problematic. The question of how many accidents or occurrences are at issue can have far reaching effects on the availability of coverage. In its purest form, the aggregation/accumulation question involves whether numerous underlying claims can be considered one accident or occurrence pursuant to the language of the reinsurance contract. Notwithstanding the arguments involving the language in the reinsurance contract, additional disputes between cedents and reinsurers can also involve the question of whether the reinsurer is obligated to "follow the settlement" with respect to the cedent's determination as to the number of applicable occurrences. Questions most often arise when there are claims involving: food poisoning, construction defects, discrimination, pollution, toxic torts and asbestos. However, the question of how many accidents/occurrences are at issue can arise with almost any type of underlying claim.

The determination of whether a certain grouping or set of claims may be considered "one accident" or "one occurrence" can have a profound impact on the amount of coverage available to a cedent. In fact, the question as to the number of occurrences will often be determinative of whether the reinsurer is obligated to indemnify the cedent for the billing. By way of example, if a cedent is successful in maintaining that a group of claims should be aggregated for reinsurance purposes as one occurrence, there will be a greater availability of coverage under the reinsurance contract (with a corresponding reduction in the number of retentions that must be satisfied by the cedent). Alternatively, if each individual claim (making up the group of claims being aggregated by the cedent) is subject to an individual retention, the reinsurer will likely owe little or nothing for the subject billing.

The disputes that develop concerning whether a particular set of claims can be considered one accident or occurrence find their genesis in the language of reinsurance contracts. Many contracts define an "accident" or "occurrence" in terms of arising or following on a "common cause," "cause," "event" or "disaster." Thus, the following questions develop: What is a cause? What is an event? For instance, was the "occurrence" a corporate hiring program where thousands of individuals claim discrimination as a result of the implementation of the program, or was each individual instance of discrimination an "occurrence"? Clearly, "multiple occurrence" questions draw into question the intent of the parties to the reinsurance contract with respect to the type and amount of coverage that would be provided in exchange for the premium paid by the cedent.

Courts have wrestled with complicated fact scenarios and contract language addressing both direct and reinsurance coverage questions. Unfortunately, courts have not been uniform in their analyses, and several different tests have been utilized to address the complexities of the "number of occurrences" question. Many courts have adopted a cause test where the analysis focuses on whether all of the losses or claims can be traced to one originating cause. For instance, it has been argued that all property damage claims facing a particular insured (as a result of environmental contamination at locations throughout the country) should be treated as one occurrence (rather than individual occurrences corresponding to each location where there was environmental contamination) because the cause of such claims was the insured's corporate decision to adopt an inadequate compliance program. Other courts have also adopted an effect test. Under the application of an effect test, courts seek to analyze the "end-result" or effect of the claims to determine

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# How Many Times Does the Reinsurer Pay — Multiple Accidents or Occurrences?

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whether there is one occurrence. Finally, a limited number of courts have employed an “unfortunate event” test to determine the number of occurrences. Under this approach, courts look to whether the individual losses can be characterized as having occurred close in time or space to be considered one occurrence.

In the direct context, courts have not ruled consistently on this question. See e.g. *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Co.*, 255 Conn. 295, 765 A.2d 891, 908 (2001)(finding multiple occurrences in the asbestos context); *In re Prudential Lines, Inc.*, 158 F.3d 65, 80-81 (2nd Cir. 1998)(finding multiple occurrences in the asbestos context). But see *Liberty Mutual Ins. Co. v. Treesdale, Inc.*, 418 F.3d 330 (3d Cir. 2005)(finding that the occurrence was the decision to manufacture and sell asbestos containing products). Correspondingly there have also been divergent decisions in the reinsurance context. See e.g. *Ruthardt v. Underwriters at Lloyd's, London*, Mass. Super. Ct. No. 91-7877C, at 9 (1998) (unpublished)(rejecting concept that all of the underlying asbestos claims could be considered one event); *North River Ins. Co. v. ACE Amer. Reins. Co.*, 361 F.3d 134 (2d Cir. 2004)(finding one occurrence in asbestos context).

The most difficult aspect of the “number of occurrences” question is that courts often identify a particular test as part of the analysis and subsequently describe factors that are more consistent with the application of an entirely different test. Thus, there is a lack of consistency in application of the tests. In the end, it appears to be a very results oriented analysis with a court identifying the conclusion to the question presented and fashioning the legal analysis to match the conclusion. Undoubtedly, since a determination as to the number of applicable occurrences has a significant effect on the availability of coverage, there also appears to be a tendency



among the courts to recognize the gravity of an adverse ruling on the issue for the insured or cedent.

