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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.

“May you live in interesting times.”

Type this phrase into your Internet search engine of choice, and you will get approximately 428,000 hits. TV quotes, books, CDs and blogs reference the phrase. Like me, you probably have heard this phrase referred to as an ancient Chinese proverb — sometimes as a blessing and sometimes as a curse. While this dichotomy used to confuse me, I understand it now. While interesting times can be exciting to the point of being thrilling, they can also be chaotic, terrifying and not for the faint of heart.

Regardless of your opinion on the phrase and its intent, as the first decade of the 21st century (will we refer to this decade as the Oughties? the Zeroties?) ends and

we look back, you have to admit that we live in interesting times.

Consider first how technology has changed the way we do business. Everything is electronic. Some meetings can often be replaced with webinars or virtual meetings. Companies add document storage through server upgrades rather than adding file cabinets and other hard-copy storage. Offices have gone paperless. Risk assessment tools are the rage, but only for companies whose risks are geo-coded!

Next, consider the huge United States occurrence losses of this decade. First, we

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Message from the Chair

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The Reinsurance Interest Group will hold its 2010 Reinsurance Symposium, “Dawn of a New Reinsurance Horizon,” March 17–18, 2010, at the historic Union League of Philadelphia, which occupies an entire city block in the center of Philadelphia’s commercial and cultural district.

endured the horrible tragedy of Sept. 11. Then the hurricanes came. Eight of the ten largest hurricane losses in U.S. history are 21st century phenomena (with Hurricanes Andrew and Hugo being the only top-10 events that preceded 2000). Purveyors of global warming sounded the alarms that we could expect continued frequency and increasing severity. Then the 2009 hurricane season came along with ... nothing. At least, nothing compared to the immediately preceding years.

Regulation, too, is in a state of flux. First, the industry endured the finite reinsurance crackdown. Then, talk of federalization and/or optional federal charters occurred. Congress became upset with the health insurance industry during the universal health care debate. Suddenly, Congress questioned the anti-trust exemption for all insurance companies. With reinsurance being a global industry, international regulatory issues, such as Solvency II, take on greater importance for all.

Finally, emerging underwriting issues begin to sound like science fiction. Nanotechnology, for example, has an impact on the food we eat and the products we make. I recently read that the National Science Foundation forecasts that \$1 trillion in nanotechnology-enabled products will be on the market in the next five years.

Interesting times? Definitely!

Why the soapbox you may ask? The Reinsurance Interest Group will focus on many of these and other hot topics at its 2010 Reinsurance Symposium, “Dawn of a New Reinsurance Horizon.” The symposium will take place on March 17–18, 2010, at the Union League of Philadelphia in Pennsylvania. More information will follow. In the meantime, please save the date! ■

Save the Date

The Reinsurance Interest Group Presents Its
2010 Reinsurance Symposium
“Dawn of a New Reinsurance Horizon”
March 17–18, 2010
Union League of Philadelphia
Philadelphia, Pa.

History/Foundation of the Union League of Philadelphia

Founded in 1862 as a patriotic society to support the policies of President Abraham Lincoln, the Union League has hosted U.S. presidents, heads of state, industrialists, entertainers and visiting dignitaries from around the globe.

Philadelphia’s classic French Renaissance-styled League House, with its brick and brownstone façade and dramatic twin circular staircases leading to the main entrance, is listed in the National Historic Register, and dates back to 1865, when the Broad Street building was completed.

With approximately one-quarter million square feet of space, the building is spread out over eight floors and has entrances on all sides: north, south, east and west. Inside, the traditional décor is accented in rich leather, patinated wood and polished marble.

Adorning the walls and hallways is the League’s distinguished art collection — artifacts imbued with the heritage and culture of its membership. The collection is a rich, historical chronicle of Philadelphia’s unique imprint on the American landscape from the 19th century to today.

Resource: The Union League Web site, www.unionleague.org. Edited and reprinted with permission.

Editor's Comments

by Richard G. Waterman, CPCU, ARe



Richard G. Waterman, CPCU, ARe, has been a member of the CPCU Society since 1978, and has served on the Reinsurance Interest Group Committee for more than 10 years.

Uncertainty. Pick up any newspaper or industry journal today, and you'll find plenty of articles about the uncertain vagaries of natural catastrophes and man-made risks that often involve the loss of lives and are increasingly more expensive. Nonetheless, despite all its variety, uncertainty contains certain regularities and sameness. Nothing we encounter is ever entirely new and unpredictable because the new event can always be placed in a known familiar category. Risk management techniques, including reinsurance, are tools to stabilize the effects of new catastrophe events and make them manageable by reducing the number of unpleasant surprises.

Continuing our discussion of critical issues facing reinsurers in today's challenging global marketplace, the theme for this edition of *Reinsurance Encounters* is uncertainty. Our lead article, "Catastrophe 'Awards Made' Excess of Loss Reinsurance," was written by **Savannah Sellman, J.D.**, an attorney with Clyde & Co. You may not be familiar with "Awards Made" reinsurance. These agreements are similar to extra contractual obligation (ECO) and Excess of Policy Limits (XPL) reinsurance protection except that they cover awards made in excess of policy limits with

respect to trials that are in progress during the reinsurance agreement period. As the frequency and severity of bad faith awards continue to increase, Awards Made reinsurance reduces the uncertainty factor in very difficult claims situations.

Our next article, "Atlantic Basin Seasonal Hurricane Forecasts," was co-written by **Philip J. Klotzbach, Ph.D.**, and **William M. Gray, Ph.D.**, from Colorado State University's Tropical Meteorology Project. Klotzbach was also our featured speaker at the Reinsurance Interest Group's first annual luncheon during the CPCU Annual Meetings and Seminars in Denver. While there is no shortage of scientific theories to explain why natural catastrophes seem to be more frequent and more severe, the Tropical Meteorology Project has been developing a new objective statistical methodology to improve and refine the uncertainty of seasonal forecasts. The new statistical models unveiled for the 2008 Atlantic hurricane season led to forecasts which were very close projections. We are planning to ask Klotzbach to update the statistical climate forecasts for the 2009 hurricane season compared with actual observed activity in an upcoming edition.

