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Managing the Risk of Lost Reinsurance Coverage

by Mary Broesch

The heart of a reinsurance arrangement is that a loss by the direct writer will be covered. The risk that coverage may be lost can be managed—practical steps can be taken to ensure that the ceding company and reinsurer remain in agreement about what business is and is not covered under the terms and conditions of the reinsurance agreement.

The reinsurance treaty is more important today than ever before. As business becomes more complex, so do the legal documents that define the intent of the parties. More detail is being added to treaties, and more time is spent negotiating language for rare and improbable events. As treaties evolve to reflect new circumstances, new wording will be tested and refined.

Underwriting and Business Exceptions

For fully underwritten life insurance, it is becoming more common to put underwriting guidelines in the treaty, including preferred criteria, age and amount requirements, the application and what underwriting manual is used. This documents how risks will be selected and classified, and defines the risk profile of new business reinsured. It will also facilitate future audits of reinsured business.

Since underwriting involves judgment, there are particular instances when a deviation from published guidelines can be justified. Underwriting exceptions can be managed so the risk profile of the business reinsured does not change. An assumption about the level of underwriting exceptions a direct writer makes should be included in the product and reinsurance pricing. Reinsurance coverage should not be affected by an underwriting exception.

Underwriting exceptions can be distinguished from business decisions, which are a violation of the issue or underwriting rules—with no justification. Many times business decisions are made under pressure from producers who need a certain rating or classification to make the sale. Business decisions may or may not be covered in a reinsurance agreement.

Reinsurers price in aggregate for a block of risks based on the underwriting philosophy and practices of the direct writer. Interpreting the automatic requirements to include strict adherence on a case-by-case basis to the underwriting guidelines specified in the treaty expands the original intent. This interpretation could imply that underwriting exceptions are not covered, while traditionally, they are.

Too many underwriting exceptions or business decisions may result in adverse mortality experience. Mortality experience of special underwriting programs may also be unfavorable. For example, under "table shave" programs, direct writers issue a slightly substandard life (up to Table 2 or 4) as a standard risk. There may be situations where a substandard life, rated Table 6 or higher, was brought down to Table 4 to qualify under the table shave program and ultimately issued standard. This will negatively affect mortality for both the standard and substandard classes.

Reinsurer Audits

Reinsurer audits are more frequent and strict today. In addition to unfavorable mortality experience, reinsurers have much larger blocks to monitor in the wake of their huge growth driven by 90/10 first-dollar quota share deals. As reinsurers have become more sophisticated with their systems, there has been a paradigm shift from reviewing a random list of individual cessions to reviewing an automated file of a group of cessions. Underwriting and administration audits today are more focused on specific issues, concerns or cases.

Audits are an important risk management tool to ensure all business is properly ceded and administered according to the treaty terms and provisions. Certain cases ceded automatically may be questioned or coverage may be denied if the treaty was violated. Audits command a considerable amount of time and energy from both parties. Unintentional clerical or administrative errors uncovered during an audit are corrected under the errors and omissions (E&O) clause in the treaty. However, E&O is not meant to cover underwriting decisions.

Treaty Language

Today, reinsurers are promoting new E&O language, primarily driven by concerns of their retrocessionaires. For example, reinsurers want to put a three-year limit on the return of past reinsurance premiums on lapsed policies that were reported as active to the reinsurer. If new E&O language is similar to recommended ACLI language, the provision will read "there is no reinsurance coverage if treaty parameters are not satisfied." In addition, negligent or deliberate acts or repetitive errors in admin- istration are not covered.

When a ceding company does not comply with treaty provisions, it is at risk for losing coverage it thought it had. While the treaty has always defined what risk is and is not covered, reinsurers are taking a more active role today in reviewing and analyzing risks ceded to them, as well as refining and updating treaty language.

Suggestions for Direct Writers

Prudent direct writers can minimize inadvertent loss of reinsurance coverage. Here are some suggestions:

- Document agreement of what risk is and is not covered
- Express clearly the intent of the parties in the treaty
- Execute treaties and amendments promptly
- Review and negotiate new treaty language prior to a quoting opportunity
- Be responsive and honest, and provide accurate information
- Use technology to build/improve processes
- Comply with treaty terms and conditions
- Create and maintain good working relationships with reinsurers

Good management of underwriting exceptions, business decisions, reinsurer audits and treaty language reduces the risk of losing reinsurance coverage. ☐

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