

Welcome to:



# Reinsurance & Other Risk Transfer Mechanisms

Session 2



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# Have the sample facultative certificates with you.

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They can be found in the Reinsurance Session 2 reading in Bb.

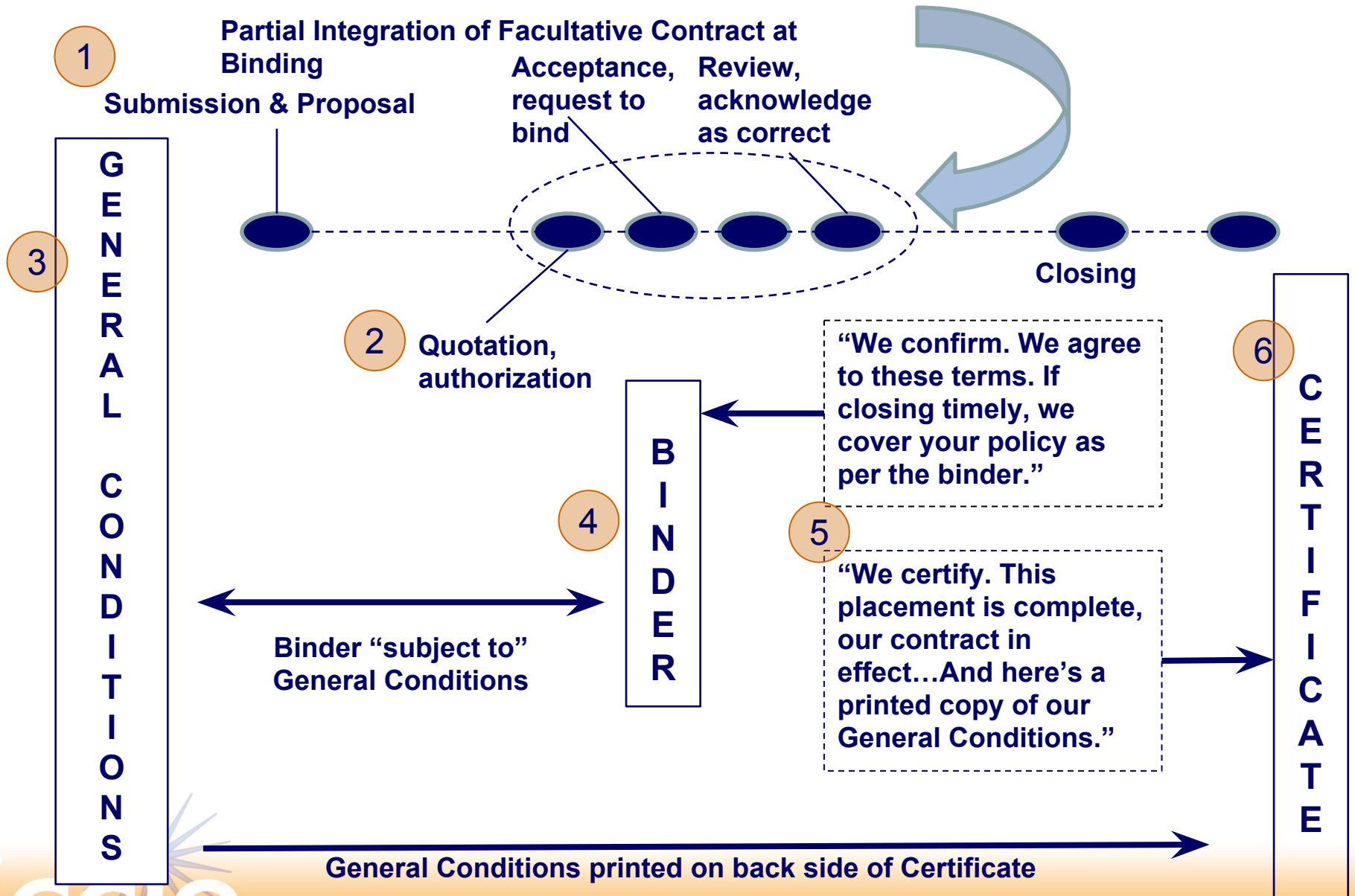
- [Master Sample Facultative Certificate](#)
- [Facultative Certificate Sample #1](#)
- [Facultative Certificate Sample #2](#)
- [Facultative Certificate Sample #3](#)
- [Facultative Certificate Sample #4](#)
- [Facultative Certificate Sample #5](#)