The number of occurrences question has far reaching effects on many different parties: insureds, insurers and reinsurers. Insurers should always be aware that insureds may seek to maximize coverage via a number-of-occurrence analysis. When it comes to reinsurance, cedents must constantly examine the underlying claims to determine whether a number-of-occurrences argument is viable. In sum, since the courts are not consistent in their analysis of the “numbers of occurrences” issue, all involved in the claims process should be aware that there is a question as to how many times a reinsurer may be asked to pay. ■

# Demystifying Catastrophe Reinsurance

by Susan Kearney, CPCU, ARM, AU, AAI



**Susan Kearney, CPCU, ARM, AU, AAI**, is senior director of knowledge resources for the American Institute for CPCU and Insurance Institute of America (the Institutes) in Malvern, Pa. She based this article on material published by the Institutes, independent, not-for-profit organizations offering educational programs, professional certification and research to people who practice or have an interest in risk management and/or property-casualty insurance. The material in this article is covered in the Chartered Property Casualty Underwriter (CPCU®) designation program and the Associate in Reinsurance (ARe) designation program, which are among the Institutes' numerous educational offerings. Kearney can be reached at [kearney@cpcuia.org](mailto:kearney@cpcuia.org).

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**T**he year 2008 will rank among the costliest years on record for insured catastrophe losses in the United States, with a flurry of severe hurricanes bearing names such as Dolly, Hannah, Gustav and Ike, along with other weather-related and man-made losses. With a major increase in the cost of great natural disasters worldwide over the past 15 years, the demand for catastrophe reinsurance as a result of natural and man-made disasters — such as tornadoes, hurricanes, earthquakes, wildfires, winter storms and terrorism — has increased.

Most insurers that sell property insurance purchase catastrophe reinsurance. Catastrophes create a separate class of insurance risk for insurance companies. Catastrophic events occur infrequently, yet the severity of the loss they produce represents significant financial hazards to an insurer, including the risk of insolvency, an immediate reduction in earnings and statutory surplus, the possibility of forced asset liquidation to meet cash needs and the risk of a ratings downgrade. Catastrophe reinsurance, sometimes called catastrophe excess of loss reinsurance or catastrophe excess, provides insurers with protection from the financial consequences of an accumulation of losses arising from a catastrophic event and safeguards their policyholders' surplus (net worth).

Coverage under a catastrophe treaty is triggered when accumulated losses arising out of a single event exceed the attachment point. Once losses exceed the attachment point, the reinsurer reimburses the insurer for losses until the reinsurance limit is reached. Unlike property per risk excess of loss, catastrophe reinsurance usually applies to all of the insurer's property business (such as all personal and commercial insurance covering property loss exposures), or a large subset of it (such as all property loss exposures in the states of Florida, Alabama, Mississippi and Louisiana), rather than to losses sustained by individual loss exposures.

Catastrophe treaties often specify that they will not respond to a loss arising out of a single loss exposure, no matter how large the loss may be. In practice, most catastrophe treaties have a sufficiently high attachment point that many of the insurer's policies would have to be involved in a loss for the catastrophe treaty to respond. For example, if the largest property policy the insurer is willing to sell has a \$1 million limit, the attachment point of the catastrophe treaty may be set at \$10 million. As with other types of excess of loss reinsurance, catastrophe treaties typically contain a co-participation provision that requires the insurer to absorb a percentage of the loss that exceeds the attachment point.

For insurers that have geographically diversified loss exposures and a limited exposure to catastrophe-related causes of loss, the price of catastrophe reinsurance is probably relatively low. However, for insurers that sell insurance almost exclusively in catastrophe-prone areas, catastrophe reinsurance is likely to be expensive and available only with a high attachment point relative to the size of the catastrophic exposure.

As with other forms of reinsurance, catastrophe reinsurance may be provided in layers. The insurer may also have a percentage co-participation in losses that exceed the attachment point, which encourages the insurer to exercise sound claim-handling practices even after the attachment point has been exceeded.

