Why Insurers Should Incorporate Reinsurance Strategic Risk Management Into Their Enterprise Risk Management Plans

By Bruce Heffner

The crux of the Enterprise Risk Management push by various regulatory entities is to apply Strategic Risk Management to each operation of an insurance company to identify, address and mitigate risks that can impact a company's ability to sustain itself. The very ingredient necessary for success in the Enterprise Risk Management quest is in recognizing what "every operation" of an insurance company includes so the company (or regulatory authority) can apply Strategic Risk Management.

Whether you write or purchase reinsurance for your Company, small to medium sized insurers may unintentionally overlook their "reinsurance operation." … "What? We don't write any reinsurance!" … "Yes, but you buy it," is the reply. Statistically, reinsurance is the largest purchase for many small to mid-sized insurance companies, year in and year out but some don't apply Reinsurance Strategic Risk Management for this major business operation expenditure.

Reinsurance Strategic Risk Management may logically include having independent reinsurance expertise review the process and determine your Company's "reinsurance asset leakage" — the loss or squandering of the Company's assets through failures, misinterpretations or misunderstandings in the Company's reinsurance process. Who is independent? It is not the Reinsurance Intermediary that sold your Company the reinsurance. That would be like saying that the auto salesmen that stands to make a hefty commission in selling the new fleet of cars to your Company is an independent source in evaluating whether or not your Company needs a new fleet of cars or if the purchase price is appropriate. The salesman (Reinsurance Intermediary) making a commission on what comes out of your pocket to purchase the reinsurance he sold you is but one indication that he is not independent. A sign for not being independent is not the issue of commissions, but upon what basis they are earned. Are they earned and measured by what it saves or gets back for your Company or based on what it costs your Company?

Points to Consider in Reinsurance Strategic Risk Management

First and foremost is the understanding that the reinsurance treaty is, by its very nature, a legal contract. Interestingly enough within that contract is a clause called the entire agreement clause, meaning that things outside of the contract (what we lawyers call parol evidence) should not be brought into the process of interpretation of the contract's terms and the implementation thereof. The Contract should say what it means and mean what it says. It cannot be so broad as to allow multiple interpretations and implementations or it will fail to even be a contract because of its indefiniteness. The rules requiring definiteness in a contract are based on the concept that a party cannot accept an offer unless the terms of that offer are reasonably certain.

Second, the one interpreting the contract is often the Reinsurance Intermediary. Interestingly enough the Reinsurance Intermediary is not a party to the Contract that it sold and made its sales commission on, and it is not part of any mandatory "arbitration agreement" in the contract, but it is vitally interested in the sales process upon which its commission amount depends.

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Finally, it is important that the mathematical rule of Order of Operation be properly followed when calculating premium. The Order of Operation is a rule in math that requires math operations be applied in a certain order in solving an arithmetic problem. Similarly, no one is legally supposed to interpret and implement the definitions in the contract in any manner that best suits them. Too often this fact may be forgotten or manipulated in the interpretation and implementation of the reinsurance contact. While the legal interpretation of the definition should get you to the same interpretation and implementation as math's order of operation rule, it is nice that there is a math rule and not just the Reinsurance Intermediary's interpretation in the process.

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The definition may go like this for the subject base premium: you start with the Gross Written Premium and multiply the composite rated premium times 80 percent to reach the property portion part of the premium, for the business insured under the contract. From that figure you subtract the inuring reinsurance treaties premium to end up with a subject base.

