Reinsurance Contracts

Out of the backroom and into the light of innovation.

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The reinsurance contract wording process in the US has moved within a short period of just a decade from a backroom function to one of being “shoulder to shoulder” with the underwriter. This evolution was driven primarily by regulatory pressure to fundamentally change its contract wording process from no written contract in some cases to a fully written and signed contract prior to its inception. Similar pressure exists to use innovation in the reinsurance contracting process to restore the economic efficiency originally intended while managing growing frictional costs.
The treaty reinsurance contract wording process is at a crossroads.

The economically efficient informal contracting between parties based on good faith at the front-end of a treaty reinsurance transaction is evolving towards a formal commercial “arms-length” contracting process designed to eliminate inefficiency in the dispute resolution process at the back-end of a treaty reinsurance transaction. This evolution in treaty reinsurance contract wording format and content raises a number of fundamental issues for which innovation may be the only solution. In this article, Section I will explain the growing importance of treaty reinsurance contracts in the US market and postulate the form and content of today’s treaty reinsurance contracts do not reflect the actual business relationship between the parties; Section II will review and discuss the critical role of innovation in reconciling treaty reinsurance contract wording form and content to the business relationship between the parties.
SECTION 1

The underwriting process has been compared to a table with four legs. One leg being the ceding company; another leg, the ceding company’s business exposures; the third leg, reinsurance pricing; and the fourth leg comprising reinsurance coverage, structure, and contract wording. The analogy goes that if any one of the four legs breaks, the table collapses.

The evolution of treaty reinsurance contracts can be demonstrated even more clearly by its change in format from informal agreements - such as a handshake, or terms written on a napkin, or a three-page (or less) slip - to more formal agreements comprising, in some cases, over a hundred pages with numerous exhibits. This evolution in contract wording format and content is a result of external factors, such as laws and regulations regarding credit for reinsurance and industry insolvencies, as well as the demand for larger reinsurance capacity.

However, this evolution was not solely a result of these external legal, regulatory, or even economic developments. Rather, this evolution of the importance of the treaty reinsurance contract from a handshake based on “good faith” to legalistic commercial “arms-length” treaties can be seen as a direct result of the dramatic change in the business relationships between ceding companies, reinsurance brokers, and reinsurers.

It is an open question whether the format and content of today’s treaty reinsurance contracts adequately reflect these dramatic changes in business relationships. The traditional economic efficiency of informal reinsurance contracts, in which the frictional costs of such informalities were managed by a small cadre of entities by self-policing and informal dispute resolution processes (i.e., arbitration), has been tested by dramatic increases in the amount and sources of capital vying for business as well as significant increases in the potential amounts in dispute.

It can be anticipated that at some point in the future, the reinsurance industry will reach a tipping point in this efficiency vs. frictional costs balance and either move toward more formal commercial “arms-length” contracts, that more closely reflect the business relationship between ceding companies and reinsurers, but which will significantly increase expense and reduce efficiency; or, evolve into something that fulfills its intended purpose of being an economically efficient method to bring capital to markets with limited frictional costs. In other words, treaty reinsurance contracts will need to follow a different path to remain a viable and useful part of the fourth leg of underwriting. Consequently, reinsurance contract wording professionals need to start thinking now about innovative ways in which treaty reinsurance contract wording can continue to evolve and support the efficient delivery of capital to its markets with the minimum of frictional costs.

External reasons for the growing importance of reinsurance contract wording

Drafting or reviewing treaty reinsurance contracts was traditionally one of the ancillary responsibilities of the underwriter, and in many parts of the world, this is still the case. In the US reinsurance market, with its litigious environment, the need to have reinsurance contract wording professionals reviewing, drafting or negotiating such agreements evolved out of four developments in the industry.
In the last ten years of the hundreds of years reinsurance has existed, the industry has forced a transition from virtually no time limit within which to finalize, draft, and execute contracts to a requirement that full and final contracts be signed by the parties at or prior to inception.

