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Reserve Mechanical: Judge Kerrigan Shows "Limited Knowledge" of Reinsurance Market

Tags: Oliver Schofield, Reinsurance, Reserve Mechanical

London-based Oliver Schofield, managing partner at risk and insurance consultancy RISCS, is an expert in captive and reinsurance structures. Discussing the Reserve Mechanical case, he questions whether Judge Kerrigan fully understands the use and purpose of quota share contracts.

Another week, another case of limited knowledge of the captive reinsurance market resulting in a contentious judgement. A bold statement but one that is I believe justified, particularly in this case.

The case raises some fundamental points about the purpose of insurance and reinsurance. The position taken by the IRS appears to be that an insurance company's risk can be distributed, but the insurer must still maintain some risk and the quota share contracts in this case do not achieve that goal.

The IRS also seem to take issue with the possibility of loss and the appropriateness of the attachment point of the stop loss policies.

In "Studien uber Ruckversicherung und deren Statistik", published 1912, Jahn states: *"One of the major purposes of reinsurance is to permit the original insurer at least to break even on his transactions. Reinsurance and retrocession insure the insurance business. They keep insurance companies out of the mortuary chapel."*

From this we must conclude that it is reasonable for an insurance company to use reinsurance to transfer risk to a third party to maintain profitability, even if it means transferring all its risk to a third party (which is not the case in the Reserve situation as the risk pooling mechanism leaves Reserve with net assumed reinsurance exposures).

The IRS judgement does recognise "pooling distributes risk across the wider capital base so that the large losses are shared amongst the many" which is what has surely been achieved here, but the IRS then goes on to fail to accept that the risk pooling can enable "the original insurer at least to break even on his transactions".

Digging deeper into risk distribution, Ehrenberg in his Handbuch des gesamten Handelsrechts, published 1913

states: *"Reinsurance..... spreads risks so widely and effectively that even the largest risk can be accommodated without unduly burdening any individual."*

The point here is that reinsurance ensures that risk is spread over a broad capital base of unrelated third parties, which is what Capstone achieved with its pooling arrangements.

Reserve, its parent and its policyholders were only related to the other Capstone clients by virtue of the fact they were all clients of Capstone, not because they had any commonality of shareholding ownership in each other. Therefore, we must conclude that the pooling arrangement meets Ehrenberg's test.

Whether the reinsurance programme is proportional (quota share) or non-proportional (excess) is not relevant here. What is relevant is whether risk is distributed to unrelated third parties, which it appears to be in this case.

I do not agree with their view that the proportional reinsurance arrangement is circular. The arrangement transfers risk from Reserve to PoolRe then to certain other captives and in that arrangement, Reserve also then assumes risk from these other captives.

Crucially though, Reserve does not reassume its own ceded risks but rather a pool of the other captives' risks to spread and distribute the risk over a broader capital base.

The judge writes: "Reserve issued direct written policies... that covered between $8 and $13 million in potential losses, and most or all of the risk of loss was associated with the business operations of just one insured."

Why should a captive have more than one insured? A captive writing a property damage policy has one insured: its parent. The risk distribution test should surely be applied to the reinsurance and pooling programme. In any event, Reserve did issue policies to three insureds each with its own business activities.

I know that increasingly captives are considering issuing policies to third parties to knock this IRS objection on its head, but any captive that is assuming third party risk over which it has no risk management control or where there is no commonality via a pooling arrangement would be advised to reinsure 100% – or as much as possible, perhaps only retaining a very distant aggregate excess of loss layer at the 1 in 20 probability layer, to avoid being taken to the *"mortuary chapel"* by risks over which it has zero control or influence.

The judgement also states: "Peak and the other insureds... never suffered any losses that would even come close to triggering the stop loss coverage." Surely that shows that their purchase of the stop loss cover was set at the right level?

Stop loss should never attach at the 1 in 1 or 1 in 3 year expected loss scenario; it is a protection against a catastrophic deterioration in loss frequency and as such should attach beyond the 1 in 10 year expected loss scenario. How anyone can conclude that the stop loss programme here is not appropriate with just a few years of results beggars belief.

Captive reinsurance is well established as an effective way of ensuring captives do not end up in the *"mortuary chapel"* and the structures should be recognised as being critical to a captive's longevity.

As risk becomes more complex, so inevitably will the reinsurance structures that provide the capital protection to this important part of our industry. Rather than throwing stones at collaborative complex solutions, law makers should work with the industry to encourage innovation and risk sharing.

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