Prof. Dr. Manfred Wandt, Prof. Dr. Jens Gal

Solvency II's Unexpected Indirect Regulation of the Reinsurance Contract

The Creation of Principles of Reinsurance Contract Law (PRICL) as a Means to Safeguard a Centuries-Old Tradition of Self-Regulation

Whilst it has become a hackney phrase that Solvency II is the reform of the century of insurance regulation and supervision, little attention has hitherto been paid to the extent to which this reform threatens the way in which reinsurance agreements have been concluded unabated for centuries. The reinsurance contract was one of the last domains of contractual freedom katexochen, meaning that the parties were free from any restrictions and thus chose to establish practices and customs – the content of which remained almost exclusively industry knowledge. Solvency II now puts indirect pressure on the industry to render clear what has been obscure.

A Business Relatively Free from Supervision

Despite being anteceded by insurance only by a few decades – the German nestor of reinsurance law, Gerathewohl, identifies an agreement of 1370 from Italy as the earliest contract having all the properties of a reinsurance agreement – reinsurance and reinsurers historically never received the same fervent regulatory and supervisory attention as did insurance. On the contrary: Since the advent of modern professional reinsurance companies in Germany – with the Cologne Re being the first of its kind on the globe in 1846 – these providers of reinsurance cover remained for over 150 years almost fully outside the scope of supervision. Neither contract nor company received any considerable amount of regulatory attention. Reinsurance was and fundamentally remained a self-regulated business, and, after some initial hiccups, thrived. Aside from minor regulation attempts, it was only in 2004 that the German legislator in an anticipated implementation of the European reinsurance directive included reinsurance undertakings into the Insurance Supervisory Act (VAG) ▸

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as supervised entities. The situation was quite the same in the legislation of other notable reinsurance markets. Even at this point, the ongoing supervision over reinsurers, however, remained simplified and adapted to the fact that the supervised entities were partaking in a global business.

Solvency II as an Interruptive Factor

This being said, Solvency II did not bring about a revolution in the field of reinsurance supervision in the sense that reinsurers would be supervised for the first time. The rules of Solvency II rather only evolved, i.e. increased, the (qualitative) degree of sophistication of regulation and supervision.

Solvency II did not bring about a revolution in the field of reinsurance supervision

What, however, has remained unaltered is that there is no particular regulation of the reinsurance agreement itself. In Germany – as in most other jurisdictions – the reinsurance contract is not subject to the Insurance Contract Act (and in particular its [semi-]mandatory provisions) but only to the (non-mandatory) general rules of the law. Alack and alas, other than under the Solvency I-System this will pose a serious problem under the Solvency II-System. This stems from the fact that the direct insurer's reinsurance strategy and cover is now subject to quantitative and qualitative regulation, which implies that the parties concerned and the supervisor must have full knowledge of the content of the reinsurance agreement. This, in turn, requires for there to be certainty about the functioning (and legality) of all contractual provisions and the underlying legal rules. For centuries, however, these agreements were regulated – at least de facto – exclusively by special trade practices and customs unbeknownst to anyone outside a rather small circle within the industry. Such obscurity of the contractual content of the reinsurance agreement poses a severe risk under the Solvency II-System as the uncertainty (of the scope) of cover might be translated by the supervisor into the necessity of surcharges, capital add-ons and the like.

The Creation of a Reinstatement of Reinsurance Practices and of an Optional Legal Regime as a Remedy

In order to remedy this situation before it truly comes to the fore, academics from Zurich, Vienna and Frankfurt (the latter being the authors of the present) set out to establish Principles of Reinsurance Contract Law (PRICL). This project – jointly funded by the Swiss SNF, the Austrian FWF and the German DFG – aims to bring to light and clarify practices and customs as established globally between parties to regulate their reinsurance agreements. The goal is, however, not only to restate these usus but rather to transform them into an opt-in legal regime to be chosen freely by the parties to govern their contract. In order to do so, and to garner acceptance for the final product, membership and participation was offered not only to other renowned academics hailing from important reinsurance jurisdictions but also, and foremost, to eminent practitioners representing in an equal measure reinsurers, insurers and reinsurance brokers. This composition of the group serves as a guarantee that customs are not given a reading that would nefariously favour one party's particular interests.