Prior to the 1990s, treaty reinsurance contract wording remained largely free from restrictions within which agreements needed to be finalized, reduced to a written form, and executed by the parties. So up until recently in the US, it was common custom and practice in the broker market to negotiate and agree upon the economic terms of a treaty reinsurance agreement, memorialize them in a 1 to 3 page document called a “slip”, and leave any discussions as to other wording or terms listed as “TBD” (to be determined) to a later date, if at all. This broker market approach was based on the fact that most treaty reinsurance business was placed or bound at one or two times during the calendar year and often involved multiple reinsurers participating severally on individual contracts. In contrast to insurance policies, which can be bound and issued at any time over a more spread out calendar year period, treaty reinsurance ceding companies, brokers and reinsurers had to review, negotiate and bind a large volume of business during a very compressed time period once or twice a year. In order to do this efficiently, the parties leveraged their utmost good faith relationship by binding the essential economic terms prior to or at inception, and producing the detailed version of the agreement with additional “boilerplate” clauses at a later date.

This industry approach to contract wording changed in 1994 with the National Association of Insurance Commissioner’s (NAIC) adoption of changes to Chapter 62 of their Accounting Practices and Procedures Manual, effective January 1, 1995. The so-called “9 month rule” provides that if a contract is not finalized, reduced to written form and signed within nine months, the arrangement is presumed to be retroactive and must be accounted for as a retroactive financial transaction rather than reinsurance. The most important aspect of this change to retroactive accounting was such that reinsurance could not be used to reduce a ceding company’s loss reserves (i.e., no credit for reinsurance).

While the “9 month rule” started the acceleration of the contract wording process in the early to late 1990’s, the September 11, 2001 attack on the World Trade Center in New York City produced another significant change.

Subsequent litigation over competing primary insurance forms and the definition of what constituted an occurrence for purposes of coverage, namely, what do parties do when there’s a loss after an effective date of an agreement but before all of the terms of the agreement are finalized.

Arising from the tragedy of 9-11 came regulatory action in the UK, Bermuda and US regarding the concept of “contract certainty,” which was a catchphrase meant to express the attainment of mutual agreement on all terms and conditions in a treaty reinsurance contract prior to its effective date. It is worth noting that in the UK and Bermuda, insurance and reinsurance are regulated together by the same governmental entity, whether or not their contracting customs and practices are different from each other. So in a period of less than 10 years, the US broker market treaty reinsurance industry was forced by regulation to fundamentally change its contract wording process from no contract in some cases, to one or two page slips followed months later by a formal contract, to a fully written and signed contract prior to its inception.

Because the treaty reinsurance industry did not significantly change its practice of binding contracts at a few specific dates during the year, enormous pressure was placed on underwriters, actuaries, and contract wording professionals to draft or review, negotiate, finalize, and reduce to a written form whole portfolios of treaty reinsurance contracts prior to their inception. This tremendous acceleration, in one decade, of the creation and processing of the industry’s contracts, which had been in place for a century or more, thrust the role of the contract wording professional from the backroom to shoulder-to-shoulder beside the underwriter.

Louis Jarvis from the Hiscox Group observed this seminal change in her April 23, 2015 article entitled “The Changing Role of a Reinsurance Contracts Specialist,” stating:

“There was a time when a contracts specialist would only get sight of a reinsurance contract long after the underwriter and broker had finished their negotiations and the slip had been signed. In recent years though, particularly given the regulatory requirements for contract certainty, but also as the market looks at ever more complex risks, and terms and conditions come under increasing pressure, the role of the contracts specialist has moved from the back office to the front line; sitting alongside the underwriter and working to make deals happen.”
Reinsurance contract wording quality has become more critical

The asbestos and environmental losses incurred by the reinsurance industry beginning in the 1970s and continuing today, as well as the larger natural catastrophe limits required by reinsureds in today's global economy, have naturally resulted in disputes involving significant sums. While most of these disputes are driven by specific factual scenarios, ceding companies, brokers and reinsurers must be constantly vigilant to identify inaccuracies or ambiguities in contract wording and correct them.