Some observers believe that by raising the temperature of the oceans, global warming has helped to make hurricanes more severe. Even if some of these theories turn out to be incorrect, the judicial system may address potential global warming liability claims which will likely affect insurance and reinsurance availability and increase costs. "Global Warming — The Next Big Thing For Reinsurance?" is a must-read, thought-provoking article written by **Andrew S. Boris, J.D.**, an attorney with Tressler LLP. Beyond any doubt, there is a great deal of uncertainty as to whether emitting green house gases ultimately lead to a variety of environmental problems. However, as Boris points out in his article, risk managers, insurers and reinsurers charged with the responsibility of identifying new and potentially challenging exposures should be aware of potential future global warming claims.

Enterprise risk management is the subject of the next article submitted by **Richard G. Berthelsen, CPCU, J.D., MBA, ARM, AIC, ARe, AU**, with the American Institute for CPCU/Insurance Institute of America. Recent years have seen heightened concern and focus on risk management, and it has become increasingly clear that a need exists for a robust framework to effectively identify, assess and manage risk. Enterprise Risk Management (ERM) has become a common technique to help organizations deal with uncertainty in a thorough and systematic manner. But exactly what is enterprise risk management? In his article, Berthelsen concisely answers the question. He also explains how acquiring the necessary knowledge and skills to implement managing risks caused by uncertainties can be a complex endeavor. An education program like *Enterprise-Wide Risk Management: Developing and Implementing*, offered by the American Institute for CPCU and Insurance Institute of America, has been designed to assist decision makers understand and build a solid ERM foundation.

The final article in this edition of *Reinsurance Encounters*, "Reinsurance Underwriting — The Basics," was written by **Bruce Carlson, FSA**, an actuary with CP Consulting Services. Typically, an insurance company or captive will transfer uncertain loss exposures above and beyond perceived norms to another party through a reinsurance contract. Carlson offers an overview of underwriting techniques customarily employed by reinsurance underwriters to structure a reinsurance program that provides the capacity and protection required by the ceding company. In addition, he explains the importance of periodic oversight to determine that initial underwriting standards are maintained, including policy forms, adequate rates and management expertise throughout the reinsurance relationship.

On behalf of the entire Reinsurance Interest Section Committee, we extend our best wishes for a happy holiday season and happy New Year. ■

Catastrophe ‘Awards Made’ Excess of Loss Reinsurance

by Savannah Sellman, J.D.



Savannah Sellman, J.D., is a partner in the San Francisco, Calif., office of Clyde & Co. She is an ARIAS-certified arbitrator and has practiced law for 37 years in all facets of the insurance and reinsurance industry, including as an assistant and deputy attorney general with the Pennsylvania Insurance and Justice Departments; as an officer and in-house counsel to two insurance companies on both the East and West Coasts; and in private practice. Currently, she counsels domestic and international insurance and reinsurance companies. She also has served as an expert witness.

What is Catastrophe ‘Awards Made’ Excess of Loss Reinsurance?

Catastrophe “Awards Made” Excess of Loss Reinsurance (Awards Made Reinsurance) provides reinsurance coverage to cedents for excess of policy limits (XPL) and extra-contractual obligations (ECO) losses. The primary purpose of Awards Made Reinsurance is to allow the cedent to cede a portion of XPL and ECO losses covered by the cedent’s insurance policies to a reinsurer. Some cedents also transfer all, or a portion of, the risk for the manner in which the cedent handles losses, as well as the losses themselves.

The risk of the manner in which the losses are handled is outside the scope of coverage of original insurance policies and generally breaks down into two parts. XPL involves a loss covered by the original policies but in an amount in excess of the policy limit; sometimes, a cedent is liable for that loss in excess of the policy limit due to the mishandling of the claim — failing to settle within the policy limit when there was an opportunity to do so. ECO losses, on the other hand, arise from wrongful actions, such as bad faith, that may be unrelated to the covered losses per se, such as deceptive or improper claims practices.

For example, the XPL coverage would respond to a trial court judgment against a cedent’s insured for an amount in excess of that insured’s policy limit. The cedent could be responsible for an XPL judgment if, for example, the cedent had an opportunity to settle a claim within the policy limit and the policyholder demanded that the cedent do so, but the cedent decided to try the case instead, believing in the strength of the defenses or because the cedent concluded that the amount for which the claim could be settled was higher than the likely award after trial.

ECO coverage, on the other hand, would respond to a judgment against the cedent itself for bad faith. This could include punitive damages awards; the typical Awards Made Reinsurance contract covers punitive damages awards to the extent that the jurisdiction in which the punitive damages are awarded permits reinsurance (or insurance) coverage for same.

In addition to providing coverage for XPL and ECO judgments, some Awards Made Reinsurance contracts include settlements made by a cedent in circumstances likely to give rise to an XPL award, or when an XPL award has been made and an appeal is pending. Cedents would be well-advised to obtain the imprimatur of the reinsurer in advance of entering into such a settlement in order to avoid a subsequent coverage dispute.

Ultimate Net Loss

A typical Awards Made Reinsurance contract defines “ultimate net loss” to mean “the sum actually paid or payable by the [cedent] in settlement of any liability incurred by the [cedent] as a result of Awards in Excess of the [cedent’s] Original Policy Limits, and/or in respect of Claims-Related Extra-Contractual Obligations.” The amount of ultimate net loss generally includes all expenses and costs or appeal costs a cedent incurs for such awards, net of all amounts covered from more specific reinsurers. Most Awards Made Reinsurance contracts exclude from ultimate net loss expenses incurred by the cedent up to the date that the award has been made in connection with the adjustment, settlement or compromise of any such loss, including expenses of litigation.

Exclusions in the Typical Awards Made Contract

Awards Made Reinsurance contracts generally exclude claims involving nuclear incidents, terrorism, liability assumed via an insolvency fund and assumed reinsurance.

Trigger of Payment

The obligation of the reinsurer to pay under an Awards Made Reinsurance contract is a judgment issued for XPL and/or ECO that is above the reinsurance retention or above underlying reinsurance coverage that also extends to XPL and ECO. For example, a cedent may have a “first layer” reinsurance contract in the amount of \$250,000 excess \$750,000, with \$750,000 being retained by the cedent; that first layer reinsurance coverage may include XPL and ECO, and if so, it typically is subject to a percentage, such as 80 percent. Under this scenario, an Awards Made Reinsurance contract could attach at the point that the cedent’s first layer reinsurance exhausts. However, a cedent also may wish to self-insure a layer above the first layer reinsurance coverage and remain self-insured for that amount and then have the Awards Made Reinsurance contract take effect above the self-insured layer.



