CHAPTER 14

REINSURANCE.

In the same way that an enterprise can transfer certain of its economic risks to an insurer, a re-insurer is the insurer of the credit insurer. Every insurer lays off portions of the risks he underwrites with re-insurers because the insurer’s own financial position might be in danger if he were to keep for his own account all the risks that he accepts when writing policies. Just like a policyholder, the credit insurer can, through reinsurance, substitute fixed costs for variable costs, – in other words, calculable reinsurance premiums for claims payments that are difficult to budget accurately.

If the credit insurer does not have sufficient capital and reinsurance, he will not be able to underwrite large and perhaps very lucrative risks or his ability to accept a large number of risks will be curtailed due to their aggregation into large exposures. This would not only mean lost business, but another credit insurer with ample capacity will take business away from the insurer who is short of underwriting capacity. Enough underwriting capacity, correctly mixed (own capital, reinsurance and types of reinsurance) and priced is therefore an important competitive strength. Reinsurance is a vital aspect of credit insurance and is the single most costly purchase. Insurance supervisory authorities (in South Africa the Financial Services Board) will not allow an insurer to operate if he does not comply with the statutory surplus asset ratio or does not have the prescribed solvency.
This legal requirement is there in order to make reasonably certain that the insurer can meet legitimate claims lodged against him and is thus a protection of the interests of policyholders.

The credit insurer will use his capital to carry risks. Thus the stronger he is capitalized, the more risk he can retain for his own account and so save reinsurance premiums. However, the insurer’s shareholders will want to see the insurer earning at least a market related return on his capital, their investment. Too much capital may make it very difficult to earn an acceptable return, and too little will make the insurer a poor risk for the policyholders, possibly unable to comply with the statutory solvency margin, and too reliant on re-insurers. Re-insurers will also be unhappy if they feel that the insurer is financially weak and thus unable to participate to an acceptable level in the risks he underwrites. They will either refuse to provide the underwriting capacity or demand more stringent conditions and higher reinsurance premiums. The credit insurer must therefore carefully balance the amount of capital employed in his underwriting operations with the reinsurance facilities he purchases. Reinsurance capacity is somewhat similar to a bank overdraft in other types of businesses. Capital may be more expensive than reinsurance capacity in which case it is obviously in the insurer’s interest to make more use of reinsurance and at other times it may be the other way around. This means that the credit insurer needs to assess carefully from time to time the optimum own risk retention in the light of his underwriting risk profile (spread in size, according to industries and geographical areas etc.), claims experience, marketing policy and the level and cost of own capital as compared to the prevailing availability and cost of reinsurance.

The cost of reinsurance depends on the types and mix of reinsurance facilities purchased. It is not appropriate to discuss reinsurance technicalities in this report. Suffice it to say that there are proportional (quota share or surplus) or non-proportional (excess of loss or stop loss) treaties and that these can be mixed in order to provide the most appropriate and cost effective reinsurance cover for the credit insurer.
It is industry practice not to deal with just one re-insurer. An insurer will have a panel of re-insurers with usually one lead re-insurer who participates with the largest share in the insurer’s treaties, has the right to agree with the insurer on matters affecting the treaty (such matters are usually detailed in the treaty) for and on behalf of the entire panel and often advises the insurer on difficult insurance issues. The credit insurer must select his re-insurers with care because providing optimum re-insurance requires detailed knowledge of credit insurance and the insurer’s business. In a specialist field such as credit insurance, the re-insurer, at least the lead re-insurer, should have a department which specializes in this class of business (including political risk) in order to be able to provide expert service to the insurer. The re-insurer should have relevant knowledge not only from his home market but also from his international connections. A credit insurer must make certain the re-insurers he employs are financially strong, are reliable and have untainted reputations.

The rights and obligations of the parties regarding a reinsurance agreement are set out in a treaty which deals with such things as:

- The class of insurance risks covered, including the geographical scope;
- The inception date of the re-insurer’s liability;
- The insurer’s underwriting limit and special limit approval procedures;
- The re-insurer’s maximum liability under the treaty and a reinstatement clause;
- The premium payable and the method of calculation of premiums for non-proportional business;
- The level of reinsurance and profit commissions;
- Accumulation of risks control;
- Definitions of “any one risk” and “any one event”;
- Follow-the-fortune and action clause (the insurer manages the credit insurance business and the re-insurer follows the decisions and actions of the insurer unless they are outside of the scope of the treaty);
- Information and notifications which the insurer will have to supply to the re-insurer concerning risks underwritten and threatening and admitted claims;
- The handling of claims, salvages and ex gratia payments;
• Bordereaux and accounts administration and settlement, including currency issues;
• Premium and claims deposits; and
• Termination and arbitration clauses.