Reinsurance structures and their contract wording have become more complex

The development by the capital markets of financing products aligned with natural perils (i.e., “Cat Bonds”) has added another level of complexity to treaty reinsurance contract wording. In the traditional property and casualty treaty reinsurance industry, the contract wording involved a ceding company, and an assuming reinsurer. Some of these placements involved additional transactions on the “back side,” e.g., a retrocession agreement to a captive of the ceding company, or on the “front side,” e.g., common account excess of loss covers for the benefit of the ceding company's quota share reinsurers. All of these transactions had a linear relationship requiring the contract wording in each agreement to be coordinated or consistent with each other, to some degree, in order for the “flow” of premium and liability to correctly reflect the intent of the parties.

The advantages to this type of business model is that it required a minimum of administrative expense to create but, at the same time, retained the ability to be customized or manuscripted depending on the needs of the ceding company. Capital market transactions could provide similar capital but at much higher administrative expense, which ultimately impacted pricing and the attractiveness (or not) of such transactions as an alternative to traditional property and casualty agreements.

However, this business model has changed as the reinsurance industry has had to respond to regulatory and market demands for larger and more complex products. Recent market conditions have made Capital Market transactions more attractive to ceding companies, despite the higher administrative expenses and complexity. While there are many different structures of Capital Market transactions, one example that shows the complexity of the structure can be represented as follows:

This type of transaction requires that the reinsurance contract not only be consistent with the terms in the retrocession agreement (e.g., wordings for exclusions) but also the terms contained in the prospectus published for potential investors. Because this transaction is heavily
regulated in the US, outside counsel is retained to review and often draft all of the documents associated with the securities offering. As a result, there is a much greater need for a cross-disciplinary approach to treaty reinsurance contracts that must be well integrated in order for the “flow” of premium, bond proceeds, bank deposits, interest, and loss payments, all to proceed as intended by the parties.

Larry P. Schiffer of the law firm Squire, Patton, Boggs in his April 27, 2015 blog entitled “The Added Value of Contract Wording Specialists” articulates the value of cross-disciplinary teams that include a contract wording specialist by stating:

“This horizontally-integrated cross-disciplinary approach to underwriting complex risks is a model that many reinsurers are undertaking (and many commercial insurers as well) to avoid mistakes that could occur without the right expertise in the room.”

He concludes with the cautionary reflection that:

“Contract wording specialists certainly add value to the reinsurance proposition. It is up to the reinsurance underwriters to recognize that value proposition up front instead of relegating these experts to the back room....”

Reinsurance contract wording does not reflect current business relationships.

In the US today, business relationships are often defined by what is in their contract. This is not unexpected given the Anglo-Saxon background of the US legal system in which private property rights and the freedom to contract are protected by statutory and common laws. In other parts of the world, however, business relationships are often defined by the personal relationship between the parties, irrespective what may be in their contract. Historically, the condensed format and broad non-specific content of treaty reinsurance contracts were intended to reflect the informal personal relationship-based business transaction.

Admittedly, treaty reinsurance contracts in the US market have evolved to some degree in an attempt to reflect the transition from an utmost good faith business relationship to one that is more commercially-based. Nevertheless, treaty reinsurance agreements have not incorporated – on a large scale - many of the arms-length terms and conditions found in commercial agreements. For example, treaty reinsurance agreements typically do not contain definitions of terms to the same extent as commercial arms-length contracts such as detailed Representations and Warranty provisions. The accounting between the parties, particularly as respects reporting forms, is not nearly as detailed as those in commercial arms-lengths contracts.
The dilemma for the reinsurance industry, particularly in the US which is experiencing extended soft market conditions, is whether, and if so to what degree, treaty reinsurance contracts should evolve into more commercial arms-length negotiated documents to reflect current business relationships. This evolution could potentially involve massive increases in administrative expense in order to hire in-house counsel, internal attorneys or outside counsel to draft and/or negotiate each individual treaty reinsurance agreement. Obviously, this is not a realistic possibility with current market conditions, but it begs the question what is the reinsurance industry going to do about this disconnect between its current business relationships and its contracts.