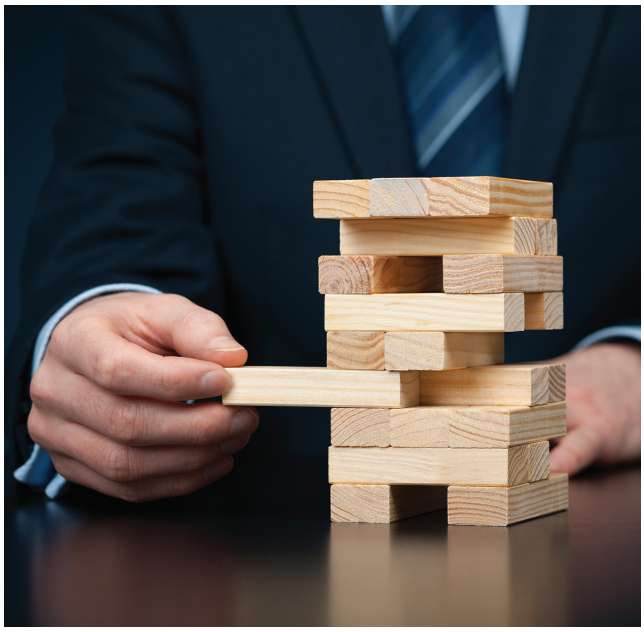
For Example: Start with 100 as the GWP. Multiply that by 80 percent = 80. Subtract the inuring premium of 20 and you end up with 60 as the subject base, and then multiply that amount by the rate to get the premium. But if you don't understand the order of operations and you start with 100 and subtract 20 = 80 and then multiply that by 80 percent, you end up with 64 to be multiplied by the rate to get the premium.

The mathematical order of operations rule requires that you multiply in figuring the subject base before you subtract, which is in line with the treaty definition as written and the proper legal interpretation and implementation. Now which would you rather your Company's subject base is when multiplied by the rate, 60 or 64? That is an easy one, obviously the lower number, 60. Any rate multiplied times 60 is smaller than that same rate multiplied by 64. As you see, taking the math and definition out of order can increase the subject base upon which your Company's reinsurance rate is multiplied, which increases the reinsurance premium. Of course even the very small insurance company has a GWP of much more than $100 but the example is clear, incorrectly applying the definition (order of operation) can definitely inflate your Company's reinsurance premiums.

Inuring reinsurance premiums reduce the subject base. It is NOT the inuring reinsurance premiums for particular claims that reduce the subject base; it is the entire premium for any other reinsurance treaty that can inure to the reinsurance treaty. The contract definition for Ultimate Net Loss is not to be confused in what is defined in the treaty for the Subject Premium.

Boomerang Recoveries LLC, a Reinsurance Strategic Risk Management Company, has reviewed reinsurance programs for clients where not only wasn't the mathematical order of operation correctly applied, but the contact's interpretation was incorrect, in both its legal interpretation and within the industry's standard practices for the business. There is no such thing as a "partially inuring" reinsurance treaty in which only a part of the reinsurance premium is inured as had been applied by the Reinsurance Intermediary but was unknown to the Reinsurers. Reinsurers want accuracy, even if it means that you may have overpaid based on incorrect mathematical order or an inaccurate interpretation and are due a refund.

For claims, the tyranny of the urgent, confusion, and belated development can lead to the incorrect utilization for claims allocation to the reinsurance excess treaty. Often having a set of independent eyes reviewing what had been initially settled or had further claim development can lead to the recovery of some of the reinsurance asset leakage involving claims.



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Time for recovery

The idea that a ceding Company that overpaid on its reinsurance cannot recover those overpayments at a later date may be premised on the incorrect idea of "fairness." The thought that once the mistake is identified, only future overpayments can be avoided but past mistakes cannot be recovered is blatantly false. Every state in the U.S. demands by law that the reinsurance intermediary MUST retain all records (including financial records) pertaining to your treaty for a period of ten (10) years from its expiration. Reinsurance intermediaries and reinsurance companies know this, so the idea of "fairness" has been established by the law.

Where you may get resistance

Remember the reinsurance intermediary makes a commission on the amount of premium you pay, or overpay, for Reinsurance, not by keeping the number of your claims to a minimum. That is, the overpayment of reinsurance premiums means an overpayment of commissions has been made to the Reinsurance Intermediary, which overpayments it will have to give back to the Reinsurance Company. The Reinsurance Intermediary makes commissions on the amount of your overpayments when you overpay based on any misinterpretation, misapplication or misstep in the reinsurance process. However, Reinsurance Intermediaries are not paid a commission on what they can save you or what they can put back in your pocket; they only make commissions on what money comes out of your pocket and how much Reinsurance you buy.

Don't be intimidated by the language of Reinsurance. Having a Reinsurance Strategic Risk Management company looking for your recoverable assets is not only a good way to show your Reinsurance Strategic Risk Management prowess and ultimately your Enterprise Risk Management capabilities; it embodies your adherence to the fiduciary duties that go along with managing an insurance company.

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