Availability of Awards Made Reinsurance

While Awards Made Reinsurance is relatively inexpensive, and provides comprehensive insurance in the event of a substantial verdict, it is not always a viable option for relatively young companies for the following reasons:

First, relatively young companies generally do not have sufficient claims to justify Awards Made Reinsurance coverage. Also, for cedents who do not try numerous cases in a given year, it may not be necessary. However, if a cedent insures in jurisdictions in which there is a history of multimillion-dollar awards and an anti-insurer judiciary, Awards Made Reinsurance may provide an important element of safety.

There is an incentive for the cedent to continuously purchase Awards Made Reinsurance until any and all potentially troubling trials are concluded. If a claim arises that proves difficult to settle within policy limits, it would be necessary to maintain Awards Made Reinsurance coverage until the claim is resolved, since coverage under Awards Made Reinsurance is triggered by an actual award or a settlement in anticipation of one.

If a cedent identifies a potentially troublesome claim, the cedent generally is required to notify reinsurers. Under those circumstances, reinsurers may elect to increase the renewal premium for the Awards Made Reinsurance contract in order to protect themselves against an award that would trigger the Awards Made Reinsurance coverage. In this regard, it warrants emphasis that the date of the XPL or ECO award is the trigger for coverage, not the date the original claim was made. This enables reinsurers to better predict, and collect premium, in anticipation of the exposure.

Definitions

Often confusing to laypeople is that the typical Awards Made Reinsurance contract defines XPL and ECO coverage similarly, insofar as the basis on which they are incurred, as follows: “Failure by the Company to settle within the original policy limit or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the preparation of the defense or in trial of any such action against their insured or

in preparation or prosecution of an appeal consequent upon such action.” However, the difference in coverage between XPL and ECO is the result of that conduct.

For XPL — awards in excess of the original policy limit — the coverage trigger is contractual losses that the cedent may be legally liable to pay, but which are in excess of the cedent’s original policy limit. For ECO — claims-related extra-contractual obligations — the coverage extends to liabilities the cedent is legally obligated to pay, but which are not covered under any other provision of the Awards Made contract and which arise from the handling of any claim on business covered under the Awards Made Reinsurance contract — in essence, awards for bad faith.

It warrants emphasis that under Awards Made Reinsurance, reinsurers will not support XPL or ECO losses where the award has been incurred due to the fraud of a member of the board of directors or a corporate officer of the cedent acting individually or collectively or in collusion with any individual or corporation or any other organization or party involved in the presentation, defense or settlement of any claim. This effectively means that if a rogue director or corporate officer commits fraud that leads to an XPL or ECO loss, there would be no coverage to the cedent under the Awards Made Reinsurance contract.

Conclusion

Cedents that try numerous cases each year, or that try cases in jurisdictions that tend to be anti-insurer-inclined to find and award for bad faith against insurers, would be well advised to protect themselves against XPL and ECO losses by obtaining Awards Made Reinsurance coverage. ■

Atlantic Basin Seasonal Hurricane Forecasts

by Philip J. Klotzbach, Ph.D., and William M. Gray, Ph.D.



Philip J. Klotzbach, Ph.D., is a research scientist in the Department of Atmospheric Science at Colorado State University (CSU) in Fort Collins, Colo. At age 18, Klotzbach graduated summa cum laude from Bridgewater State University in Massachusetts with a bachelor's degree in geography. He earned a master's degree in 2002 and doctorate in 2007 from CSU. In 2006, Klotzbach became first author on the hurricane seasonal forecasts issued by the Tropical Meteorology Project at CSU.

William M. Gray, Ph.D., has been with the Department of Atmospheric Science at Colorado State University (CSU) since 1961. He has worked in the observational and theoretical aspects of tropical meteorological research for more than 50 years. Gray pioneered Atlantic basin seasonal hurricane forecasts, which he has been issuing for the last 25 years. He is an author of more than 80 published papers and more than 60 extensive research reports. Gray received his Ph.D. from the University of Chicago under renowned hurricane researcher Herbert Riehl, Ph.D. He has specialized in the global aspects of tropical cyclones for his entire professional career.

Authors' note: The Tropical Meteorology Project (TMP) at Colorado State University, headed by William M. Gray, Ph.D., has been issuing Atlantic basin seasonal hurricane forecasts since 1984. The TMP currently issues seasonal hurricane forecasts at four lead times — early December, early April, early June and early August. Prior to the mid-1980s, there was no objective methodology available for determining how active the upcoming Atlantic hurricane season was likely to be. Since we are attempting to forecast small-scale weather events (e.g., hurricanes) months in advance, we utilize a statistical climate modeling approach for our forecasts. We are constantly working on improving and refining our seasonal forecast schemes. New statistical models were unveiled for the 2008 Atlantic hurricane season and led to forecasts which were very close to observations.

Statistical climate forecasts are based on the premise that those global oceanic and atmospheric conditions which preceded comparatively active or inactive hurricane seasons in the past provide meaningful information about similar trends in future seasons. We build our forecasts by applying a hindcast technique (using the past to predict the future), whereby we select predictors that explained a considerable amount of the variability in hurricane seasons over the past 60 years.



Several of the key features that are investigated in these seasonal hurricane forecasts include current and predicted states of El Niño (anomalously warm eastern and central

tropical Pacific sea surface temperatures), tropical and North Atlantic sea surface temperatures and sea level pressures, and tropical Atlantic vertical wind shear (the change in wind direction with height).

Typically, more active Atlantic hurricane seasons are associated with La Niña (anomalously cool eastern and central tropical Pacific sea surface temperatures) in the tropical Pacific, warmer than normal tropical and North Atlantic sea surface temperatures, lower than normal tropical Atlantic sea level pressures, and reduced levels of tropical Atlantic vertical wind shear.

Our methodology is to be contrasted with numerical modeling, which involves observing atmospheric fields such as winds and pressures and numerically integrating them forward in time using known mathematical formulae. This technique works very well out to about seven to 10 days when the atmospheric wind and pressure fields are the dominant factor. However, after this point, forecasts using numerical modeling tend to degrade toward chaos, because one must take into account a plethora of interrelationships between the atmosphere, the ocean and the land surface.

Insurance Industry Interpretation of Seasonal Hurricane Forecasts

Seasonal forecasts issued by the Tropical Meteorology Project (TMP) since 1984 have shown moderate levels of skill above that specified by a climatological average forecast or a previous five- or 10-year running mean. Forecasts issued in June and August have shown the highest levels of skill, which is to be expected since we are then closest to the events (e.g., the upcoming hurricane season) that we are trying to predict.