An ordinary reinsurance treaty is simply an agreement to share risk. However, some treaties go much farther and may authorize the re-insurer to inspect, supervise and thus influence the direct insurer’s original business by having a say in the determination of some aspects of the basic business policy. It may also empower the re-insurer to help manage the business, rate risks and approve the insurer’s policy wordings. Re-insurers may also, under appropriate circumstances, supply the insurer with capital, provide specially qualified staff and give the insurer expert advice and information. The latter may involve suggesting the best suited reinsurance agreement, maximizing and evening out underwriting profits.

As already alluded to in chapter 12 “Underwriting,” the political risks inherent in the export of capital goods/services on medium to long credit terms can normally not be placed in the private market. For this reason such business is either underwritten directly by the exporting country’s government (through a specially established export credit agency) or the government acts as a 100% re-insurer for such political risks. Such government support seems fair where the necessary credit insurance cover cannot be provided by the private market. Otherwise the export business would be lost. It would however be an unwarranted interference in the market economy if the insurance/reinsurance cover was in fact readily available form the private sector. Where the government acts as re-insurer, it is usual that the insurer can bind the government within certain laid down mandates. Matters falling outside of such authorities will need discussion with and prior approval of the government re-insurer before the insurer can act. Ecological and social issues are of particular importance in the underwriting of exports of capital projects on medium to long credit terms. Both the insurer and the re-insurer should in these matters be guided by the “Equator Principles” as mentioned in chapter 12 “Underwriting”.

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What are the ethical issues for the credit insurer that arise from such a relationship? I believe the following are the major moral points the credit insurer has to keep in mind. They are all rooted in the Kantian conceptions of promise, deception, fraud, autonomy, trust and the Formula of the End-in-Itself (see page 11), i.e., neither of the parties to the reinsurance contract should treat the other merely as a means but as an end-in-itself.

1. As in the insurer’s direct business, his reinsurance relationships are based on mutual trust and complete and full relevant information disclosure. The credit insurer should voluntarily supply relevant information and be candid in his answers to the re-insurer’s legitimate questions. The basic principle of reinsurance, namely that the re-insurer is to follow the fortunes and actions of the direct insurer, would break down and the treaty would become unworkable if the re-insurer felt he could not trust the insurer (the opposite is of course also true). The insurer needs to consult the re-insurer on any unusual matter that will affect the treaty and thus the re-insurer’s interests, e.g., new or unusual types of risks that the insurer intends to underwrite and cover under the treaty, changes in his underwriting policy or claims payment philosophy and new geographical markets he wishes to enter.

2. The more comprehensive the treaty is, the closer must be the co-operation between the parties. A normal treaty is, in law, an insurance contract; however, a comprehensive reinsurance agreement could be construed to be more, i.e., an insurance contract and a type of partnership. The characteristics of a comprehensive treaty will include some of the points already mentioned above, i.e.:
   - Revenue sharing (profits and losses);
   - The pooling of resources to create economic value for one another;
   - Both parties aim to make a profit out of their co-operation, at least in the medium to long term;
   - Although the insurer has autonomy in running his business, the re-insurer may have certain rights, in terms of a comprehensive treaty, to exercise some control over aspects of the business, to be fully informed about the business and to provide advice and possibly even capital, other assets and expert staff.
But even a comprehensive treaty does not limit the insurer’s autonomy and the extra rights granted in such a treaty are one sided, i.e., they give the re-insurer rights over and above those that flow from a pure risk sharing arrangement but not the insurer. A genuine legal partnership is therefore not formed through a comprehensive reinsurance treaty but this discussion highlights again the basis on which a reinsurance contract rests, namely, that of uberrima fides (utmost good faith). Uberrima fides is in insurance language the same as Kant’s Formula of the End-in-Itself (see page 11), his demand for the respect of the dignity and autonomy of others. The nexus of contracts (refer pages 49 and 50) which give the insurance and reinsurance companies their power also compels them to keep their promise, to act in utmost good faith, otherwise they will behave immorally.