In addition, the insurer typically has other reinsurance that applies before the catastrophe treaty. This is known as inuring reinsurance because it inures to the benefit of (reduces the loss to) the catastrophe treaty. For example, the insurer might have purchased quota share or per risk excess of loss reinsurance to reduce the amount of loss to be covered

*Continued on page 10*

# Demystifying Catastrophe Reinsurance

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by the cat treaty. The catastrophe treaty applies only when the insurer's net retention (after inuring reinsurance) exceeds the attachment point.

Catastrophe treaties also typically contain the common clauses that appear in other excess of loss treaties. Clauses designed or adapted for use in catastrophe treaties include a term clause, retention and limits clause, ultimate net loss clause, loss occurrence clause, other reinsurance clause and reinstatement clause.

In order to anticipate the financial effect of catastrophic events and to help them select reinsurance limits, insurers use catastrophe modeling. Natural catastrophe models have been developed for a wide range of catastrophic risks and geographic territories worldwide, including specific industry types. All major natural hazards are modeled, including hurricanes, earthquakes, winter storms, tornadoes, hailstorms and floods. A number of catastrophe modeling firms have also developed models that help quantify the potential financial impact from emerging risks such as terrorism. Using data from catastrophe models, the insurer can select a reinsurance limit that will protect it from the largest loss it expects to occur.

Users of catastrophe modeling information should understand what assumptions underlie the model and how results can be evaluated. Because results from different catastrophe models vary, it is important to recognize that many insurers engage multiple catastrophe models when assessing their exposures. The use of multiple catastrophe models may provide different outcomes, enabling a better understanding of the book of business and the application of more targeted underwriting decisions. While many insurers use catastrophe models today, as with any financial or meteorological model, there are no guarantees. After all, you can't fool Mother Nature! The hurricane seasons of

2004 and 2005 and the record dollar value and number of claims paid to policyholders by insurers underscore the point that catastrophe models are not an absolute predictor of risk.

Despite having more sophisticated catastrophe models than ever before, many reinsurance buyers find it increasingly difficult to be confident they are making the best decisions. In this situation, the reinsurance broker can play an important role in helping catastrophe reinsurance buyers get the best out of a model. It is important to recognize that although no current catastrophe models can make decisions for you, they can be used as part of the decision-making process. The ability to integrate decision-making with the modeling is a key factor in successful catastrophe reinsurance buying. ■



# Reinsurance Optimization in the New Regulatory Environment

by Jonathan Tilman and Martin Davies

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**Abstract:** Solvency II will fundamentally change reinsurance purchasing and products as reinsurance becomes integral to the risk and capital management strategy of insurers.

**G**lobal consolidation, increasing rating agency scrutiny and improvements in modeling capabilities have fed the demand for regulatory change and increased policyholder protection. Consolidation within the industry has produced larger financial groups with global reach and a more complex array of business lines and risks.

Taken together, these powerful trends make it essential for senior managers at insurance entities to understand the resulting group risk profile of their organization, not just the risks of each operating unit and region.

Companies really have little choice. Rating agencies have responded to criticism of inadequate anticipation of company problems with increased scrutiny. Shareholder value can be significantly impacted by upgrade and downgrade decisions. In addition, rapid improvements in technology provide more robust modeling capabilities to better understand corporate risks. Improvements in data quantity and quality allow companies to develop innovative products and gain competitive advantage.

## Historical Evolution

In the past, regulatory systems relied on simplistic formulas to set required capital amounts. For example, Solvency I requirements were based solely on premiums or claims, with little distinction between different lines of business. Standards did not reflect important differences in individual firm risk profiles.

In the 1990s, the U.S. introduced its risk-based capital framework, which was more sensitive to the enterprise's actual risks and took into account asset risk, growth risk and correlations between lines of business. In 2005, the U.K. introduced its new Individual Capital Adequacy Standards (ICAS) regime, which sought

to quantify entity-wide risks and relate them to the firm's capital structure and business decision-making.

## Solvency II

Solvency II, the new EU regulatory framework, will be implemented in late 2012 and will bring considerably more depth to the process of determining adequate capital. Solvency II is risk-sensitive and places significant emphasis on management's responsibility for implementing a clearly defined risk management strategy linking strategic planning and capital management processes with effective business decision-making.

Solvency II recognizes that companies that apply stronger risk management capabilities are less likely to default on their obligations to policyholders and therefore need less capital. It is important to watch responses to Solvency II as it develops alongside global solvency regulatory initiatives. (See *Emphasis* 2008/4, "Toward a Global Solvency Standard IV.")

So how will Solvency II affect the reinsurance buying decisions of insurers?