Even though the hurricane season runs from June 1–Nov. 30, we feel that issuing a forecast on Aug. 1 is still of considerable use, as approximately 95 percent of all major hurricanes (storms with one-

Table 1
Verification of the Authors' Early August Forecasts
of Atlantic-Named Storms and Hurricanes
Between 1984–2008

Year	Predicted Named Storms	Observed Named Storms	Predicted Hurricanes	Observed Hurricanes
1984	10	12	7	5
1985	10	9	7	6
1986	7	4	4	3
1987	7	7	4	3
1988	11	12	7	5
1989	9	8	4	7
1990	11	12	6	7
1991	7	7	3	4
1992	8	6	4	4
1993	10	7	6	4
1994	7	6	4	3
1995	16	14	9	10
1996	11	10	7	7
1997	11	3	6	1
1998	10	13	6	10
1999	14	11	9	8
2000	11	14	7	8
2001	12	14	7	9
2002	9	11	4	4
2003	14	12	8	5
2004	13	14	7	9
2005	13	20	8	12
2006	13	7	7	5
2007	13	12	8	6
2008	13	12	7	6
Average	10.8	10.3	6.2	6.0
1984-2008 Correlation		0.62		0.58

Notes: Observations only include storms that formed after Aug. 1. Observe that these early August forecasts have either exactly verified or forecasted the correct deviation from climatology in 23 of 25 years for named storms and 19 of 25 years for hurricanes. If we predict an above- or below-average season, it tends to be above or below average, even if our exact forecast numbers do not verify.

minute sustained winds of more than 111 mph) form after this date.

Table 1 displays seasonal forecasts issued by the TMP in early August for named storms and hurricanes forming after that date.

It is important that the insurance industry appreciates that these seasonal forecasts are based on statistical schemes which, owing to their intrinsically probabilistic nature, will fail in some years. Moreover, these forecasts do not specifically predict where within the Atlantic basin these storms will strike. The probability of landfall for any one location along the coast is very low and reflects the fact that, in any one season, most U.S. coastal areas will not feel the effects of a hurricane no matter how active the individual season. However, it must also be emphasized that a low landfall probability does not ensure that hurricanes will not come ashore.

Our project, in partnership with the GeoGraphics Laboratory at Bridgewater State College, Bridgewater, Mass., has recently developed the United States Landfall Probability Project, which provides probabilities of landfall based on historical data and adjusted based on the premise that more active seasons tend to have more landfalls. This data is currently available online at <http://www.e-transit.org/hurricane>. The Landfall Probability Web site is adjusted with each seasonal forecast update.

Long-Term Trends in Atlantic Hurricane Activity

There is currently a vigorous debate as to whether storm activity in the Atlantic is getting worse due to human-induced climate change. Our project has done extensive study into this question and finds that at this point there are no detectable trends in levels of activity in the Atlantic. Although Atlantic hurricane seasons have been much more active since the mid-1990s, similar active periods are also documented in historical data maintained by the National Hurricane Center from 1926–1969 and during the late 19th century.

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Atlantic Basin Seasonal Hurricane Forecasts

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The Atlantic basin has more pronounced variability on multidecadal timescales than does any other tropical cyclone basin (such as the Northeast Pacific and the Northwest Pacific). This variability is likely driven by natural ocean circulation changes that drive changes in Atlantic sea surface temperature, sea level pressure and vertical wind shear patterns in such a way as to make Atlantic seasons more or less active.

As one goes back further in time, our ability to detect and monitor tropical cyclones degrades. Prior to the mid-1960s, there was no satellite data, while prior to the mid-1940s, no aircraft reconnaissance was conducted. However, we find that the U.S. coastline has been quite densely populated since around 1900, and therefore, we use the number of U.S. landfalls to investigate potential changes in levels of hurricane activity.

For the insurance industry, tropical cyclones are typically only of consequence if they make U.S. landfall. Table 2 displays U.S. landfalls from 1900–1949, along with the most recent 50-year period (1959–2008). Even though global temperatures have risen during this time period, the number of U.S. landfalls has actually gone down slightly.

This decrease in landfall is especially dramatic for the U.S. East Coast and Florida Peninsula. Figure 1 displays landfalling major hurricanes during the 43-year period from 1923–1965, along with the most recent 43-year period of 1966–2008. Only seven hurricanes made landfall over the most recent period compared with 24 during the earlier period.

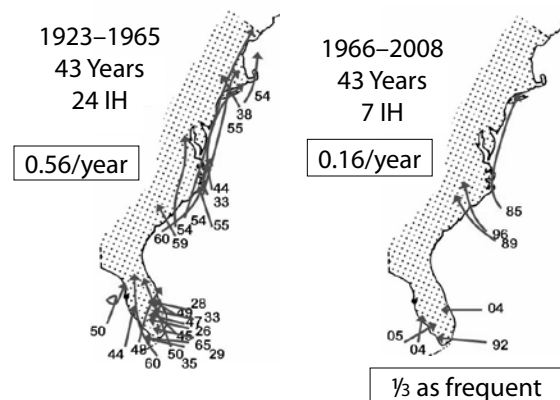
Summary

Seasonal hurricane forecasts issued by the TMP generate a considerable amount of interest among the insurance industry and the general public. This is likely due to the fact that there is inherent curiosity about how active the upcoming season is likely to be. Using historical data, there is significant hindcast skill available for

Table 2
U.S. Landfalling Tropical Cyclones Binned by Landfall Intensity During Two 50-Year Periods

Years	Named Storms	Hurricanes	Intense Hurricane (Cat 3–4–5)	Global Temperature Increase
1900–1949	189	101	39	+0.4°C
1959–2008	167	85	33	

Figure 1
Contrast of Tracks of East Coast and Florida Peninsula Major Landfalling Hurricanes



Note: Figure 1 shows the contrast of tracks of East Coast and Florida Peninsula major landfalling hurricanes during the 43-year period of 1923–1965 versus the most recent 43-year period of 1966–2008. If we predict an above- or below-average season, it tends to be above or below average, even if our exact forecast numbers do not verify.

predicting the upcoming season. One must realize that these are statistical forecasts which will fail in some years. However, we find that we also learn a lot from our forecast errors.