# Reinsurance Session 2 - Overview

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- Facultative Placement Process
- Facultative Documentation
- Facultative Binder
- Facultative Certificate
- Facultative General Conditions
- Other Common Facultative Clauses
- Mandatory Facultative Clauses

# Facultative Placement Process



# Facultative Documentation

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- **Binder** – *Final written agreement* issued immediately by the reinsurer stating the reinsurer is bound on a risk, subject to reinsurer's General Conditions, primary closing and receipt of the policy – within a specified time frame.
- **Facultative Certificate** – Short form documentation of the *entire reinsurance placement process*, with standard clauses (*for that particular reinsurer*) that reflect the reinsurer's general underwriting philosophy.

# Facultative Binder - Purpose

- Confirms final agreement reached between reinsurer and reinsured
- Subject to the reinsurer's applicable General Conditions
- Creates material obligation for reinsured to timely provide a copy of the policy to reinsurer
- Limits validity of contract to a specific time frame (*to allow reinsured time to close the primary insurance and to minimize the reinsurer's risk of change*)
- Partially integrates the contract (i.e., *evidence of the agreement*)



# Facultative Certificate – Overview

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## A Facultative Certificate

- Does *not* replace the binder
- Is *not* a legal contract by itself

# Facultative Certificate – Purpose

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- Attests that the facultative reinsurance placement is complete ([Master Sample Fac. Cert.](#))([Sample Certificate 3](#)) and that a contract is in effect
- Consists of two parts
  - Front
    - Certifies reinsurance coverage ([Master Sample Fac. Cert.](#))([Sample Certificate 2](#) and [Sample Certificate 5](#)).
    - Restates contract terms in the Declarations (type of insurance, policy limits and application, company retention, reinsurance accepted and basis of acceptance, etc.)
    - Terms are identical to binder unless modified in writing subsequent to binder's issuance.
  - Back
    - General Conditions
- Allows reinsurer to invoice reinsured for premium

[Master Cert.](#) - [Cert. 1](#) - [Cert. 2](#) - [Cert. 3](#) - [Cert. 4](#) - [Cert. 5](#)



# Questions

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Raise your hand to ask a question by audio.

**OR**



Type in your question in the Chat Box



# General Conditions – Overview

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- Reinsurer's standard terms of trade
- Reinsurer may have multiple General Conditions for different lines of business ([Master Sample Fac. Cert.](#)) ([Sample Certificate 1](#) and [Sample Certificate 5](#) are specifically for Casualty business) or may have single multipurpose set of General Conditions that is modified by endorsement for specific lines of business ([Master Sample Fac. Cert.](#)) ([Sample Certificate 3](#) has a Casualty Special Conditions endorsement)
- Preexist any particular facultative submission
- Underlie the entire facultative placement process
- Considerable variety and diversity exists among reinsurers (as Sample Certificates illustrate!)

[Master Cert.](#) - [Cert. 1](#) - [Cert. 2](#) - [Cert. 3](#) - [Cert. 4](#) - [Cert. 5](#)

# General Conditions - Preamble

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## Purpose:

- Obligates reinsurer to reinsured
- Assumes consideration (premium) has been, or will be, paid by reinsured
- Assumes agreement has been reached per the Declarations and subject to the General Conditions

## Considerations:

- May, or may not, be labeled (Master Sample Fac. Cert.) (*only Sample Certificate 3 uses a label*)
- May, or may not, immediately precede the General Conditions (Master Sample Fac. Cert.) (*only Sample Certificate 1 and Sample Certificate 3 have the Preamble immediately before the General Conditions*)
- Expresses no intent to integrate the contract, despite the use of legalese terms like "herein", "hereof", "hereby", "hereto" and "agreement"