### (1) Reinsurance Buying within an Integrated Capital Management Framework.

The constant theme is a transition from considering reinsurance on a stand-alone basis to one where it is an integral part of the organization's risk and capital management strategy. Increasingly, shareholders will expect a well-defined risk appetite to inform strategic business decision-making. Reinsurance buying will be linked explicitly to corporate risk appetite to keep net retained risk within acceptable limits. Shareholders will increasingly see reinsurance as strategic rather than tactical in nature and expect it to be used to support the growth in

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# Reinsurance Optimization in the New Regulatory Environment

Continued from page 11

profitable business. (See *Emphasis* 2009/1, "What's Your Risk Appetite?")

Our global ERM survey shows that the more advanced entities already recognize that reinsurance is a form of capital, to be considered alongside the company's equity/debt structure. Increasingly, reinsurance-buying decisions are made by the chief risk or financial officer as part of a broad approach to meeting capital needs.

Solvency II will force companies to adopt a more holistic attitude that encompasses all the risks faced by the enterprise. As reinsurance becomes generally accepted as a form of capital, firms will want to select the reinsurance structure that best fits their risk management hedging strategy and optimizes the mix of capital from debt, equity and reinsurance.

The corporate finance perspective increases shareholder value by optimizing the capital structure relative to risk. If management is able to leverage both its risk (by deciding on the right level of risk retention and risk transfer) and its capital structure, then it will create additional shareholder value. Exhibit 1 illustrates the relationship between risk and capital structures. Reinsurance is a strategic and integrated part of the capital resources that support the risk portfolio.

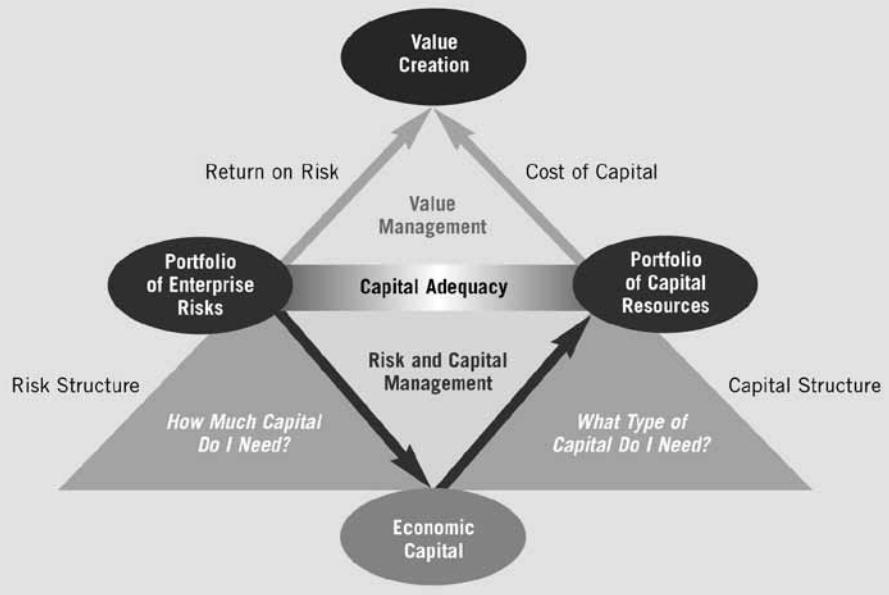
With a new generation of enterprise risk modeling driven by Solvency II, companies can develop a reinsurance strategy that is assessed with reference to the creation of shareholder value. When shareholders value the reduction in risk that reinsurance brings more than it costs them to reduce that risk, shareholder value is increased.

## (2) Group versus Business-Unit Purchasing.

Currently, reinsurance buying is often considered only in the context of each single line of business. A line underwriter may buy reinsurance to protect a business plan, to provide capacity or to reduce accumulations of risk. Line underwriters

