SOCIETY OF ACTUARIES

Article from:

Reinsurance Section News

May 2005 – Issue 55

RATE CHANGES UNDER YEARLY RENEWABLE TERM REINSURANCE CONTRACTS – AN EMERGING ISSUE

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That many of the traditional principles, customs and practices of reinsurance have been subject to serious attack over the past few years will come as a surprise to almost no one. Even those industry participants fortunate enough to avoid actual disputes need look no further than the host of "emerging issues" discussed in industry periodicals and at industry gatherings to see that the reinsurance traditions which were considered sacrosanct perhaps as little as a decade ago are now fair game for attack. One of these emerging issues which has received relatively little attention so far concerns the ability of reinsurers to raise premium rates under yearly renewable term (YRT) life reinsurance contracts and the propriety of such rate increases.

As is the case with many reinsurance issues, this one arises from a contradiction between contract wording and industry practice. YRT reinsurance contracts typically permit the reinsurer to raise premium rates, at least to some extent. The reason is that, as a regulatory matter, if the reinsurer were to guarantee rates, it might be required to put up deficiency reserves, which, of course, no reinsurer wants to do. There are a variety of these rate change provisions. For example, some YRT contracts simply state that the reinsurance premium rates are not guaranteed and that the reinsurer reserves the right to change them. A second common form of provision permits the reinsurer to increase rates up to a certain limit, often linked to the 1980 CSO Mortality Table. Both of these types of provisions may include a statement to the effect that although the reinsurer may raise rates, it does not anticipate doing so. A third type of provision permits the reinsurer to raise rates for a particular cedent only if and to the extent it raises rates for all cedents from which it assumes similar business. These are, of course, only general illustrations of the types of rate change clauses commonly seen in YRT reinsurance contracts; the actual wording of particular clauses varies widely.

Despite express contractual language permitting reinsurers to raise rates, however, many in the industry believe, some very strongly, that reinsurers cannot and should not do so under any circumstances. Moreover, as a matter of actual practice, rate increases under YRT reinsurance contracts are extremely rate. A number of reasons are cited for this belief. First, it is argued that once the reinsurer sets its rates initially, in fairness it should be bound to live with the profitability or unprofitability of its decision. A second argument is that if the reinsurer has the right to increase its rates freely, there has been no transfer of risk from the cedent to the reinsurer and, thus, the resulting arrangement is simply not reinsurance as it is commonly understood. A third view draws upon the tradition that reinsurance is really a "gentlemen's" or "handshake" agreement. Thus, according to this line of thought, no matter what the contract may say as a matter of regulatory boilerplate, there is a firm and binding understanding between cedent and reinsurer that rates will not be raised. Finally, some participants in the industry take the position that given the widespread understanding that rates are not to be raised, any attempt to do so may constitute a breach of good faith.

As noted above, despite increasing discussion of this issue within industry circles, there appear to have been few actual disputes. There is no reported case law on this subject, and there appear to have been at most only a few arbitrations. Nonetheless, given the poor results of a substantial number of life reinsurance treaties, together with the marked increase in the number and contentiousness of life reinsurance disputes, over the last few years the emergence of rate changes under YRT contracts as a more frequently disputed issue seems very likely. This is borne out by anecdotal evidence.

In the absence of a substantial body of case law or arbitration experience, it is difficult to predict reliably how disputed rate change issues might be resolved. Having said that, however, there are a number of factors which should almost certainly be considered in analyzing these issues, and these are discussed briefly below.

First, it is important to keep in mind that most rate-change issues will be resolved in arbitration rather than litigation. This is of particular importance because virtually every rate change provision we have seen is unambiguous on its face and would almost certainly be enforced by a court. What an arbitration panel would do, however, is much less certain. A very large proportion of arbitration clauses in reinsurance contracts provide in words or substance that the arbitrators need not follow strict rules of law or the literal language of the contract. Many go further and provide that the contract will be viewed as an "honorable engagement." These provisions, of course, support the "gentlemen's agreement" rationale relied upon by many of those who argue that rate change provisions should not be literally enforceable. More broadly, because arbitrators have very wide discretion in shaping awards by virtue of both the typical arbitration clause wording and well established arbitration practice, there is always a real possibility that a panel will look beyond the rate change wording in a YRT contract to what it is persuaded is the industry custom with regard to rate changes and decline to enforce the literal wording. Obviously, however, the decision in any particular case will depend upon the composition and views of the particular panel as well as the circumstances involved.