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# General Conditions – Reinsuring Clause

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## Purpose:

1. Warrants the reinsured's retention
2. Obligates the reinsurer to indemnify the reinsured ("follow the liability")
3. Subject to the terms, conditions, and limits of the reinsured's policy
4. Establishes a duty for the reinsured to timely provide a copy of the policy to the reinsurer

## Considerations:

- May be self contained ([Master Sample Fac. Cert.](#)) ([Sample Certificate 3](#) expressly covers items 2, 3 and 4 in its Reinsuring Clause but is silent with respect to the reinsured's retention warranty)
- May be addressed in multiple clauses ([Master Sample Fac. Cert.](#)) ([Sample Certificate 2](#) covers item 1 in [Clause 2 \(Retention and Limit\)](#), items 2 and 3 in [Clause 1 \(Reinsurance Provided\)](#) and item 4 in [Clause 6 \(Copy of Policy and Access to Records\)](#))

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# Reinsuring Clause – Retention Warranty

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- Important consideration in underwriting, pricing and structuring reinsurance coverage.
- Makes reinsured keep a meaningful stake in the risk
  - indication of quality of risk
  - incentive for reinsured to prudently handle claims
- "shall retain for its own account or that of its treaty reinsurers, if applicable, the liability specified ..." ( *A. Retention and Limit in Sample Certificate 1* )
- "warrants to retain for its own account the amount specified...." (2. *Retention and Limit in [Sample Certificate 2](#)* )
- Don't be fooled by the explicit lack of documentation about a retention warranty in Sample Certificate 3 and Sample Certificate 5! It is implied via the entire facultative placement process.

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# Reinsuring Clause – Follow the Liability

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- Loss paid under the original policy is the trigger for the reinsurer's duty to indemnify the reinsured
- Implied exclusion of payments made by reinsured when it is not liable under its original policy
- All reinsurers in the Sample Certificates "follow the liability" of the reinsureds

- ***General Conditions***

***Reinsuring Clause*** *Except as otherwise agreed in this Certificate or where the reinsurance is non-concurrent, the Reinsurer's liability under this Agreement shall follow that of the Reinsured for losses under all terms, conditions, and limits to the Reinsured Original Policy or Policies specified in the Declarations ("the Policy").*

# Enhancements to Follow the Liability (1)

## Follow the Settlements

Provides that a reinsurer must cover settlements made by the reinsured in a businesslike manner, provided the settlement is arguably within the terms of the reinsured's policy and the reinsurance agreement and the settlement is not affected by fraud, collusion or bad faith. Requires the reinsurer to abide by the reinsured's good faith **determination to settle, rather than litigate**, claims under a reinsured policy. Focused on "loss settlement", not necessarily tied to a "risk determination".

## Sample

### Sample Clause

*"This reinsurance is declared and agreed to be subject to the same terms, clauses and conditions as the original policy and is to follow the settlements of the Reinsured"*

# Enhancements to Follow the Liability (2)

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## Follow the Fortunes

Provides that a reinsurer must follow the **underwriting fortunes** of its reinsured and therefore is bound by the decisions of its reinsured in the absence of fraud, collusion or bad faith. Requires a reinsurer to accept a reinsured's good faith, business-like decision that a particular risk is covered by the terms of the underlying policy. Focused on "risk determination", not necessarily tied to a "loss settlement".

### Sample

#### Sample Clause

*"Subject to all terms, clauses and conditions as original and to strictly follow the fortunes of the Reinsured in all things."*



# Extra Contractual Obligations

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Extra contractual obligations (ECO) refers to damages, which are:

- typically punitive in nature, that arise from the reinsured's own actions (not the original insured's)
- beyond the scope of the original reinsured policy. (Hence, the term "extra contractual.")