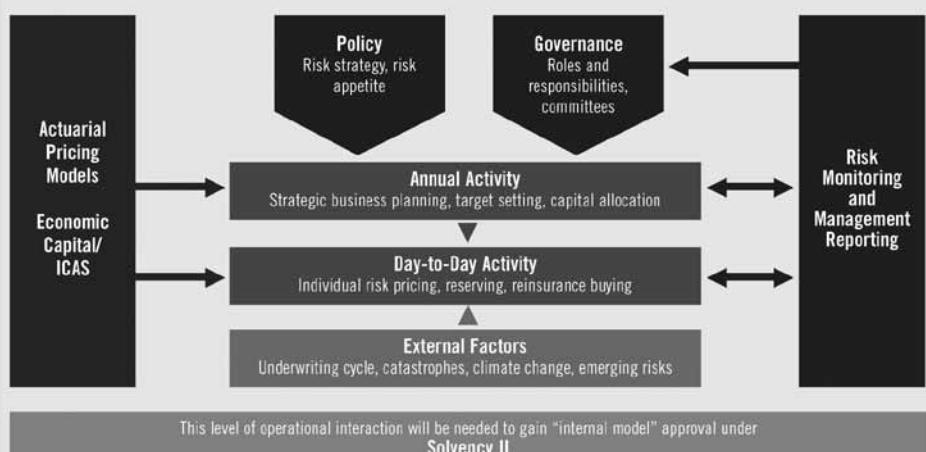
## Exhibit 1

An enterprise risk management (ERM) framework should be comprehensive



## Exhibit 2

The key to an organization's success is developing capabilities in parallel



This level of operational interaction will be needed to gain "internal model" approval under Solvency II

are risk-averse and willing to trade a lot of corporate upside to protect their own plans. If they all do this, then the firm as a whole will likely end up purchasing more reinsurance than is optimal from a group perspective.

Within Solvency II, there is a requirement to analyze the capital position of the overall group. This will lead to more sophisticated modeling of all lines of business together in order to quantify the amount of economic capital required by the group at a given probability level. Analyzing how the amount of economic capital changes in response to different reinsurance structures allows management to assess whether reinsurance buying is optimal for the group rather than for each individual line of business. In this environment, reinsurance is part of an integrated set of capabilities that support internal capital models relied on for determining capital requirements for regulatory purposes. (See Exhibit 2.)

### **(3) Risk-Consistent Buying.**

Traditionally, reinsurance has often been bought with reference to existing cover and to what peer companies are purchasing. This means that current reinsurance programs are unlikely to be optimal. Under Solvency II, as reinsurance buying is more integrated into a comprehensive risk management framework underpinned by economic capital modeling, we expect it to more accurately reflect the specific risk profile of the firm.

### **(4) Integration of Reinsurance Buying into the Strategic Planning Process.**

Reinsurance involves a trade-off between reducing insurance risk, on the one hand, and increasing credit risk through the addition of reinsurance recoverables to the balance sheet, on the other. Reinsurance has always been a way to achieve solvency capital relief, but under Solvency II the capital relief will depend both on the type of reinsurance purchased and the lines of business covered.

All too often, current reinsurance purchasing is divorced from the planning process, and the amount spent is often just a line item in the business plan. But business planning is likely to increase in importance in the future, and firms will produce longer-term plans that consider portfolio mix, growth and profitability. This will help management make decisions about the extent of risk assumption, retention and transfer, along with the appropriate balance of paid-up capital (equity and debt) with reinsurance and other contingent capital. Reinsurance decision-making will be a product of the plan rather than a cost input.

### **(5) More Sophisticated Reinsurance Evaluation.**

Historically, reinsurance analysis has been rather basic and centered around experience and exposure rating, but some sort of stochastic modeling is increasingly becoming the norm. In a fully integrated corporate modeling framework, it becomes directly apparent how much reinsurance costs (what the reinsurer's margin is) and what the net benefits are in terms of reducing economic and regulatory capital requirements and the consequent reduction in the cost of capital. This is a key element in translating Solvency II Pillar I compliance into improved performance.

### **(6) More Conscious Reinsurer Selection.**

The choice of reinsurers and the maximum to be ceded to any one reinsurer are currently based largely on subjective criteria. Solvency II will make companies more mindful than ever of the amount of reinsurance recoverable assets held by any single reinsurer and the commensurate credit risk. We expect that companies will consciously measure the trade-off between a lower reinsurance price and lower security, and act accordingly.

## **Solvency II Trends in Buying Reinsurance**

Many of these trends are under way, making it easier to forecast the reinsurance products and buying patterns that are likely to emerge from Solvency II.

Indeed, we can already see that buyers of reinsurance are being influenced in a very similar direction by certain common forces at work in the marketplace:

- The major insurer rating agencies have adopted risk models similar to those underlying Solvency II.
- Enterprise risk management concepts, a key component of modern corporate governance, are also in harmony with Solvency II.
- The current problems in the capital markets have led to an enhanced focus on capital efficiency and risk management.