Our end-of-the-season verifications give much information on explaining what the factors were that dictated the number and frequency of storms. Some of these factors may not have been considered in our forecasts for that particular year, and we often add new predictors in a

quantitative or qualitative manner based on our end-of-the-season verifications. We will continue to revise and hopefully improve these seasonal forecasts in future years. ■

Global Warming — The Next Big Thing for Reinsurance?

by Andrew S. Boris, J.D.



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

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There is a persistent fear that a new form of catastrophic claim will disrupt the insurance and reinsurance markets. Over the years, many have expressed concern that new claims involving Y2K, mold or certain building products would take on the characteristics of the large environmental and asbestos claims that have plagued the industry over the past three decades.

As experts try to forecast the next “big thing,” there have been several “global warming”-related cases in the past few months that raise the specter that such claims may proliferate and ultimately lead to an influx of problematic claims for insurers and reinsurers. See *State of Connecticut, et al., v. American Electric Power Co., et al.*, 583 F.3d 309 (2d Cir. 2009) and *Comer v. Murphy Oil USA, et al.*, 2009 U.S. App. Lexis 22774 (5th Cir. Miss. October 4, 2009).

The “global warming” cases involve plaintiffs suing a variety of different corporate defendants (often involved in the energy, utility, chemical fields) for their alleged role in emitting greenhouse gases — ultimately leading to a variety of damages. By way of example, many of the suits allege that by virtue of the defendants’ actions or inactions there has been an increase in the levels of greenhouse gases in the atmosphere, resulting in rising ocean water levels, loss of land due to the higher ocean levels and increased ferocity of hurricanes.

Until recently, courts were not convinced that “global warming” issues should be addressed by the judiciary and have, in turn, dismissed the cases. See *State of Connecticut v. American Power Co.*, 406 F.Supp.2d 265 (S.D. N.Y. 2005); *People of the State of California v. General Motors Corp. et al.*, 2007 U.S. Dist. Lexis 68547 (N.D. Cal. September 17, 2007); and *Comer v. Nationwide Mutual Ins. Co.*, 2006 WL 106645 (S.D. Miss. February 23, 2006).

In effect, the courts in these cases opined that the questions presented by allegations of “global warming” are not justiciable, as they involve political questions that should be addressed by Congress. In addition, courts have questioned whether the plaintiffs in such cases had adequate standing to assert their claims because their injuries were not fairly traceable to the defendants’ alleged misconduct.

However, two recent cases from the Second and Fifth Circuit Courts of Appeals ruled that climate change issues can be addressed by the courts. In both cases, the appellate panel distanced itself from the lower court’s decision dismissing the case and ruled that the plaintiffs had stated a cognizable federal claim.

In *State of Connecticut*, the plaintiffs (various states, New York City and individual land trusts) filed suit against numerous utility companies contending that the defendants were major sources of greenhouse gases and the ultimate cause of “global warming.” In turn, the plaintiffs asked, among other requests, the court to cap and order a reduction in the defendants’ greenhouse gas emissions.

In *Comer*, the plaintiffs contended that the defendants’ increased greenhouse gas emissions fueled (and increased) the ferocity of Hurricane Katrina. In turn, the increased strength of the hurricane caused additional (and greater) property damage when Katrina hit the U.S. coastline.

In both cases, the courts determined that the judiciary was charged with responsibility for addressing complex claims that also address political and social concerns. Finding that the plaintiffs were able to advance a cognizable federal claim and had standing to bring the claim, the courts reversed the respective lower court’s rulings dismissing the cases.

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Global Warming — The Next Big Thing for Reinsurance?

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Interestingly, at approximately the same time the Second and Fifth Circuits determined that “global warming” cases can be handled by the judiciary, another federal court ruled that it lacked subject matter jurisdiction because the plaintiffs’ injuries were not fairly traceable to the defendants’ alleged misconduct and it was impermissibly being called upon to issue a ruling on a political question. See *Native Village of Kivalina v. ExxonMobil Corp., et al.*, 2009 U.S. Dist. Lexis 99563 (N.D. Cal. September 30, 2009). The action was filed by the Inupiat Village of Kivalina, Alaska, claiming, as a result of “global warming,” that Kivalina was disappearing due to the rise of the sea level in the Arctic Ocean.

Distancing itself from some of the reasoning embraced by the courts in *Connecticut* and *Comer*, the *Kivalina* court found the case should be dismissed. Of note, the judge was clearly troubled by the fact that the problems associated with “global warming” were shared (and potentially caused) by the world’s population and yet only a handful of defendants were being held potentially liable. As in other cases, the judge believed that the plaintiffs’ causes of action were asking the judiciary to make policy choices and determinations that were better left to the legislative branch.

What does this mean? It is hard to tell if a new trend is developing where courts will embrace the idea that “global warming” can be addressed by the judiciary. If so, the size and scope of such cases are hard

to predict, but many worry that the variations of such claims could present challenges for insurers and reinsurers.

Complicating matters has been the difficulty that many insurers have had in drafting an exclusion that could be utilized to address the full range of potential “global warming” claims. However, since virtually all forms of commercial and business activity arguably contributed to the rise of greenhouse gas levels in the atmosphere, the potential for different variations of a global warming action is significant.

Nonetheless, based upon the lessons of past environmental coverage litigation, direct insurers retain a number of different arguments to defeat coverage claims for “global warming”-related losses. As to reinsurance, there is a fear that “global warming” cases could lead to a new round of highly charged environmental coverage litigation.

Although direct insurers are better able to challenge claims involving environmental losses, reinsurance disputes involving questions about the underlying allocation of damages, the application of “follow the fortunes and settlements” and the number of occurrences/aggregation would surely follow.

The most recent “global warming” cases have opened the door to potential future problems, but it remains unknown whether the plaintiffs will be able to overcome the many hurdles that stand in their way to proving actual damages. Among other challenges, the arguments involving causation and apportionment of liability will be quite complicated and take time to develop. However, for those that are charged with the responsibility of identifying new and potentially complicated future risks, “global warming” claims have identified themselves on the horizon. ■



Volunteer Leaders, Rising Stars to Gather in Phoenix

The CPCU Society’s current and emerging leaders will focus on strategic issues affecting the Society and your chapter at the 2010 Leadership Summit. The conference will be held on April 29–May 1, 2010, at the Pointe Hilton Squaw Peak Resort in Phoenix, Ariz.

All volunteer leaders are urged to attend this distinguished gathering to chart the Society’s future course and participate in a free-flowing exchange of ideas on vital topics.

The Summit will include:

- Board of Directors meeting.
- Committee, task force and interest group meetings.
- CPCU Society Center for Leadership courses. Open to all members.
- Chapter and interest group leader workshops.
- Leadership luncheons with special guest speakers.