Supervisor must have full knowledge of the content of the reinsurance agreement

The difficulty of the work resides in the fact that several customs may have different iterations geographically – e.g. the principle of utmost good faith, while in principle ▸

Principles of Reinsurance Contract Law (PRICL)
Prof. Wandt is a founding member of a joint research project on the draft of Principles of Reinsurance Contract Law (PRICL). This project is headed and coordinated by the applicants, Prof. Heiss and Prof. Schnyder (both University of Zurich), Prof. Schauer (University of Vienna) and Prof. Wandt (University of Frankfurt am Main). The Principles Drafting Committee (PDC) consisting of academics from countries with leading insurance sectors and representing as many jurisdictions in the world is advised by the Advisory Group Reinsurers and the Advisory Group Direct Insurers.

In providing a uniform frame of reference and uniform legal terminology the PRICL aim to encourage international academic discourse regarding the law of reinsurance.

See for further information: http://www.rwi.uzh.ch/oe/PRICL/home.html

accepted in all jurisdictions as a founding principle, can be very differently understood pertaining to its content – or depending on the fact if one is dealing with facultative or treaty reinsurance. It is hence the goal providing for principles that aim to establish a global standard, even where such may hitherto not have (fully) existed, and provide for solutions adequate for all types of reinsurance agreements or, where such is not possible, supply specific provisions for particular agreements. At the same time, all provisions of the PRICL will be non-mandatory, allowing parties to deviate from any rule and thus affording them the necessary flexibility.

In its final iteration, the PRICL would not be state law but rather a self-regulatory instrument in the sense of non-state law. This raises the question if parties will be able to freely choose the PRICL to govern their contract. In order to answer this question, one firstly has to point out that art. 3 in connection with art.7 para.1 s.2 of the Rom I Regulation affords parties to a reinsurance agreement absolute party autonomy. The choice of law is, however, pursuant to the prevailing opinion limited to national laws. This would mean that a choice of the PRICL would not be a choice of law in the strict sense but would rather work only in the way that all such provisions of the applicable state law that pertain to a question covered by the PRICL would be materially altered. Since most countries regard their reinsurance contract law – if the content of such is really known or developed, is another question – to be non-mandatory, the result would still be quite satisfactory. In practice, however, almost all reinsurance agreements contain an arbitration clause. It is here, where the PRICL can reach its full potential. Pursuing to common wisdom the Rom I Regulation is not applicable to arbitration proceedings. Arbitrators rather have to apply the arbitration-specific conflict of law rules enacted at the seat of the tribunal. At least German arbitration law, and that of several other countries, allows for parties to also choose non-state law thus contracting-out of any state law. In doing so, parties would of course not only exclude any reinsurance-specific national rule but also general principles, e.g. regarding contract conclusion, remedies, calculation of damages and interest or statutes of limitation. Since on the one hand it seems unfeasible for the PRICL to establish such general rules and on the other hand one should not risk the application of an unforesee national general rule that might unduly alter the content of a rule of the PRICL, another solution has to be found. The solution currently favoured by the project group consists in including into the PRICL a clause providing that all questions not covered by the PRICL will be subject to the Principles of International Commercial Contracts (PICC) as developed by UNIDROIT. Applying the non-mandatory rules of this non-state legal instrument – which themselves are a restatement of internationally recognized standard or best practice rules for the application to commercial contracts – seems most appropriate for reinsurance contracts. By using these rules to fill any remaining non-reinsurance-specific legal gaps, the PRICL are turned into a fully autonomous reinsurance contract code that can solve all contractual conflicts without any recourse to etatic law. In this way, a truly global law would apply to this truly international business without infringing on any supervisory duty. ◆

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