# Excess of Policy Limits

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Excess of policy limits (XPL) refers to losses which are:

- in excess of the original underlying policy limits, which arise from the reinsured's own actions in failing to settle a claim within the policy limits.
- Like ECO, XPL is not reinsurance, rather it is an insurance coverage provided to the reinsured (similar to an E&O policy) but only if the claim is covered as specifically provided for within the reinsurance agreement.

# Reinsuring Clause –

Subject to the terms, conditions and limits of the Company's policy

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- Presumes coverage is concurrent with original policy unless explicitly agreed that coverage is non-concurrent
- Definitions in [Sample Certificate 1](#), [Sample Certificate 2](#) & [Master Sample Fac. Cert.](#) outlines how retention and limits work when coverage is non-concurrent
- [Sample Certificate 3](#) and [Sample Certificate 5](#) do not address non-concurrency

[Master Cert.](#) - [Cert. 1](#) - [Cert. 2](#) - [Cert. 3](#) - [Cert. 4](#) - [Cert. 5](#)

# Reinsuring Clause –

## Duty to Furnish a Copy of Policy & Endorsements; Changes Affecting Original Policy

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- Provides reinsurer with all terms and conditions in original policy that is subject to reinsurance
- May, or may not, be part of reinsuring clause
  - Sample Certificate 3 and Sample Certificate 5 include in the Reinsuring Clause
  - Sample Certificate 1 includes in C. Inspection and Information; Sample Certificate 2 includes in 6. Copy of Policy and Access to Records
- Policy documentation may include entire policy (manuscript, independent forms) or only declarations page (ISO forms, renewal)
- May require policy documentation within a specified period of time (Sample Certificate 3, E. Final Documentation indicates 90 days)

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# General Conditions –

## Period of Reinsurance; Cancellation, Renewal and Extension

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### Period of Reinsurance:

- States the contract's duration (date, time and place coverage begins and ends)
  - May be self-contained ([Sample Certificate 5](#)) ([Master Sample Fac. Cert.](#))
  - Or may rely on the original policy ([Sample Certificate 1](#), [Sample Certificate 2](#) and [Sample Certificate 3](#))

### Cancellation:

- Identifies the circumstances that would trigger the contract's termination
- Outlines notice requirements
  - [Section 14 in Master Sample Fac. Cert.](#)
  - [Section N. in Sample Certificate 1](#)
  - [Sections 15, Section 16 and Section 17 in Sample Certificate 2](#)
  - [Section 11. in Sample Certificate 3](#)
  - [Section 10 in Sample Certificate 5](#)

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# General Conditions –

## Express Exclusion of Privity with Third Parties

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- Only the reinsurer and reinsured have rights under the contract
- Clause creates a contract-based defense that is already implied
- Exceptions:
  - Insolvency
  - “Cut through” endorsements
- Potential issues:
  - Reinsurer exerting too much control in claims handling (see [Section 6 in Sample Certificate 3](#))
    - [Section 6 in Sample Certificate 1](#)
    - [Section 8 in Sample Certificate 2](#)
    - [Section 3 in Sample Certificate 3](#)
    - [Section 1 in Sample Certificate 5](#)
    - [Section 7 in Master Sample Fac. Cert.](#)

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# General Conditions –

## Right of Inspection and Duty to Provide Access to Records

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- Gives the reinsurer the contractual right to inspect all of the reinsured's records that pertain to the coverage provided by the facultative reinsurance agreement.
- Imposes a duty on the reinsured to preserve records and cooperate.
- The right generally goes until all activity associated with the contract has concluded.
- In facultative reinsurance the reinsurer often has no reason to audit a reinsured unless there are claims.
  - [Section C in Sample Certificate 1](#)
  - [Section 7 in Sample Certificate 5](#)
  - [Section 10 in Master Sample Fac. Cert.](#)

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# General Conditions – Changes

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- No change, modification, amendment, endorsement or waiver of agreed facultative reinsurance is valid unless
  - In writing
  - Signed by the reinsurer
- No “oral” amendments
- Expresses the finality of the agreement reached at binding
  - [Section O. in Sample Certificate 1](#)
  - [Section 18 in Sample Certificate 2](#)
  - [Section 13 of Sample Certificate 3](#)
  - [Section 5 in Master Sample Fac. Cert.](#)

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**



# Questions

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Raise your hand to ask a question by audio.