Visit www.cpcusociety.org for a sneak preview.

Preparing Your Organization for Risk, Threats and Opportunities — The Importance of Enterprise-Wide Risk Management (ERM) Education

by Richard G. Berthelsen, CPCU, J.D., MBA, ARM, AIC, ARe, AU



Richard G. Berthelsen, CPCU, J.D., MBA, ARM, AIC, ARe, AU, is director of content development for the American Institute for CPCU/Insurance Institute of America (the Institutes) in Malvern, Pa. He writes and maintains textbooks, course guides and other course materials for several programs, including those used in risk management. Before joining the Institutes in 2003, Berthelsen worked as an attorney in private practice for the insurance defense law firms of Chunn & Pilcher and Phillips & Akers in Texas. Previously, he served as regional counsel for USAA and as in-house counsel for Alliance Insurance companies. Berthelsen can be reached at berthelsen@cpcuiia.org.

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If today's volatile business climate has taught us anything, it is that organizations must deal with uncertainty in a thorough and systematic manner. But how? Organizations of all sizes are struggling to understand how to effectively deal with the uncertainties of conducting business to not only survive, but also to thrive. The answer is implementing an enterprise-wide risk management (ERM) approach to manage risks that are caused by uncertainties. These risks can be threats or opportunities.

What is ERM? It is a holistic approach to managing an organization's uncertainty in order to maximize stakeholder value and optimize risk taking. Unlike traditional risk management, ERM deals with the strategic risks your organization faces, not just the operational ones. With a properly designed and implemented ERM program, an organization can optimize its risk taking, which will allow it to react more quickly and efficiently to avoid or mitigate threats and capitalize on opportunities.

Developing and implementing an effective ERM approach requires a significant investment of resources, as well as education across the enterprise. But it is an investment that will yield two important organizational benefits:

- Enhanced decision making.
- Improved risk communication.

Enhanced Decision Making

No matter what kind of business you run, an ERM approach allows you to explore new opportunities for profit and growth while effectively managing internal and external threats. Rather than consolidating risk management decisions at the top of the organization, an ERM approach opens this up to decision makers at all levels. The idea is that

when risks, threats and opportunities are understood across the enterprise, decision making is made more nimble to meet marketplace challenges. In addition, the following advantages can be realized:

- **Increased Profitability.**
ERM increases your organization's profitability because strategic decisions involve more than preparing only for adverse outcomes. Properly implemented, ERM allows organizations to engage in additional business opportunities by allocating resources through rational decision making at the optimal level. With ERM, strategic decision making is integrated across departmental and unit silos, which makes it more sound and improves economic efficiency. Over time, organizations with a sound ERM approach will show higher earnings.
- **Reduced Earnings Volatility.**
In addition to maintaining cash flows and balancing its budget, your organization must manage its cash flow to ensure adequate capital to meet challenges and to explore strategic growth opportunities. ERM provides a framework that allows organizations to deploy capital through organization-wide decision making, which ultimately results in stable earnings projections to achieve higher financial ratings, appeal to stakeholders and fund future projects.
- **Improved Ability to Meet Strategic Goals.**
ERM provides for organization-wide involvement in the strategic formulation and decision-making process. This process examines internal and external factors that contribute to threats to growth and the achievement of established goals. When used effectively, ERM can reduce variation

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Preparing Your Organization for Risk, Threats and Opportunities — The Importance of Enterprise-Wide Risk Management (ERM) Education

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through thorough risk identification, assessment and management, thus improving your organization's ability to meet its strategic goals.

- **Increased Management Accountability.**

While an ERM approach must be supported in the C-suite, those closest to a particular risk are in the best position to evaluate and manage it. Therefore, ERM must be embedded throughout your organization's corporate culture. When ERM is part of your organization's DNA, the board and senior executives establish the overall mission, vision and strategic goals, but each manager is responsible and accountable for decision making about risks within his or her individual unit, which increases accountability.



Improved Risk Communication

ERM allows your organization to develop systems that drive information, eliminating the barriers created by "information silos." You know the problem with silos — they limit access to critical knowledge about risks, corporate strategies and organizational frameworks. ERM also encourages communication about risk management across all layers of the enterprise. This includes making

managers aware of the need to identify obstacles and opportunities that could interfere with or aid in the achievement of your organization's strategic goals.

Improved organization-wide communication results in fewer surprises for managers who could otherwise lack adequate information or full knowledge of the gravity of risk. Strong communication can also mean greater management consensus and improved stakeholder acceptance.

- **Management Consensus.**

ERM improves management consensus by creating a culture that embraces risk as a component of each decision. By empowering all managers to consider risk optimization and the cost of risk, ERM provides them with more complete information about the potential effects of a decision, including the downsides and upsides. Managers who can successfully gauge threats and opportunities act more confidently because they can appropriately evaluate the alternatives associated with a course of action. Upper management must lead the initiative and motivate all employees to embrace ERM and encourage risk ownership across all levels of your organization.

- **Stakeholder Acceptance.**

ERM improves acceptance by internal stakeholders by building a spirit of cooperation among management, which can also increase confidence among employees. Boosting the spirit of cooperation begins with managers understanding that the way they manage risk will have a positive impact on the organization, employees and themselves. A strong ERM program also encourages the buy-in of an organization's external stakeholders by establishing management strategies that protect the organization's reputation and assets. Experts estimate that for many organizations, intangible reputation-related assets may be worth several times more than tangible ones.

Establishing an effective ERM approach can be a complex endeavor. This is why ERM education is critical. Like the practice of ERM itself, ERM education must be provided throughout your entire organization, from the C-suite to the loading dock. There are a variety of ways to acquire the necessary knowledge and skills.

