Reciprocal Insurance

"[R]eciprocal exchanges are not traditional insurers, they are the result of a group of subscribers exchanging reciprocal exchange contracts of indemnity or insurance with each other."

Excerpted from the CAIR (Canadian Association of Insurance Reciprocals) letter to FSRA (Financial Services Regulatory Authority), June 2024.

What is a reciprocal insurance exchange?

Reciprocal insurance offers insurance coverage for insured members that are pooled together as similar, homogenous risks. Ideally, for instance, there should not be a trucking company in the same pool as municipal recreation centres; the risks are too different. That homogeneity is an important underwriting element. It can be similar risks within a geographic location: hospitals in a particular region will all have similar property risk profiles: the same relevant legislation and funding will apply to their operations. Conversely, the homogeneity can be based on operations: senior long-term care hospitals pooled together, for example.

A reciprocal insurance exchange is made up of member "subscribers" who enter into an agreement to participate in the insurance exchange. This long-term legal agreement requires the reciprocal to indemnify members if/when a loss occurs. The subscriber's agreement differs from a typical insurance policy in that if there is inadequate funding to pay claims, subscribers, whether they suffered a loss themselves or not, must contribute funds back into the reciprocal – even if they are no longer members.

How do reciprocal exchanges work?

In a reciprocal exchange, each member's insurance coverage is governed by a board of directors and the subscriber's agreement. Reciprocals are typically managed by an agent, or an Attorney-in-Fact (AIF), who may have the capabilities of issuing policies, underwriting and sometimes even claims management. Individual subscribing members may be required to sit on the governance board.

Though reciprocals themselves may be "not-for-profit," the agents or AIFs that manage them are typically insurance organizations that have similar profit margins and goals as traditional commercial insurers. There can be no doubt they profit from the services they offer.

The subscriber's agreement differs from a typical insurance policy in that this long-term agreement requires buy-in and expertise from each individual subscriber (insured). Even if the policy "expires" the obligations can continue.

What are the pros and cons of a reciprocal?

Pros

- Reciprocal exchanges are often not-for-profit which *could* lead to an overall savings in insurance premiums.
- The pooling of risk supports deep comprehension of risk exposures. This is especially true of pools that are well-established and deeply involved with the members of the pool.
- Risk pooling enables insured clients with "less-than-stellar" loss experience to benefit from those in the pool who have good experience. If the pool grows due to good management and excellent loss experience within the pool, all of those in the pool can benefit. *A rising tide lifts all boats*, as it were. Poor underwriting and many large losses however, can "*sink your ship.*"
- The pool can gain direct access to the wholesale reinsurance market which can lead to lower insurance costs. **it should be noted that most pools, though "reciprocals" still access traditional insurance in one form or another.*
- Different types of pools can be structured in different ways that can offer, at least up-front, different benefits: *Some could offer a profit-sharing benefit where if the reciprocal is successful, any profit feeds back to the members of the exchange.*

Cons

- Traditional insurance policies are typically underwritten and in place for one year. By their very nature, reciprocals require a long-term commitment to be effective and create an exposure to future "cash calls" for the subscribing members if the reciprocal requires extra funding to pay claims.
- A reciprocal exchange needs to have critical mass to function effectively: there must be adequate membership in order to capitalize the insurance required and to "smooth out" negative claims results (*see CBC article shared under Further reading and resource material*).
- Because of the homogeneity necessary to make the pool operate effectively, not all "lines" of coverage may

be available under the reciprocal. Like in the hospital example above, a reciprocal may offer competitive rates for the hospital's medical malpractice, but not provide competitive property coverage. The hospital misses out on the holistic or umbrella advantage of having all their collective risk exposures under one functional policy which can make a significant difference in a claims scenario.

- Insured member clients are potentially exposed to *assessments* from the pool, both immediate and even into the future. In contrast, once you have paid your premium to an insurance company, there are no further payments or assessments required regardless of the claims experience of the insurer. With a reciprocal, if there are insufficient funds to pay the overall claims *of the pool*, an insured member is exposed to future assessments, *even if they had no claims themselves*. CAIR in appealing to the FSRA for less oversight states, "*…the subscribers are required to make up any deficiency…this is different than in traditional insurance,* ***where an insurer cannot go back to the insured and request additional premium***.*"*[emphasis added]
- In a reciprocal, insured members are well-advised to know all of their fellow members; who they are, what type of risk they represent, and what is their loss experience? This can require expertise and manpower that is not readily available in-house, so the insured may rely on the manager of the reciprocal or Attorney-in-Fact (see resource material). The financial implications of not knowing precisely who is joining the reciprocal however, can be terribly significant.
- Though profit-sharing may be a feature of the reciprocal agreement, understanding the actual contract being entered into and ensuring there are reasonable timeframes for the reimbursement is essential and can be very complex. Due to the very nature of long-tail municipal liability claims, it may be necessary to keep those funds in reserve for in excess of twenty years (unless other timeframes can be accommodated in the membership agreement) – even then, there is no guarantee of funds to come back to your municipality.
- There can be significant legal and accounting costs associated with joining (or forming) an insurance reciprocal. To ensure the municipality's best interests are protected, prior to entering into a reciprocal agreement, professional legal counsel should be sought – especially from firms that are experienced in the risks associated with alternative risk transfer mechanisms, such as insurance reciprocals.
- Anonymity becomes less possible between members in the pool; if one insured had an impactful loss, the other members of the reciprocal exchange are entitled to know about it as well.
- Forming a reciprocal is not always permitted by provincial regulators. Regulators have a responsibility to only permit insurers into the marketplace who are capable and financially strong. We have seen the ill effects of lack of governance in the insurance market, and though compliance can be a challenge at times, it is, by evidence of Canada's strong insurance market, a necessary evil.

Reciprocal insurance exchanges exist, to varying degrees, across Canada for differing types of risks: from universities to municipalities. Their success relies upon a myriad of conditions, but their mere creation does not guarantee the desired outcomes: **Ontario Municipal Insurance Exchange (OMEX) suspends underwriting operations**.

Regardless of whether insurance is being offered in the form of a typical insurance policy or via a reciprocal insurance exchange, understanding the importance of expertise, trust, and industry acumen is vital when assessing your insurance provider.

Further reading and resource material:

https://www.insurancethoughtleadership.com/commercial-lines/reciprocal-insurer-right-you

CAIR Response to FSRA June 2024 Final.pdf

Proposed Guidance: Own Risk and Solvency Assessment (ORSA) for Ontario-incorporated Insurance Companies and Reciprocal Insurance Exchanges | Financial Services Regulatory Authority of Ontario

Severe weather events caused insurance at some Alberta school districts to increase by more than 300% | CBC News

Reciprocals, Local Pools and the Commercial Market – What is Right for My Municipality?

[intact] public entities