3. Re-insurers can also offer facilities that will help the insurer to even out his underwriting profit from year to year or stabilize his cash-flow. These are attractive products because the nature of insurance business makes the attainment of reliable profits or cash-flows difficult to achieve due to the uncertainty of the timing and size of claims. Credit insurance underwriting profits can fluctuate widely from year to year, depending to a large extent on the economic cycles. Being able to smooth profits more evenly over the years, either by way of a reinsurance facility or the establishment of an equalization reserve is thus something that the management of an insurance company would welcome. However, such mechanisms distort the real results and thus the financial statements of the insurer. Any misinformation is detrimental to shareholders and not in compliance with good corporate governance.

4. The insurer should appraise his re-insurers, or at least the lead, of his strategies, business plans, corporate governance, sustainable development policies and code of ethics. The insurer needs the full supported by the re-insurer(s) of these policies. Without such backing the parties will not be able to co-operate to the best advantage of all concerned. This does not mean that the insurer must obtain the re-insurer’s prior approval (he is autonomous in managing his business) but if the re-insurer is aware of the plans and policies of the insurer he can and should provide an appropriately tailored
reinsurance service. By the same token, the insurer should satisfy himself about the re-insurer’s own guidelines concerning these matters and needs to feel comfortable with them for there to be a constructive and long term association. If either party acts unethically or fraudulently toward the other, such action should automatically be grounds for the cancellation of the reinsurance treaty.

5. The policyholder relies on the credit insurer’s ability to pay any valid claim promptly. It would therefore be unethical if the insurer would not be able to fulfill his promised indemnity due to the insurer’s faulty, unsatisfactory or non-existent reinsurance or due to his non-compliance with the treaty terms. The obligation (morally and legally) to properly reinsure accepted risks, or to be able to provide for them out of own capital, is therefore intrinsic to the policy of insurance. Where very large risks are involved which far exceed the insurer’s own capital, a policyholder can insist on a so called “cut-through” clause which, if agreed, would give the policyholder the right to call directly on the re-insurer(s) for settling a loss resulting from the risk concerned.

6. Would it be fair to expect the insurance industry supervisory authorities (in South Africa the FSB) to pay any loss sustained by a policyholder due to the insolvency of the policyholder’s insurer? Many countries’ governments have established bank supervisory bodies backed by a mechanism that provides compensation to depositors who have lost money due to a bank’s liquidation. The situation with regard to insurance companies does not seem that different. If government expends taxpayers’ money to set up supervisory bodies, they should put their money where their mouth is and make good losses sustained which are, at least partly, due to the failure of its supervision/control. Such a scheme would have to require that the insurer’s auditors confirm periodically to the authorities that the insurer is complying with the terms of the relevant reinsurance treaties. Losses due to fraud by insurers could be financed from a small premium payable by every insurer to the authorities. A system of this type would give additional security to the insuring public, would assist insurers in marketing their product and would give additional assurance to re-insurers.
7. It has also happened that re-insurers have defaulted. For this reason it is important that the insurer regularly checks the financial soundness of the members of his reinsurance panel – a task which could also be controlled via the system suggested under 6. above. As has been said earlier, the insurer has a moral duty towards policyholders, shareholders and all other stakeholders to make certain that the losses sustained from the risks accepted by the credit insurer are appropriately secured by own capital and/or reinsurance facilities so that the claims can be paid promptly and without endangering the soundness of the insurance company.

8. It is necessary that the concepts of “any one risk” and “any one event” are clearly defined in the treaty and well understood by the parties. The most unfortunate case of the terrorist attack on the twin towers of the World Trade Centre highlights the problem. By deciding that this incident represented two separate events the court decreed that the insurers/re-insurers had to pay double the indemnity. These types of predicaments raise legal and ethical questions which are not easy to solve but the outcome of which can have major economic consequences.

9. The insurer should consult the re-insurer before settling very large claims and before agreeing to costly recovery actions. In chapter 13 “Claims” it was suggested that a credit insurer had an obligation to pursue debtors and/or guarantors who have defaulted, particularly if fraud is involved or alleged. As the concomitant legal cost may be considerable, it is only fair that the insurer discusses such action beforehand with the re-insurer.