An education program like "Enterprise-Wide Risk Management: Developing and Implementing," from the American Institute for CPCU and Insurance Institute of America, will help provide the necessary understanding for building a solid ERM foundation within your organization. Whatever education provider you choose, it is critical that the program be ERM-specific. It is also critical that ERM training be conducted at all levels of your organization, so managers and other decision makers understand the role and benefits of ERM as they relate to their job functions. ■

Reinsurance Underwriting — The Basics

by Bruce Carlson, FSA



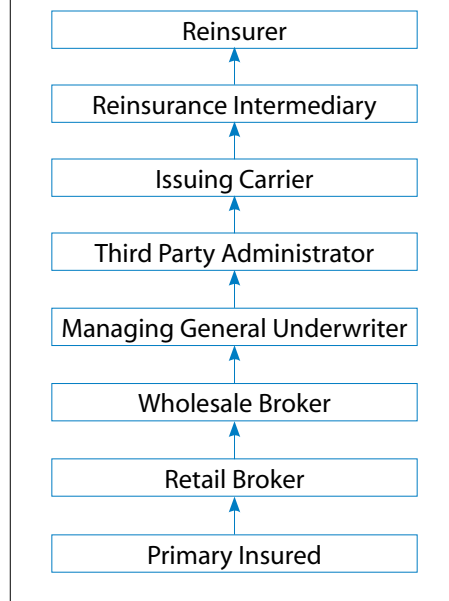
Bruce Carlson, FSA, is a fellow member of the Society of Actuaries as well as an ARIAS-US Certified arbitrator, umpire and qualified mediator. In addition to arbitrating reinsurance and securities disputes, Carlson serves as an expert witness in the insurance, reinsurance, self-insurance and managed care industries. He is the CEO of CP Consulting Services LLC.

Underwriting a reinsurance program involves due diligence both on the structure of the program as well as the people responsible for managing the program. The latter involves checking backgrounds, tracking records, having expertise, and ensuring that incentives are properly aligned — no small or easy task. This article focuses more on the structure of the program itself and identifies certain areas that are often overlooked when considering a program to reinsure.

Primary Coverage Properly Priced

If the underlying primary risk is under priced or if the underwriting guidelines are not followed, the program is doomed from the beginning. The easiest risks to write are those that other insurers have rejected or that are underpriced. That is how some reinsurers got burned. Large public workers compensation programs were written at rates far below historical experience.

Figure 1



Frequent underwriting and claim audits are necessary to ensure that underwriting guidelines are adhered to, that net premium covers expected claims with a reasonable margin for profit, and that the gross premium includes fair loads for those persons/entities being paid from the gross premium.

Too Much Erosion

Too often we see numerous non-risk-taking entities eroding far too much of the premium while adding little, if any, value. As an example, Figure 1 shows a typical stop-loss program and the entities that may be involved:

In this simple example, six parties take a bite at the apple before it gets to the reinsurers.

To determine how much premium is being eroded, “follow the money.” In other words, trace a “dollar” of gross premium through the system and ask how much is taken, by whom and for what purpose.

Poor Risk Selection

Primary underwriting is both risk selection and pricing. You cannot correct poor risk selection with adequate pricing.

Both must be done properly, and a good underwriter can make or break a program. The old adage, “Don’t let the scent of the premium overpower the stench of the risk,” is sound advice.

Arbitrators are often unsympathetic to reinsurer complaints about poor underwriting when the complaints are not raised until after the results of the program are known, particularly when the reinsurer knew of these practices while the program was operating and took no action to curtail them. Similarly, if the reinsurer had the right to audit but failed to exercise that right, it may have weakened its right to complain later.

Reinsurers should audit soon after the program begins writing business, put the audit findings into a written report along with any required program changes, and follow up soon thereafter to ensure those changes were implemented.

Excess Reinsurance Layers Not Properly Priced

The reinsurer needs to be comfortable not only that the gross premium is adequate, but also that the portion allocated to the layer it participates on is sufficient to cover expected claims within that layer. This is difficult to do, especially at the higher layers, since few claims penetrate into those layers and no credible data exists. If credible claim distributions are not available, a higher profit margin can be added to the rates to protect the reinsurer along with an experience refund provision to reward the cedent should experience turn out favorable.

Disproportionate Risk Premium within a Layer

All reinsurers participating in a given layer should be treated equally in terms of the premium they receive for their respective share. Different reinsurers within the same layer should not be allowed to negotiate different terms for what is essentially the same risk.

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Under- and Over-Subscribed Programs

Reinsurers should understand how the total program is split into layers, if the program is fully subscribed, and who are the other reinsurers. If any lower layers are not filled, then claims falling into those gaps may “percolate” through to the layer in which you participate. This is the infamous “London Spiral,” where upper layer reinsurers ended up paying on claims that should have been reinsured at lower layers. Similarly, if any higher layer is not filled and the program is “joint” or is written as a pool, lower layer reinsurers may be on the risk for unreinsured claims falling into that higher layer. The same can happen if a reinsurer goes insolvent or is otherwise unable to meet its obligations.

Conversely, if a program is oversubscribed with more than 100 percent reinsured, the cedent has an incentive to write bad business since reimbursements will exceed primary claims payable.

Make certain the program is fully subscribed but not oversubscribed, and that agreements are written such that any portion or layer not reinsured is a risk of the issuing carrier. Since that issuing carrier is not paying reinsurance premium for any under-subscribed full layers, it should not be reimbursed on those portions not reinsured.

Risks Covered Not Well Defined

Quite often reinsurers are surprised and disappointed to learn what primary risks were written. If the slip or treaty doesn’t specifically exclude a category of risk, then, under the “Follow-the-Fortunes Doctrine,” the reinsurer may not be able to avoid covering that risk.

Insist on a well-crafted definition of what is and is not covered and put that into the placement slip, letter of understanding or signed treaty. Examples of common restrictions include:

- (1) No reinsurance or retrocessions will be assumed.
- (2) No multiyear contracts.
- (3) No multiyear rate guarantees.
- (4) No portfolio transfers.
- (5) No risks written outside of a well-defined UW manual.
- (6) Geographic restrictions.
- (7) Volume restrictions.

Improperly Aligned Incentives

You can often predict people’s behavior if you understand how they get paid. However, that is easier said than done. Many programs have been written where the Managing General Agent (MGA) or Managing General Underwriter (MGU) is handsomely rewarded for writing bad business. Even fronting carriers that take a small portion of the risk can negotiate a ceding allowance containing profit margins that more than offset underwriting losses on their small retained share.

In the insurance business, MGA and MGU compensation is often a percentage of premiums written. A profit-sharing agreement may help to align incentives, but only if the other compensation just covers costs with perhaps a small margin for profit. Otherwise, these bonus arrangements are often viewed as “frosting on the cake,” and the people managing the program get fat and happy eating the cake without the frosting.

Misaligned incentives are difficult to detect. What is the appropriate fee income an MGU or MGA needs to cover its costs? What other related sources of income (e.g., case management referral fees) does the administrator receive? Does the marketing entity participate in any captives where it has an incentive to place good risks in a particular facility and reinsure bad risks in your program? These questions need to be explored.