With these trends, we would expect to see greater and more varied use of reinsurance to manage insurer solvency. Specifically, we see growth in the use of products that reduce the amount of premium retained, address specific peak risks and protect the underlying capital of the insurer from risk in the aggregate.

## **Quota Share**

Quota share reinsurance contracts enable an insurer to share its premiums with reinsurers so that the insurer exchanges the fluctuating results of its underwriting activities for a fixed override commission. Although these transactions frequently contain variable and profit-related commission provisions as well, their primary purpose is to exchange premium that has an uncertain return for a more certain income stream. The insurer is rewarded for its marketing of the business but is insulated from the associated risks.

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# Reinsurance Optimization in the New Regulatory Environment

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We have recently seen a surge of interest in quota share transactions as insurers reduce their net retained risk rather than seek new capital. Such arrangements are also attractive to reinsurers because they provide access to well-developed business, and their interests are aligned with those of the ceding insurer.

Looking forward, we expect the increase in quota share transactions to enable companies worldwide to exchange risks and improve their geographic diversification. This will improve capital efficiency and solvency.

## Peak Risks

Another trend driven by the increasing use of capital models is the identification and elimination of peak risks — those concentrations of exposure that give rise to the largest possible claim events. Stochastic modeling of exposures frequently indicates that losses in the tail of the overall loss distribution are driven by the same identifiable aggregations of risk. Similarly, the deterministic approach of testing a portfolio of insurance against realistic disaster scenarios can identify peak exposures that generate an excessive need for capital.

Once the capital that these risks require has been identified and its cost calculated, the insurer can decide whether to buy reinsurance to transfer the risk or to retain it.

We expect to see an increase in the trend toward buying products that cap exposures to named, realistic disaster scenarios or protect against isolated catastrophe losses. Examples include single-state industry loss warranty products and Gulf of Mexico wind-speed protections.

## Stop Loss

As a product, stop loss reinsurance fits well into the Solvency II framework. It protects an insurer from all sources of underwriting losses, acting equally to address claim severity and frequency, as

well as catastrophe and large individual claims. A stop loss contract responds to them all because it is triggered by the aggregation of losses, often expressed as a loss ratio.

The sophisticated economic capital models at the heart of Solvency II can calculate probabilities of various aggregate losses in a year, which can then be translated into a reinsurance buying strategy. A primary insurer can buy a stop loss reinsurance contract to protect it from a given level of losses. The insurer could then consider releasing any resulting excess capital.

We are beginning to see more stop loss reinsurances bought specifically as surrogates for capital. In these cases, the attachment levels are carefully chosen so it is cheaper to buy reinsurance than to hold capital to maintain solvency.

## Continuity of Capacity

The longevity of the benefit that reinsurance provides means that it is a serious alternative to holding capital. Recently, credit providers have seen their business models collapse because they could not refinance their access to funds. The securitization markets unexpectedly ceased to operate, and credit providers were caught in the trap of lending long and borrowing short.

Reinsurance provides protection and solvency benefits for the term of the contract; the protection continues with cash payments that can be made well after the benefit period. The danger is that an insurer can become dependent on reinsurance for continuing solvency benefits. Reinsurance capacity and prices are notoriously volatile, and capacity crunches are a regular part of market cycles, making this a risky expectation.

There are two solutions that we expect to become increasingly common. The first is the use of multiyear transactions, where solvency is the prime motivation, in order to lock in capacity at known prices.

The second is greater diversification of capacity sources. The increase in capital market participation in major reinsurance programs will provide greater breadth of capacity and access to capacity providers whose primary exposure is not to the catastrophe risks that often lead to the disappearance of reinsurance capacity. Although diminished from prior high levels, risk securitization markets remain robust. (See *Emphasis* 2009/1, "Insurance-Linked Securities Reaching Critical Mass.")

The U.K.'s Financial Services Authority (FSA) is looking for companies to have a directional feel for company capital adequacy over the next three to five years. Companies are likely to adopt a longer time horizon for reinsurance buying in response.

## The Way Forward

The impact of global consolidation, rating agency scrutiny, new technologies and demands for improved corporate governance are causing widespread change and an increased emphasis on financial modeling and specialized expertise, without which the ICAS regime in the U.K. and Solvency II in the EU would not have been possible. Solvency II will fundamentally change the nature of reinsurance purchasing, planning, evaluation and marketing, prompting insurers to consider a wide spectrum of holistic risks that goes beyond traditional underwriting risk.

