Feature Article

Commutations of Reinsurance Agreements:

A Business Decision Based on Economics and Risk Appetite; A Collaborative and Negotiable Process

Charles J. Widder

By Charles J. Widder

The subject of entering into commutation arrangements has been discussed, argued about, written about, described in various accounting pronouncements, but rarely discussed as a critical process of the parties to the commutation. In this article, the author will attempt to share his thoughts and experiences as to the process of entering into and executing commutation arrangements between the contracting parties, the reinsurer and the ceding entity.

Background and Rationale

Every product has a shelf life. This is also true for reinsurance arrangements. When initiated and originally structured, the reinsurance agreement between the reinsurer who assumed the risks and the ceding entity that ceded the risks, both parties had business objectives to achieve from the original reinsurance transaction. Those business objectives may have included capacity relief for the ceding entity, stabilization of underwriting results, protection against catastrophic events and relief from managing highly technical and volatile books of business. Assuming the reinsurance arrangement performed as expected by the contracting parties (the converse may also be true), there comes a time when one or both parties to the original reinsurance arrangement may conclude that commuting the transaction may be in the interest of all concerned. What does the term "commutation" actually mean? Statutory accounting guidance in Statement of Statutory Accounting Principle No. 62, Property and Casualty Reinsurance, which is included in Volume I of the "Accounting Practices and Procedures Manual", defines the term as follows: "*A commutation of a reinsurance agreement, or any portion thereof, is a transaction which results in the complete and final settlement and discharge of all, or the commuted portion thereof, present and future obligations between the parties arising out of the reinsurance agreement.*" As such, it is not necessary to commute the entire reinsurance agreement. Perhaps certain layers within the reinsurance agreement, or clearly defined lines of business, or certain risk categories, or accident year data, if properly identified and reported may be subject to a commutation arrangement.

Every product has a shelf life. This is also true for reinsurance arrangements.

Interested Parties to the Transaction

The most obvious answer to the above side heading is the reinsurer and reinsured or ceding entity. Having said that, the interested party in the case of the ceding entity might be an insurance department regulator, deputy or receiver if the ceding company is exiting a book of business, or, due to financial concerns, including a state of insolvency. The ceding entity, may in fact, have concluded that the reinsurance provided is no longer necessary and prefers to assume the liabilities back from the reinsurer along with a cash payment. This may be particularly attractive to the ceding entity if the development on the loss and loss expense reserves previously ceded to the reinsurer has been favorable to the reinsurer. Usually, the reinsurance contract will contain a clause that specifies the timing and conditions under which the contract can be commuted.

If an insurance department or court appointed receiver is involved, the rationale for entering into commutation discussions typically will be motivated by generating cash flow to discharge obligations of the entity being liquidated. Payment by the reinsurer is usually made on a "paid" basis for loss and loss

Charles J. Widder is President of CJW Consultants, LLC and can be reached at charles.widder@verizon.net.

adjustment expenses and not when those obligations are in reserve status. The entity being liquidated is typically cash constrained and it is in the best interest of the insureds and other creditors of the ceding entity to generate as much cash as possible to discharge its obligations, or portion thereof. Additional motivations may include concerns by the ceding entity that certain reinsurers on their program are no longer financially strong and pose a credit risk. Commutation is one of the tools available for managing this credit risk.

The Collaborative Process

Just as the reinsurer relied upon technical experts in various disciplines when the original reinsurance treaty was executed, a similar team of technical experts should be assembled to perform the due diligence when commuting the original agreement, or part, thereof. Typically, the team is composed of the following disciplines: financial, claims, actuarial, legal and underwriting. Reasons for entering into the commutation process should be agreed and documented. For the process to proceed efficiently, a project (team) leader should be responsible for mapping out the due diligence process. That leader can be a respected and knowledgeable person from any of the above disciplines. The author's experience has been with a financial executive leading the process.

A project plan is crucial to keeping the team on track as to document needs, analysis, deliverable dates and discussion with the counterparty to the commutation. Agendas should be used to keep the meetings of the commutation team focused, and minutes taken to document discussions, analysis of data, issues and strategies for resolving identified issues. Claims expertise is crucial to understand the nature and exposure of the reported reserves to be commuted. Disputed coverage issues need to be identified early in the process and communicated to the team. Legal and claims expertise is crucial to this process. The existence of any trust agreements, letters of credit and funds held needs to be evaluated and discussed with the legal representative to avoid legal entanglements down the road as to attachment and set-off rights, draw downs, state requirements (legal and regulatory) regarding set-off rights.