**OR**



Type in your question in the Chat Box



# Other Common Clauses – Definitions

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## Purpose:

- To clearly set forth key terms used in the contract
- To make locating the definitions easy

Not always all encompassing as some terms may still be defined elsewhere as they are used in other clauses.

*Sample Certificate 2 has a Definitions section (9) but also defines terms within other sections ("claims expenses" are defined in section 12)*

*Master Sample Fac. Cert. has a Definitions section (20)*

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**

# Other Common Clauses – Premium Taxes

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To clearly indicate that the reinsured is responsible for the payment of all premium taxes.

*Section 1. in Sample Certificate 1*

*Section 7 in Sample Certificate 2*

*Section 19 in Master Sample Fac. Cert.*

Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5

# Other Common Clauses - Currency

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## **Purpose:**

- Specifies the base currency (such as USD) used in the treaty.
- Specifies the basis of any conversion of the base currency.
- Whatever currency premium is on, losses will be paid on the same basis.



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# Other Common Clauses – Applicable Law

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- Specifies the law that governs the agreement.
- Gives context as to how it will be interpreted based on precedent and case law.



*Section 15 in Sample Certificate 3*  
*Section 17 in Master Sample Fac. Cert.*

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**

# Other Common Clauses - Exclusions

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- No standard exclusions exist, although Lloyd's Non-Marine Association has developed some exclusion wordings that are widely used (*see D. Special Conditions Exclusion 1.2 Nuclear in Sample Certificate 3*; the NMA xxxx refers to these standard Lloyd's wordings).
- Examples of exclusions:
  - Asbestos (*Sample Certificate 3*) (Master Sample Fac. Cert.)
  - Nuclear Incident (*Sample Certificates 1*, *Sample Certificate 2*, and *Sample Certificate 3*) (Master Sample Fac. Cert.)
  - Pollution (*Sample Certificates 4*)
  - War (*Sample Certificates 1*, *Sample Certificate 2*, and *Sample Certificate 3*)
  - Terrorism
  - Insolvency Fund (Master Sample Fac. Cert.)
- In some cases a reinsurer relies on the exclusions in the reinsured's policy(ies). (*Sample Certificate 5*) (Master Sample Fac. Cert.)

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**

# Other Common Clauses - Arbitration

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- Sets forth the types of disputes subject to the arbitration, the details of selecting the board of arbitration, time for pleadings and the procedures to be followed in such an arbitration proceeding.
- Determines the allocation of expenses incurred in the arbitration proceeding.
- States that the final decision be in writing.
- Issues:
  - Arbitration panels are not bound by procedure and evidence rules or by legal precedent
  - Arbitrations have no precedence values

Master Sample Certificate, Sample Certificate 1, Sample Certificate 2, Sample Certificate 3, and Sample Certificate 4  
*all have Arbitration Clauses*

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**

# Other Common Clauses - Offset

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**Purpose:** Allow the ceding company and the reinsurer to offset balances due one another.

- Right to offset exists in common law. It can have the broadest possible application (across multiple contracts) or a rather narrow one (single contract only), subject to the law of the applicable jurisdiction.

Sample Certificate 1, Sample Certificate 2, and Sample Certificate 5  
have broad offset provisions

while Sample Certificate 3 has a narrow offset provision

Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5



# Other Common Clauses -

## Subrogation and Salvage Recoveries

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- Reinsured has a fiduciary responsibility to pursue all avenues of recovery.
- Recoveries are applied to reduce the amount of loss recoverable from excess of loss reinsurers.
- Any overage after the ceding company reimburses the reinsurer totally for the loss is kept.
- Expenses incurred to pursue recoveries are deducted from the recovery before the reinsured reimburses the reinsurer.