A second factor that must be considered is the contract language itself. All things being equal, a rate change is much more likely to stand under a contract which provides simply that rates are not guaranteed, as opposed to a contract that limits the magnitude of rate increases or subjects the reinsurer's ability to impose such increases to express conditions. The impact of language to the effect that the reinsurer does not anticipate raising rates may well depend upon the circumstances. For example, if the rate increase at issue comes a relatively short time after the inception of the contract, the ceding company may have a stronger argument than it would 10 years after the inception of the contract. A panel may also look at evidence relating to the negotiation of the rate change provision to try to determine the parties' intent. However, this may be difficult since in many cases the rate change provisions, if not precisely boilerplate, are not intensely negotiated, and the evidence may be sparse if it exists at all.

To the extent a panel is inclined to construe the contract strictly, i.e. to enforce the literal language and some arbitrators, are strict constructionists, it may be important whether the contract contains an integration clause providing that it constitutes the entire agreement between the parties. Clearly, the inclusion of such a clause makes it much more difficult to argue that a provision permitting the reinsurer to raise premium rates is subject to an unwritten understanding, which nullifies or limits its effect.

In short, the precise wording of the rate change provision in a YRT reinsurance contract will be a key factor in determining the enforceability of that provision. It is, of course, important to keep this in mind not only in viewing potential disputes, but also in negotiating such provisions in the first place. The ability of either party to prevail in a dispute over a rate change may well be enhanced by the care and precision employed by that party in negotiating the rate change provision and by contemporaneous documentation of the negotiations.

Based upon discussion within the industry, another issue which may well arise in connection with rate change disputes, is the occasion for and reasonableness of such increases. For example, assuming a rate change provision, which imposes no restrictions, can a reinsurer impose a rate change merely because treaty results have been poor? Similarly, and again in the absence of any restrictions, can a reinsurer raise rates 100 percent? Or 500 percent? These are obviously very difficult questions to answer; however, a few thoughts may be helpful.

A VERY LARGE PROPORTION OF ARBITRATION CLAUSES IN REINSURANCE CONTRACTS PROVIDE IN WORDS OR SUBSTANCE THAT THE ARBITRATORS NEED NOT FOLLOW STRICT RULES OF LAW...

First, it seems likely that an arbitration panel would require a reinsurer to comply with some rule of reasonableness. Hypothetically, a panel might have a very different view of a situation in which a reinsurer was attempting to raise rates in order to break even or achieve a reasonable profit going forward on a treaty which had been performing poorly, as opposed to a situation in which the reinsurer was attempting to enhance the profitability of a

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Perhaps reinsurers should go back and reread Dale Carnegie's book, *How To Win Friends and Influence People*, which taught a simple lesson. Sometimes how you deliver the message is almost as important as the content of the message. Reinsurers need to remember this when revising their terms and conditions. In order to maintain their relationships, they need to work with their clients to come up with a way to do business that is mutually beneficial, not one-sided in favour of themselves.

"It would set a much better atmosphere if the reinsurers would explain why they are suddenly changing the wording, length of provisions and general tone of their agreements. Also, some of the new provisions are too one-sided. Finally, the reinsurers seem to feel that they are now able to dictate terms, as opposed to seeking compromises."

Some reinsurers will suffer because they won't figure it out. Others that continue to work with their customers, in a true sense of partnership, will build stronger and healthier franchises.

Conclusion – Flaspöhler's Thoughts

To the Direct Writers:
Accept the fact that you played a role in creating the problems faced today. Direct writers:

- Continued to demand low price, even when not justifiable
- Believed that it was easier to fight the reinsurer than the field
- Allowed too many exceptions in underwriting

To the Reinsurers:
Accept the fact that (some) reinsurers played a role in creating the problems faced today:

- Remember "what goes around, comes around"
- Let profitability and results be your driving factors
- Don't forget to treat especially well those who have performed
- Don't forget the "small" writer
- Communicate
- Communicate some more ✺

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treaty that was already breaking even or performing well. Moreover, in the former situation, a panel might look to how carefully the reinsurer had underwritten the business in the first place and the completeness and accuracy of the underwriting information furnished by the cedent. In the same vein, a panel might take an entirely different view of a situation in which the reinsurer was simply attempting to achieve a reasonable profit going forward as opposed to a situation where it was attempting to convert past losses into profits. And, in any case, a panel would probably look at least to some extent for guidance from the actual contract language as well as any evidence concerning the negotiation of the rate change provision.

None of this is meant to predict what a panel might actually do in a particular situation, but rather, simply to indicate the kind of questions that might be raised in a dispute of this type and how a panel might choose to approach those questions. Given the relative lack of dispute experience in this area, there are few actual signposts to follow. It seems likely, however, that the experience of the next few years will furnish more. ✺