

Commutations 101

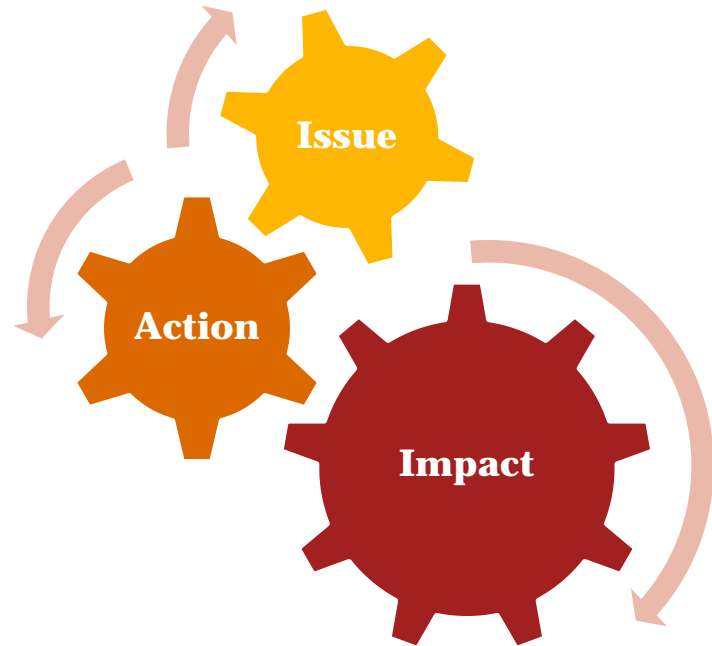
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What is a commutation?

A Commutation is a termination of a reinsurance obligation of an agreement between a reinsurer and the reinsured

Steps to effectuating a commutation



- Identify targets
- Assess viability, motivators of parties
- Information gathering
- Assessment/establishing value
- First meeting
- Party to party reconciliation
- Follow up meetings
- Final agreement
- Post commutation activities

Identify targets and assess motivators

Reasons as to why a reinsurer or reinsured would commute:

- Reinsurer /Cedent wants finality/cease processing/cut off administrative costs
- Reinsurer desire to avoid adverse loss development
- Cedent in need of liquidity (cash)
- Reinsurer at risk for insolvency
- Disputes between the reinsurer and reinsured

Leading practices:

- Annual assessment of all reinsurers
 - Penalties
 - Disputes
 - Payment patterns
 - Ongoing versus run-off relationship
 - Number of claims/contracts being processed
 - Agreements with last man standing
 - Credit worthiness
 - Schedule F

Information gathering



- Identify all relationships
- Contracts (Ceded and Assumed)
 - Mandatory commutation terms
 - Sunset clauses
- Schedule F data (all parties)
- Accounting records
 - Premium/Loss data
 - Loss sensitive calculations
 - Collateral
 - Offsets
- Precautionary claims
- Past interactions
 - Total premium and losses paid
 - Length of business relationship
 - Disputes and outcomes
- Current relationship
 - Volume of business and premium
 - Contacts
 - Future expectations

Example: Treaty information



- Reinsurer treaty #
- Cedent treaty #
- Broker treaty #
- Treaty period
- Treaty Name
- Type of agreement
- Treaty limit, retention, aggregate extension
- Reinstatements
- Written line % or value
- Signed line %
- Class of business
- Gross and ceded premium
- Gross and ceded paid loss
- Gross and ceded outstanding reserve
- # of open claims
- # Precautionary claims
- Estimates for development on existing claims
- IBNR
- Funds held
- LOC details/listing

Assessment

- Reconciliation of balances
 - Premium reconciliation offset
 - Paid/Outstanding position
 - Deductibles
 - Loss Sensitive Premium
 - Collateral
- Payment history
- Funds held by broker
- IBNR
 - Development on existing, precautionary and unreported claims
 - Frequency and severity analysis
 - Limit and aggregation analysis
 - Estimate payment patterns
 - Determine Survival Ratios and other methodologies
 - Estimate present value discounts
 - Determine inflation factors
- Establish a range

- Solvency of Cedent/Reinsurer
- Credit worthiness of Reinsurer
- Pending Litigation/Arbitration issues
- Schedule F balances Cedent/Reinsurer
- Schedule F Penalties
- Cost benefit analysis
 - Estimated obligations of reinsurer less:
 - Dispute risk
 - Credit risk
 - Administrative costs
 - Legal costs
 - Penalties
 - Stress of relationship/ongoing business
 - Negative publicity/reputation
- Establish range first offer to minimum level of acceptance
 - Impact on balance sheet

The first meeting

- ❑ Requesting the meeting
 - ❑ Initiated by party requesting commutation
 - ❑ Location typically the “other party” or industry event (i.e. AIRROC)
 - ❑ Requestor sets agenda
- ❑ Attending the meeting
 - ❑ Who - primary negotiator and data/accounting representative
 - ❑ Introductions – roles and background
 - ❑ Express purpose of meeting/goals
 - ❑ Stated in terms of exploring possible finality of the relationship
 - ❑ Define advantages for both parties
 - ❑ Discuss potential disadvantages if do not commute
 - ❑ Data cut offs and define time frames in which to complete
 - ❑ Contracts/relationships to include
 - ❑ Procedures Roles and Responsibilities
 - ❑ Data exchange for reconciliation timing and protocols/formats
 - ❑ Audit time frames and scope
 - ❑ Establish next meeting date, post data reconciliation

Party to party reconciliation and audits

- Define data to be exchanged
- Understand format
- Reconcile accounting issues
- Exchange information (i.e. copies of agreements, etc.)
- Audit
 - Clearly define scope and what will be made available
 - Requirements for receiving audit list
 - Confidentiality agreement
 - Logistics: systems access, office hours
 - Copies of materials
 - Discussions with counsel
 - Audit reports timing and distribution

On going negotiations

- ❑ Requestor of the commutation typically is party that pursues adherence to an agenda
- ❑ Substantive negotiations often do not take place until reconciliation initiatives and audits are complete
- ❑ Disputed issues and positions are discussed on a high level
- ❑ IBNR calculations may be shared and discussed
- ❑ Contracts with mandatory commutation clauses are highlighted
- ❑ Typically values are not agreed based upon initial offers
- ❑ Deals not completed by the agreed cutoff date require data updates and restatement of offers

Elements of a commutation agreement

- ❑ Preamble: identify participants and participating shares, intent and general agreement
- ❑ Consideration: amount, timing and method of payment
- ❑ Release of Obligations and Liabilities: known, unknown, and future obligations under the agreements that are to be released
- ❑ Waiver of future claims: prohibits cedent from submitting future claims
- ❑ Confidentiality clause: limiting disclosure to third parties
- ❑ Jurisdiction: usually consistent with the terms of the reinsurance agreement
- ❑ Dispute resolution: usually consistent with terms of reinsurance agreement
- ❑ Good faith transaction: knowledgeable parties entering into the commutation agreement
- ❑ Exhibits: known contracts included

Post commutation activities

- Notify brokers, intermediaries and managing agents
- Allocate sums received to appropriate reinsurance agreements
- Write off any appropriate balances
- Establish contra coding or other mechanism to shut off logic that generates cessions
- Maintain copies of the commutation agreement

Thank you

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