SECTION 2

Innovation in reinsurance contracts

1) Disruptive innovation

Faced with the dilemma of how to balance the treaty reinsurance contract wording process with maximum efficiency and a positive cost benefit impact, reinsurance contract wording professionals need to be innovators. The traditional treaty reinsurance contract wording process may not be necessary or relevant in the near future. For example, in the December 14, 2015 Discussion Paper published by Münchener Rückversicherungs-Gesellschaft (Munich Re), entitled “Bitcoin – a niche currency for ‘IT nerds’ or a revolution in the financial world?” the authors’ state:

“Both the Bitcoin community itself and technology and finance experts soon recognized that blockchains have many more uses than merely representing a currency. In every transaction...it can also be used to store data or software that have nothing to do with the actual payment. Blockchains thus constitute a global, secure and trustworthy medium for the documentation and changing of ownership. Their use is not limited to currencies – references to a whole range of goods can be traded via blockchains and even contracts performed.”

This type of innovation is called Disruptive Innovation, which is a term first used by Harvard professor Clayton M. Christensen in his book The Innovator’s Dilemma, published in 1997. The theory explains how a certain type of innovation can transform an industry and create a new market by eliminating the existing industry.

2) Sustaining innovation

The other type of innovation is called “sustaining” innovation, which is not intended to create new markets but rather only enhances upon existing ones. The two types of sustaining innovation include those that are “evolutionary” or “revolutionary.”

Evolutionary innovation

Most of the activity surrounding treaty reinsurance contracts has been sustaining innovation that is evolutionary in nature and intended to make the contract process more efficient. There have been evolutionary innovations that have been essentially forced on the industry by regulations as well. For example, in response to instances of broker fraud and reinsurer insolvencies, states adopted their own version of the NAIC Credit for Reinsurance Model Act. The result of which required brokers and reinsurers to include Intermediary and Insolvency clauses in their treaty reinsurance agreements (in addition to Unauthorized Reinsurer and Services of Suit clauses). Finally, employers are realizing innovation is an important element to attract and retain the newest members of today’s workforce.

The International Association for Contract & Commercial Management (IACCM) is an organization involved with innovation in commercial contracts. The IACCM describes itself as the global forum for contract innovation and is focused on identifying and promoting the international contract wording standards and practices. The IACCM hosts an annual Innovation Awards and publishes on their website the winners along with some of the details of the innovation that is being recognized.

The IACCM has also promoted the concept of contract "simplification" and the various principles to consider when attempting to simplify commercial contracts including, but not limited to:

- Consideration of contract format and content that is in alignment with the parties’ needs;
- Need for flexibility to change contract format and content as the transaction progresses;
- Ability to manage resources and support for lengthy and complex negotiations;
- Use of plain language versus the parties’ “preferred” expression of the same intent;
- Measuring and evaluating the readability and clarity of the contract (i.e., no ambiguities);
- Use of graphics, flow charts, formulas, case studies, and other visualization techniques.
Revolutionary innovation

More revolutionary types of sustaining innovation in contracts has developed, at least conceptually, in academia, both in the US and Nordic countries. Sponsored by the IACCM, recent events such as “Ask the Expert” webinars involve professors and academics presenting papers and research on the topics including user-centered contract design and contract visualization.

One example of contract visualization in Figure 1 involved diagrams distinguishing the operations of a contract with a 5 year term with termination one year in advance versus a 5 year contract that can be terminated anytime upon one year advance.

Rogers’ Understanding:
The contract is valid for an initial period of 5 years. One year prior to the end of this period, either party can give one year’s notice to terminate.

Aliant’s Understanding:
The 5-year contract can be terminated at any time with one year’s notice.

Figure 1 © 2011 Stefania Passera & Helena Haapio.
Another example of contract visualization in Figure 2 included using color coded arrows to identify interconnected clauses in a contract.