A reconciliation of account balances needs to be performed in conjunction with the due-diligence review. This is typically performed by the accounting department. Part of this process probably will include ongoing discussions with the counterparty to the commutation in order to reconcile account balances, funds held amounts, etc.

Just as the reinsurer relied upon technical experts in various disciplines when the original reinsurance treaty was executed, a similar team of technical experts should be assembled to perform the due diligence when commuting the original agreement, or part, thereof.

The Claims Department team member, in addition to addressing disputed claims, will provide invaluable assistance in reconciling the inventory of open reported claims between the parties to the commutation.

Actuarial support is needed to prepare a range of incurred but not reported (IBNR) loss and loss adjustment expense estimates by contract, or part to be commuted. Discount factors need to be applied to both the reported and IBNR claims to bring the outstanding liabilities to present value. The discount factors to be used will depend upon the type of business being commuted. Long tail liability claims will have deeper discounts and longer payout patterns than property claims.

The commutation team needs to review, analyze and reconcile all the data gathered and prepare a report that projects possible financial underwriting results, both to the reinsurer and ceding entity. The underwriting results should be developed based upon worst case, best case and expected case scenarios, then communicated to senior management to apprise them of possible financial impacts to the company from the proposed commutation. Buy-in by senior management is essential to proceeding with further negotiations with the counterparty.

The Negotiation Process

The underwriting and financial scenarios are used as a framework to discuss and resolve account balances, fund balances, outstanding claims and IBNR reserves with the ceding entity or its representative. The negotiation process should include reasonable and agreed time frames to conclude the process, rather than having an open ended process. Agreement upfront between the parties for handling immaterial amounts

continued on next page

can greatly expedite the process and avoid having the process bog down. Face to face meetings between the commutation parties can be extremely beneficial and promote focused attention on issues and expectations. Minutes of the meetings are crucial to maintaining order and closure on agreed account balances, reserves and coverage issues.

Ideally, each party to the negotiation process should walk away from the table satisfied that a reasonable and fair settlement has been reached.

It may be that one party is in a stronger negotiating position, either because of financial strength, better and more accurate record keeping, or timing for the final commutation agreement not being an issue. Regardless of party relative strength, the commutation negotiations should be conducted professionally and among equals. Each of the contracting parties has goals and objectives in the commutation process. It is important to discuss and understand those goals and objectives for each side. Ideally, each party to the negotiation process should walk away from the table satisfied that a reasonable and fair settlement has been reached.

The Final Product

A memorandum of understanding should be prepared to document the decisions reached, amounts to be discharged and method and timeliness of payment. This understanding should be the foundation of a written addendum to the treaty, including the release language of all current and future obligations of the parties to the commutation agreement. Legal and contract underwriting departments typically handle this part of the process. In the case of broker involvement, the intermediary can perform this process. Appropriate signatures and dates on the commutation agreement are executed (including state insurance regulatory) where required.

Accounting Treatment of Commuted Reinsurance

Statutory accounting guidance is contained in Statement of Statutory Accounting Principle (SSAP) No. 62, Property and Casualty Reinsurance. This guidance requires the ceding entity to recognize the present value payment (cash and/or securities) received in the underwriting accounts as a "negative" paid loss (income) and the loss reserves recoverable are eliminated (expense). Any resulting net gain or loss is reported in the statutory income statement as underwriting. The reinsurer recognizes the present value cash payment as a paid loss (expense) and eliminates the carried loss and loss adjustment expense reserves from its balance sheet (income), with the resulting net gain or loss reported as underwriting in the statutory income statement.

All commuted balances are removed from related schedules and exhibits of the annual statement by ceding entity and reinsurer.

The accounting treatment under U.S. GAAP is prescribed in Statement of Financial Accounting Standards (SFAS) No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts. The ceding enterprise is effectively re-assuming the obligations previously ceded to the reinsurer for a present value cash payment. The accounting recognition through the underwriting accounts is essentially the same as for statutory accounting described above for both ceding entity and reinsurer.

There is an added requirement for income recognition by the reinsurer, (assuming that the commutation transaction resulted in a gain) in that the total obligation to the ceding entity has to be extinguished. The language of the commutation agreement (addendum to the original contract) specifically releases the reinsurer from all current and future obligations for the business commuted. Therefore, the extinguishment of liability condition has been met.

Conclusion

The collaboration of various insurance and reinsurance disciplines is necessary to maximize the effectiveness and timeliness of the commutation process and ultimate agreement. Having a work plan with specific target dates sets the commutation process in motion and provides progress and feedback to the entire team. The negotiation then is predicated on documentation and analysis and dealing effectively with coverage issues and other differences with the counterparty to the transaction. Being able to provide a "win-win" situation to both parties is crucial to a successful outcome. ■