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Now is a Good Time to Review Your Reinsurance Agreements

By Amy Stern

While we have yet to see the full magnitude of the COVID-19 pandemic, early signs point to a significant impact on the global insurance industry. As questions emerge as to what may or may not be covered by insurance policies, associated considerations will arise around reinsurance coverage.

While reinsureds expect their reinsurers to follow good faith claim decisions, reinsurance contracts often contain provisions which limit the type and/or size of losses covered by the subject underlying policies. In considering the potential impact of pandemic-related losses for a particular reinsurance contract, one must look to the entirety of a contract's terms and conditions.

Even in their broadest forms, such as an "unlimited quota share" treaty arrangement, reinsurance agreements contain a set of exclusions. When I began my career in the reinsurance business in the late 1980s, reinsurance underwriters could insert lengthy lists of excluded exposures. Over time, these have often been whittled down to a handful of "standard" exclusions, such as for nuclear risks or insolvency fund assessments.

Notwithstanding this general trend toward fewer exclusions, a specific reinsurance transaction may include a targeted set of exclusions for exposures that are not contemplated in the modeling and pricing of the transaction, or that could be outside the reinsurer's risk tolerance. Whether we are considering an individual risk ("facultative") or portfolio of risks ("treaty") reinsurance arrangement, the contractual relationship is between two sophisticated parties, allowing plenty of room for the creation of bespoke provisions in the reinsurance contract.

It’s More Than Just Exclusions

In addition to exclusions in contracts, there are considerations around the particular agreement’s operation. It’s important to keep in mind that reinsurance contracts’ operational definitions don’t necessarily follow those of underlying policy definitions. While some reinsurance contracts will be more closely aligned to subject policy operation, agreements providing – or limiting – coverage based upon the aggregation of individual policy losses will have independent descriptions of terms. These might include bespoke definitions of “loss,” “occurrence,” or “event,” as well as the inclusion of temporal limitations such as “hours clauses.”

When there is the potential for increased litigation arising out of contract intent and interpretation, one must also evaluate the treatment of defense expense and insurer claims handling within the confines of the reinsurance contract.
Some examples:

- Reinsurance agreements may provide independently derived treatment for loss adjustment expense or declaratory judgment actions.
- “Extra Contractual Obligations” coverage in reinsurance may be subject to varying levels of co-participation or aggregate limitation.
- Possible coverage or exclusion for “ex-gratia payments”

The bottom line is that understanding the full extent of any one reinsurance cover mandates a thorough review.

Lessons Learned Through Crisis

As we move through this current crisis, and whether resultant losses are directly related to the virus or to the knock-on effects of a recession, experience has taught me the following:

1. **Clearly drafted reinsurance contracts tend to result in better outcomes for the counterparties.** Similar to insurance, reinsurers tend to stand behind the cover they intended to provide and for which they charged commensurate premium. Although I’ve encountered some insurers and reinsurers who prefer the flexibility of ambiguous language, parties don’t typically prefer dealing with a dispute.
2. **Reinsurance contracts can be easily changed upon renewal – with coverage expanded or contracted.** Taking a look at upcoming renewals and having early discussions around both sides’ expectations generally leads to a better meeting of the minds than frenetic negotiation against a looming deadline.
3. **Reinsurance partnerships matter.** When counterparties have historically traded broadly, with the expectation of this continuing in the future, disagreements over coverage may be efficiently and effectively resolved. While there’s nothing necessarily wrong with “opportunistic” relationships, these tend to function better when things are going well.

Another important lesson we’ve learned from prior catastrophic events is that the reinsurance industry is well-designed for paying valid claims. It efficiently incorporates new data into new models, derives creative approaches to tackling difficult exposures, and designs contracts which reflect the “new normal.” Despite the size and shape this event may yet take, experience would indicate that the reinsurance industry will continue its critical function supporting insurers in allaying future fears across the risk spectrum.

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