[Master Cert.](#) - [Cert. 1](#) - [Cert. 2](#) - [Cert. 3](#) - [Cert. 4](#) - [Cert. 5](#)

# Other Common Clauses -

## Loss Notice

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### Purpose:

- A necessary part of excess of loss, as opposed to proportional, reinsurance certificates.
- In proportional reinsurance contracts, all losses are reported making the clause unnecessary. In excess of loss contracts, not all losses are reported to the reinsurer – only those likely to hit the reinsurer's layer.

*Section D. in Sample Certificate 1*

*Section 11. in Sample Certificate 2*

*Sections 5. and 6 in Sample Certificate 3*

*Section 4. in Sample Certificate 5*

*Section 9 & 10 in Master Sample Fac. Cert.*

**Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5**

# Questions

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**OR**



Type in your question in the Chat Box



# Other Mandatory Clauses – Insolvency (1)

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**Purpose:** Many states have passed laws requiring that an insolvency clause be included in every reinsurance agreement providing that in the event of insolvency:

- payment of reinsurance recoveries will be made directly to the reinsured's liquidator
- such payments will be on the basis of the liability of the reinsured's original policy (i.e. not the amount actually paid by the reinsured)
- such payments will be without diminution because of the insolvency of the reinsured

Master Cert. - Cert. 1 - Cert. 2 - Cert. 3 - Cert. 4 - Cert. 5

# Other Mandatory Clauses – Insolvency (2)

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Such insurance laws also allow that:

- the reinsurer and liquidator have the right of offset, subject to applicable law ([Section 14. in Sample Certificate 2](#) and [Section 9. in Sample Certificate 5](#)) ([Section 13 in Master Sample Fac. Cert](#))
- the liquidator must give written notice to the Reinsurer of all claims pending
- the reinsurer may investigate or defend any claim at its own expense (chargeable, subject to court approval, against the insolvent reinsured)
- the reinsurer can make payment pursuant to a *cut-through* or *guarantee* endorsement

[Master Cert.](#) - [Cert. 1](#) - [Cert. 2](#) - [Cert. 3](#) - [Cert. 4](#) - [Cert. 5](#)

# Other Mandatory Clauses - Intermediary

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## Purpose:

- Requires the reinsurer to accept financial responsibility (credit risk) for funds transferred from the reinsured to the reinsurer through a reinsurance intermediary.
- Payments by the reinsured to the intermediary constitute payment to the reinsurer.
- Payments made by the reinsurer to the intermediary only constitute payment to the reinsured when they are actually received by the insurer.

*Sample Certificate 1, Sample Certificate 3, and Sample Certificate 5 are from direct reinsurers*

*Sample Certificate 2 involves an intermediary (Section 22.)*

*Section 24 in Master Sample Fac. Cert*

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# Other Mandatory Clauses – Unauthorized Reinsurance

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## **Purpose:**

- Specifies what the unauthorized reinsurer must satisfy in order for the transaction to receive favorable accounting treatment as a reinsurance transaction.
- Allows for posting of a letter of credit or other collateral acceptable to state insurance regulators by unauthorized reinsurers.

*Section 16. Loss Reserve in Sample Certificate 3*

*Section 18. Loss Reserve in Master Sample Fac. Cert*

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# Questions

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Raise your hand to ask a question by audio.

**OR**



Type in your question in the Chat Box





# Homework 1

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## ***As a team:***

Using Sample Certificate 4, provide a title for each of the 17 clauses in the document. Which clauses constitute the “core” facultative General Conditions? Which ones are mandatory? Provide a short description as to what each clause means and why it is important for you to know the information in that clause *before* binding coverage.

Submit your response as a team on the discussion board in Bb.

# Homework 2

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## *As an individual:*

Using Bb's discussion board, compare and contrast "follow the liability", "follow the fortunes" and "follow the settlements". As a captive owner *buying* facultative reinsurance which basis might be more beneficial to you? Why?

Back up your answer using information from the class lecture and personal experiences.