

Managing the Risk in Pool Reinsurance

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The Rise and Fall of Pool Reinsurance

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Origin of Pool Reinsurance Accident & Health

- The concept was developed in the early 1970's as an alternative (U.S.) Reinsurance Market to Lloyd's.
- Solicited large, financially stable (A.M. Best A- Rated) Insurance Companies (primarily life companies).

Similar Approach to Lloyd's

- Develop substantial reinsurance capacity by spreading the risk among many.
- Insurance Company Capital vs Individual Name
- Pool Members share the underwriting profit or losses
- "Several not joint" liability

Most Prominent Pool Managers

- Duncanson & Holt Group
- IOA Re
- Lockwood, Dipple and Green
- Reinsurance Management Services (RMS)
(Combined capacity of \$200,000,000 per occurrence)

Most Prominent Pool Managers (cont'd)

- Managed Multiple Mono-Product Facilities
 - Accident
 - Medical
 - Disability
- Pool member participated in all facilities
- Income for pool manager produced through management fees and profit commission

1970-1995 “Halcyon Years”

- Healthy amount of reinsurance capacity
- Emphasis on underwriting for profitability
- Responsible premium growth
- Focus on core product lines
- Healthy balance between management fees and Profit Commission
- Pools reconstituted each year with ease
- General understanding that our ultimate responsibility was to product profits for our pool members

1995 – Present: Decline and Demise

- Abundance of reinsurance capacity
 - Direct
 - Retro
- New (naïve) capacity
- Liberal interpretation of underwriting authority by pool managers
- Involvement in London/Lloyd’s market
- Lack of due diligence

Reinsurance Capacity

- Too much capacity put downward pressure on pricing and profits
- Some companies supported multiple/ competing facilities
- Retro allowed underwriters to retain smaller risk positions
- “Arbitrage”

Underwriting Authority

- Accident Business became:
 - Workers’ compensation
 - Aviation carve-out
 - Marine carve-out
- Little experience or expertise in these reinsurance lines:
 - Pricing
 - Reserving
- Significant underwriting losses

Involvement in Lloyd's Market

- Lack of understanding of the intricacies of Lloyd's risks
- Underwriters unaware of actual exposures
- Accident spiral hit many U.S. and Canadian companies
- Significant underwriting losses

Lack of Due Diligence

- Companies were too generous with their capacity
- Companies marginally involved in the risks they were reinsuring
- Few audits
- Self-destructive strategy – supported too many facilities

“The Perfect Storm”

UNICOVER

The Importance of the
Audit in Analyzing Risk

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What is Pool Risk?

- In the reinsurance world, **Risk** is not the possibility of loss, probability of loss, or the level of expected losses
- The term **Risk** is often used to refer to the insured subject matter
- For our purposes, **Pool Risk** is the level of uncertainty, i.e., the degree of deviation from the expected loss
- The higher the uncertainty, the greater the risk

Implications of Uncertainty

- Higher premiums
- Inadequate reserves
 - Inadequate information to assess true losses
- Overly conservative reserves
 - Playing it safe
- Unpredictable swings, higher earnings volatility

Pool Characteristics

- Grouping of insureds/reinsureds
- Different attachments, policy periods, lines of business
- Underlying risks have numerous and varied terms and conditions
- The pool in its entirety represents the “risk” being insured

A company that delegates underwriting authorization to a Managing General Underwriter (“MGU”) may lack understanding of the entire portfolio being reinsured

How Can an Audit Help?

- ***An audit can shed light on some unknowns through:***
 - On-site review of files to ascertain information not captured by management information systems
 - Interviews with pool managers’ personnel
 - Review of claim handling practices, accounting processes, and reinsurance allocations and cessions
 - Identifying special cases with unique handling

**The audit answers the
WHAT and HOW questions**

The Audit's "WHAT" Questions

- **What** does the underlying pool risk look like
- **What** . . . lines of business, . . . types of contracts, . . . what limits and attachment points, . . . what exclusions, . . . what contract periods, etc.
- **What** information was available during the initial underwriting and placement

The Audit's "HOW" Questions

- **How** does the ceding company / MGU operate?
- **How** does ceding company / MGU:
 - price the product?
 - monitor open claims?
 - handle the reporting and accounting?
 - reserve at first notice of loss, etc.?

Types of Audits

- Book Composition Audit
- Underwriting Compliance Audit
- Accounting and Transactional Audit
- Claims Audit
- Operational Audit

Types of Audits (cont'd)

- The purpose of the Book Composition and Underwriting Compliance Audit is to understand the reinsurance exposure and determine whether they were the intended exposures

These audits answer the WHAT questions

The Book Composition Audit

- Geared towards finding out what the book is comprised of
- Starts with the list of risks received, delves into questions normally not on the management information systems
- Can indicate hidden risks imbedded in retrocessions, spirals, open covers and line slips

Underwriting Compliance Audit

- Compares the findings in the Book Composition Audit to what was expected from the placement documents and contract wording
- Audit focuses on what types of risks and the duration of policies that are allowed
- Special emphasis on warranties, exclusions, and representations

Types of Audits (cont'd)

- The purpose of the Accounting and Transactional, Claims and the Operational Audits is to ascertain how well the company/MGU actually carries out its obligations and responsibilities as an insurer/reinsurer

These audits answer the HOW questions

Accounting and Transactional Audits

- *Review of the process and procedures in place*
- *Some important areas that can affect book analysis:*
 - Are there lags in reporting, or a backlog of unprocessed accounts?
 - Does ceding company/MGU accrue for premium?
 - Are premium estimates exceeded by actual written premium?
 - Is all available inuring reinsurance being utilized?

Claims Audits

- *Review of claims handling practices and procedures*
- *Some important areas that can affect book analysis:*
 - Is reserving conservative or aggressive?
 - What techniques are used?
 - Are there time lags in reporting?
 - Are there many corrections and/or adjustments that impact triangles?
 - What dollar value of losses are not subjected to a high level of scrutiny?

Operational Audit

- Analyzes the operation of the ceding company/MGU as a whole
- Is company aggressive in disputing coverage?
- Does it follow up on correspondence and ensure that contracts are properly documented?
- Are staff well trained?
- Is there a Claim VP on staff?
- Is there an Actuary on staff?

The Pool Audit Process

- Pre-Audit Review
- On-Site Inspection
- Post-Audit Review

The Pool Audit Process (cont'd)

- *Pre-Audit Review*
 - Obtain bordereaux, or lists of risks and claims
 - Review placement documentation, contracts, MGU agreements
 - Confer with client's underwriters, claims and actuary personnel
 - Are there areas of special concern?
 - Review results, identify file selection

The Pool Audit Process (cont'd)

- ***On-Site Inspection***

- Includes file reviews and interviews with key personnel
- Opportunity to assess professionalism and quality of staff
- Opportunity to evaluate workflows

- ***Post-Audit Review***

- Follow-up questions, document production
- Report

Putting it all Together

- *The audit should reduce uncertainty in the book being analyzed*
 - Composition, underwriting terms and conditions, underlying risk descriptions
- *The audit will add information that can assist in assessing future development*
 - Processing problems, handling of reported losses and IBNR, prevalence of adjustments, net accounting, timing issues
- *The audit will pinpoint areas of special concern that can be isolated and reserved for separately*