Framework agreements on the purchase of processing services

Recurring topics

- Scope of supply, order & deliver
- Prices
- Documentation
- Markings
- Subcontracting & Subcontractors

Appendix 1 - Terms and Conditions

1. Purpose of the Agreement
2. Prices
3. Documents, materials and production tools
4. Marking the delivery and documents
5. Delay in delivery
6. Warranty and liability for defects
7. Liability
8. Cancellation and termination of the Agreement
9. Applicable law and legislation
10. Miscellaneous

Appendix 2 - Description of service, prices and delivery

9. Process overview (flowchart)
10. 1. Scope of supply, capacity and delivery time
10. 2. Logistics, documents and information exchange
11. 3. Markings and packing
11. 4. Stock and storage
12. 5. Scraps
13. 6. Defects and claims
13. 7. Damages
14. 8. Price list

15. Appendix 3 - Contact Persons
16. Appendix 4 - List of approved subcontractors

Figure 2 © 2012 Aalto University and Stefania Passera. Used with permission.

Other revolutionary innovation in contract wording being developed under the banner of the Proactive Law Movement, includes Relationship Contracting, which is based on the perceived growing business emphasis on “collaborative relationships” involving “therapeutic jurisprudence and mindfulness.” A study conducted by the IACCM observed that adversarial competition in the contracting process undermined many established relationships, and is being replaced by an approach where “competition and relationship management operate in greater harmony.”

A potential blueprint for revolutionary change in the treaty reinsurance contracting process, which recognizes the evolving commercial nature of the business relationship while maintaining the concept of “utmost good faith,” is laid out in the article entitled “Using Proactive Law for Competitive Advantage” authored by George J. Siedel and Halena Haapio and published in the American Business Law Journal. The article outlines the concurrent development of the concepts of “competitive advantage” in the US and “Proactive Law” in Europe.
The conclusion of the article synthesizes both concepts by postulating:

“The use of Proactive Law for competitive advantage highlights the linkage between economic, legal and ethical considerations.”

While the ethical component of the contracting process is not extensively discussed in the article, it does suggest a notion that can be related to the “uberrima fedis” model of utmost good faith which is still the acknowledged basis of treaty reinsurance contracting process.

Finally, several non-US reinsurers have publically announced their intention to utilize cognitive computing (e.g., Hortonworks Data Platform; IBM's Watson) for business analytics and big data applications, including keeping contract wording up-to-date as well as to understand and interpret their contracts. One of these reinsurers has organized an International Conference on Contract Simplification with four stated purposes to resolve dysfunctional contract wording communication, provide a forum for the exchange of relevant solution-oriented ideas, expand scholarly discourse, and raise awareness about the concept of simplifying contracts.

The fundamental problem with this conference, as well as all of the above described innovations, is that they assume a commercial “arms-length” business relationship already exists between the parties. In other words, none of these innovative ideas are being developed within a historical context of an “utmost good faith” business relationship which, while evolving, is still represented in current treaty reinsurance contract wording custom and practice. Another assumption of these innovations is that the treaty reinsurance contracting process is between two parties, which is not always the case in the reinsurance industry which has both direct and broker distribution channels. While reinsurance brokers are a non-party to treaty reinsurance contracts, their influence on the contracting process as well as terms and conditions is growing as their market share of the US reinsurance industry increases.

Conclusion

Reinsurance contracts are the foundation for the business activities of the reinsurance industry. In the US market, it is the content of the contract that determines the future of the parties’ business relationship and the instrument in allowing the broker and reinsurer to achieve the business objective of providing efficient risk capital to insurance companies. Consequently, administration of treaty reinsurance contracts should be a key objective of senior management on a corporate and business unit level throughout the industry.

It is unlikely – at least in the short term - that the treaty reinsurance industry is prepared to consider any of the “revolutionary” innovations being developed and implemented in the commercial contracts environment due to expense concerns. While the concept of competitive advantage and Proactive Law may be a promising pathway to successful transformation of treaty reinsurance contracting, it will require more scholarship and contributions among practitioners from different reinsurance disciplines. What is clear, however, is that reinsurance contract wording professionals need to proactively think about treaty reinsurance contract innovation and try to develop creative, cost effective, and practical “evolutionary” enhancements that reflect the historical custom and practice of the reinsurance industry in order to remain relevant during a time of intense competition and increasingly rapid technological changes.
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