We expect the reinsurance buying process to be subject to more rigorous testing and validation to determine its benefits in comparison with prior forms of solvency provision. With reinsurance as part of an overall solvency equation, rather than as a stand-alone risk protection, the decision to buy will be based on capital efficiency rather than subjective perceptions of value. ■

# New Interest Group Member Benefit

by CPCU Society Staff

**E**very Society member is entitled to benefits from every interest group for no extra fee beyond the regular annual dues, including access to their information and publications, and being able to participate in their educational programs and functions.

An Interest Group Selection Survey was e-mailed to members beginning mid-November 2008. By responding to the survey, members could identify any of the existing 14 interest groups as being in their primary area of career interest or specialization. If you did not respond to the survey and want to take full advantage of this new member benefit, go to the newly designed interest group area of the Society's Web site to learn more about each of the interest groups and indicate your primary area of career interest. You will also see options to receive your interest group newsletters.

Currently, there are 14 interest groups: Agent & Broker; Claims; Consulting, Litigation & Expert Witness; Excess/ Surplus/Specialty Lines; Information Technology; International Insurance; Leadership & Managerial Excellence (former Total Quality); Loss Control; Personal Lines; Regulatory & Legislative; Reinsurance; Risk Management; Senior Resource; and Underwriting.

As part of the Interest Group Selection Survey, members also were asked to express their interest in the following proposed new interest groups: Actuarial & Statistical; Administration & Operations; Client Services; Education, Training & Development; Finance & Accounting; Human Resources; Mergers & Acquisitions; New Designees/Young CPCUs; Nonprofits & Public Entities; Research; Sales & Marketing; and The Executive Suite.

Members may update their interest group selections on the Society's Web site or by calling the Member Resource Center at (800) 832-CPCU, option 4. Members can also order printed newsletters for nonprimary interest groups at an additional charge. ■

The **Agent & Broker Interest Group** promotes discussion of agency/brokerage issues related to production, marketing, management and effective business practices.

The **Claims Interest Group** promotes discussion of enhancing skills, increasing consumer understanding and identifying best claims settlement tools.

The **Consulting, Litigation & Expert Witness Interest Group** promotes discussion of professional practice guidelines and excellent practice management techniques.

The **Excess/Surplus/Specialty Lines Interest Group** promotes discussion of the changes and subtleties of the specialty and non-admitted insurance marketplace.

The **Information Technology Interest Group** promotes discussion of the insurance industry's increasing use of technology and what's new in the technology sector.

The **International Insurance Interest Group** promotes discussion of the emerging business practices of today's global risk management and insurance communities.

The **Leadership & Managerial Excellence Interest Group** promotes discussion of applying the practices of continuous improvement and total quality to insurance services.

The **Loss Control Interest Group** promotes discussion of innovative techniques, applications and legislation relating to loss control issues.

The **Personal Lines Interest Group** promotes discussion of personal risk management, underwriting and marketing tools and practices.

The **Regulatory & Legislative Interest Group** promotes discussion of the rapidly changing federal and state regulatory insurance arena.

The **Reinsurance Interest Group** promotes discussion of the critical issues facing reinsurers in today's challenging global marketplace.

The **Risk Management Interest Group** promotes discussion of risk management for all CPCUs, whether or not a risk manager.

The **Senior Resource Interest Group** promotes discussion of issues meaningful to CPCUs who are retired (or planning to retire) to encourage a spirit of fellowship and community.

The **Underwriting Interest Group** promotes discussion of improving the underwriting process via sound risk selection theory and practice.



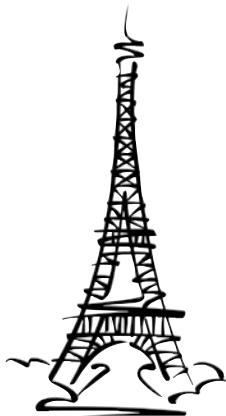
# Reinsurance Interest Group

## Reinsurance Encounters

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#### Questions?

Contact Dick Vanderbosch, CPCU, at (970) 663-3357 or [rbosch@aol.com](mailto:rbosch@aol.com) or visit <http://seniorresource.cpcusociety.org>.

The Reinsurance Interest Group newsletter is published by the Reinsurance Interest Group of the CPCU Society.

**Reinsurance Interest Group**  
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