10. An insurer will sometimes pay a claim even though strictly speaking he is not liable for it in terms of the policy. He will settle the claim or portion thereof because the policyholder has, through unfortunate, unforeseen circumstances not complied with the conditions of the policy and/or because it makes good business sense to make a payment on an ex gratia basis to the policyholder. Is this an ethical action by the insurer vis-à-vis his stakeholders, particularly the re-insurer? Where small amounts are involved and provided the insurer has carefully and honestly applied his mind to the
problem and has pointed out the policy breach to the insured, there should not be any objection because the cost involved is not material and it would be in the insurer’s interest to avoid irritating and damaging arguments with the policyholder. However, in case of a large ex gratia payment the insurer should obtain at least the lead re-insurer’s concurrence.

In chapter 13 “Claims” I stated that the credit insurer should find reasons for the payment of a claim rather than try to unearth grounds for repudiating it. This could result in a dilemma: on the one hand, the insurer wants to pay claims even if there are small justifications for refusing an indemnity because for marketing reasons, he does not want to be seen as a haggler who hassles instead of paying up. But, the re-insurer – who has to follow-the-fortune and actions of the insurer – may feel that the insurer should adhere strictly to the terms and conditions laid down in the policy wordings (which the re-insurer may have specifically approved). It is for this reason that the insurer needs to disclose his business policy and culture to the re-insurer who should support them. In the end, what is good for the insurer, i.e., his impeccable reputation in the marketplace, will also be good for the re-insurer. But clearly, the insurer must always know what errors or omissions by the policyholder he condones and such a conciliatory claims payment policy cannot apply to policy breaches that will have a meaningful effect on the insurer and his stakeholders including the re-insurer(s).

11. Sometimes insurers employ reinsurance brokers to place their business. Although the broker can help in designing a suitable reinsurance programme and in placing it on acceptable terms with re-insurers, the insurer should always remain closely involved and know his re-insurers. Because reinsurance is a business that rests largely on trust, insurer and re-insurer need to visit each other in order to develop close relations and understand one another’s business. The proper reinsuring of the ceding company’s business is complicated, expensive and vitally important, and the insurer should therefore have a suitably qualified person on his staff to deal with these matters in consultation with the company’s CEO.
12. Good and relevant statistics are an important tool for the insurer to help manage his business and are essential for devising an appropriate reinsurance programme. But the statistics must be meaningful and not be used, in the words of Andrew Lang, “like a drunken man uses lamp-posts – for support rather than illumination.”

13. Mention has been made in chapter 11 “Marketing and Sales” of the significance of Black Economic Empowerment (BEE) in South Africa. It would be to the advantage of the insurer if he could purchase his reinsurance facilities from re-insurers who are BEE compliant. As most re-insurers are international companies not registered in South Africa this may be a difficult goal to achieve but re-insurers need to give this matter serious thought (see also chapter 5 “Cultural Relativism”).

14. Finally, confidentiality on the part of both the insurer and the re-insurer is most important. The re-insurer will be dealing with many credit insurers and needs to treat information he obtains from each of them with the utmost confidentiality.

An ethical credit insurer can expect an efficient, fitting and excellent reinsurance service complete with advice that should help in building and nurturing his business.

Insurance is an important strand in the economic fabric and if it is rotten the entire structure is weakened. That is why people like the New York State’s attorney-general, Eliot Spitzer (also referred to in chapter 11 “Marketing and Sales”) are so critically important in keeping this industry (and others) on the straight and narrow, although some no doubt do not like Spitzer and his mission. Even if his motives are not entirely altruistic he performs an important job. During the past decade or so many businesses have forgotten or conscientiously ignored ethics in favour of greed, and the result can be seen to-day on practically every page of the business press. The time has come to turn this trend around in the interest of all and in particular for business’ sake.

Re-insurers, insurers, brokers, their clients and other stakeholders such as auditors, lawyers and shareholders must realize that greed, fraud, corruption and sly behaviour are
neither in the long term interest of their businesses, nor will support economic
development, growth and healthy enterprise. The credit insurance industry needs to
seriously deliberate, together with its relevant associates, about the efficacy of its present
moral attitudes and policies. It is time to reconsider its ethical institutions and employ its
international associations to manage a code of ethics for the industry.