Excessive Ceding Allowances

Reinsurers and cedents often argue over the proper level of ceding allowances. Reinsurers are suspicious those allowances may contain hidden profit margins. This is a two-edged sword, however, as the ceding allowance is designed to cover not only certain expenses of the cedent, but also any additional risks the cedent takes for writing those risks on its paper. Some of those costs and risks are:

Costs

- (1) Compliance — keeping policy forms compliant with various state and federal laws.
- (2) Audit — the cedent should periodically perform compliance and market conduct audits of those who market its products.

Risks

- (1) Fines and other regulatory actions.
- (2) Reinsurer insolvency.
- (3) MGU or Third Party Administrator (TPA) insolvency.
- (4) Dispute-resolution costs.

These risks occur infrequently and are hard to quantify, making it difficult to judge which level of ceding allowance is proper.

Lack of Oversight

All too often, no single reinsurer is identified as the “lead” that is responsible for initial and ongoing due diligence to make certain underwriting guidelines are being followed, premium is being accurately calculated and collected, and claims are properly adjudicated. In many cases, the question of who is responsible for oversight is never addressed until after a dispute arises.

The lead underwriter is typically, but not always, the reinsurer with the largest share of the risk. Since that reinsurer

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2009–2010 Reinsurance Interest Group Committee

Chair

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

American Agricultural Insurance Company
Schaumburg, Ill.
Phone: (847) 969-2947
E-mail: tpavelko@aaic.com

Newsletter Editor

Richard G. Waterman, CPCU, ARe

Northwest Reinsurance Inc
Minneapolis, Minn.
Phone: (952) 857-2460
E-mail: northwest_re@msn.com

Webmaster

Jonathan P. Wit, CPCU, ARe, ARM

American Agricultural Insurance Company
Schaumburg, Ill.
Phone: (847) 969-2963
E-mail: jwit@aaic.com

Richard T. Blaum, CPCU, ARe

Swiss Reinsurance Group
Armonk, N.Y.
Phone: (914) 828-8155
E-mail: richard_blaum@swissre.com

Barbara R. Burns, CPCU

Hackensack, N.J.
E-mail: barbara-burns@msn.com

Marsha A. Cohen, CPCU, ARe

Reinsurance Association of America
Washington, D.C.
Phone: (202) 783-8329
E-mail: cohen@reinsurance.org

Timothy D. Foy, CPCU

XL Insurance
Exton, Pa.
Phone: (610) 968-9345
E-mail: timothy.foy@xlgroup.com

Nicholas J. Franzi, CPCU, ARe

Munich Reinsurance America, Inc.
Princeton, N.J.
Phone: (609) 243-4632
E-mail: nfranzi@munichreamerica.com

Charles W. Haake, CPCU, ARe

Transatlantic Reinsurance Company
Shawnee Mission, Kan.
Phone: (913) 319-2520
E-mail: chaake@transre.com

Eric F. Hubicki, CPCU

BMS Intermediaries, Inc.
Barrington, Ill.
Phone: (847) 277-0201
E-mail: eric.hubicki@bmsgroup.com

Gordon J. Lahti, CPCU, ARe

Swiss Re
San Francisco, Calif.
Phone: (415) 834-2276
E-mail: gordon_lahti@swissre.com

Michael J. Lamplot, CPCU

Chilington International, Inc.
Elmhurst, Ill.
Phone: (630) 359-3722
E-mail: mlamplot@il.chilingtonusa.com

Ralph K. Riemensperger, CPCU

E-mail: mgysgt1@aol.com

Duane C. Soper, CPCU, CIC, ARe, ARM, AIM

General Re
Overland Park, Kan.
Phone: (913) 661-6916
E-mail: dsoper@genre.com

Liaisons

Connor M. Harrison, CPCU, ARe, AU, ARP, AAM, AIAF

AICPCU
Malvern, Pa.
Phone: (610) 644-2100, ext. 7557
E-mail: harrison@cpcuiia.org

Susan J. Kearney, CPCU, ARM, AU, AAI

AICPCU/IIA
Malvern, Pa.
Phone: (610) 644-2100, ext. 7226
E-mail: kearney@cpcuiia.org

John J. Kelly, CPCU

CPCU Society
Malvern, Pa.
Phone: (800) 932-CPCU, ext. 2773
E-mail: jkelly@cpcusociety.org



CPCU Society
720 Providence Road
Malvern, PA 19355
www.cpcusociety.org

Reinsurance Underwriting — The Basics

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will be doing a fair amount of work, it needs to be compensated for that work. Typically, 0.5 to 1 percent of additional risk premium is added to cover these ongoing costs. That compensation should be contingent on the other reinsurers' receiving periodic written audit reports identifying follow-up steps that the cedent, MGA or MGU needs to take to get a poorly performing program back on track.

Volume Cap

Every program should contain a cap on the volume of premium the reinsurer will assume. The cap can always be increased and creates an opportunity to review what has been written to date.

Document Representations Made

Cases for rescission are often based on material misrepresentations made before the contract or slip was signed. For rescission to be successful, the misrepresentation must have been:

- Material.
- Relevant.
- Relied upon.

A simple letter of understanding documenting any representations made, that they were relied on and why the representation is important (relevancy), will lend support should a case for rescission later arise. Most often, this letter will generate discussions and any representations made will be clarified.

A letter of understanding should not serve as a substitute for due diligence and periodic audits. If a reinsurer doesn't have the expertise, or is reinsuring a new line of business to gain market intelligence or simply to diversify its book of business, then consider hiring an outside consultant, selecting a lead underwriter with the required expertise, or limiting its exposure by taking a small share or placing a cap on the premium volume that will be accepted. ■

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Reinsurance Interest Group
<http://reinsurance.cpcusociety.org>

Chair

Thomas M. Pavelko, CPCU, J.D., ARe
American Agricultural Insurance Company
Phone: (847) 969-2947
E-mail: tpavelko@aaic.com

Editor

Richard G. Waterman, CPCU, ARe
Northwest Reinsurance Inc.
Phone: (952) 857-2460
E-mail: northwest_re@msn.com

CPCU Society

720 Providence Road
Malvern, PA 19355
(800) 932-CPCU
www.cpcusociety.org

Director of Program Content and Interest Groups
John Kelly, CPCU

Managing Editor
Mary Friedberg

Associate Editor
Carole Roinestad

Design/Production Manager
Joan A. Satchell

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