Achieving Finality: 
The Commutation Process

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Abstract
The last thirty years have been turbulent times for the reinsurance industry. Natural catastrophes such as hurricanes, floods, typhoons and earthquakes have resulted in losses of a level rarely experienced in years gone by.

As a result the reinsurance market has changed dramatically. During the 1980s and early 1990s it became a market increasingly inhabited by companies in run-off, insolvent and/or subject to some type of scheme of arrangement. Following a number of large catastrophe events over the past few years and the effects of current financial conditions, it is possible that another wave of run-offs and insolvencies may soon be upon us. The situation in which the reinsurance market has found itself in recent years has led to increasing prominence being given to the subject of commutations.

A commutation is a commercial agreement between two parties, (re)insured and (re)insurer, where, subject to the payment of a mutually agreed sum to the (re)insured, the (re)insurer is discharged of all past, present and future liabilities arising from the contracts ceded by the insured or reinsured, which are the subject of the commutation.

The commutation payment made by the reinsurer is in respect of all past, present and future liabilities. It will therefore be made in consideration of all unsettled balances, outstanding claims and incurred but not reported (IBNR) claims. Any payment will usually be discounted to reflect the fact that settlement is made in advance of the time when the payment would have become due were the treaties allowed to run to extinction. Therefore, when a commutation is negotiated, the reinsured will wish to maximise the final settlement and the reinsurer will wish to minimise it. Ideally the settlement should be equitable, although considerations, such as each party’s reason for completing the commutation, may mean that this is not always the case.

This paper considers, in detail, the reasons companies have for wanting to commute with each other, before moving on to consider the processes involved in negotiating a commutation, with particular emphasis on the role of the actuary in the process. It also discusses in detail some of the problems and issues that are frequently encountered, as well as detailing some of the ongoing implications of commutations. It concludes with a summary and makes some observations regarding the major problems which can be encountered when negotiating a commutation.

Key words: Commutations, reinsurance, run-off, “excess of loss”, “quota share”, “follow the fortunes”
1. What is a commutation?

The last twenty years have been turbulent times for the reinsurance industry. Global natural catastrophes such as hurricanes, floods, typhoons, earthquakes and bushfires have resulted in losses of a level rarely experienced in years gone by.

In addition, asbestos, pollution and health hazard (APH) losses continue to hit reinsurers worldwide. Even after all this time, the full extent of the reinsurance market’s ultimate APH exposure is still not fully known.

Added to this is the turmoil of the recent Global Financial Crisis (GFC) and its impact on credit, D&O and professional indemnity insurance in particular, as well as a rapidly changing regulatory environment. The effects of the GFC are still being monitored in a global basis, by individual companies, national regulators and international bodies such as the Bank for International Settlements (BIS) and the International Association of Insurance Supervisors (IAIS). The IAIS has been requested to set up a Financial Stability Committee to review and report on financial stability within the global insurance market.

As a result the reinsurance market has changed dramatically. During the late 1980s and early 1990s it became a market increasingly inhabited by companies in run-off, insolvent and/or subject to some type of scheme of arrangement.

A second wave of run-off occurred around ten years later, triggered by events of September 2001 and other large losses during the beginning of the new century. A further ten years on, it is possible that another wave of run-offs and insolvencies may emerge, although it current appears that the global insurance market has not been significantly impacted by the GFC.

The situation in which the reinsurance market has found itself in recent years has led to increasing prominence being given to the subject of commutations. At reinsurance conferences, time is frequently allocated to speakers who will advise the audience on negotiating commutations. Many reinsurers, run-off companies and service providers have established their own specialist departments to handle commutations.

A commutation is a commercial agreement between two parties, (re) insured and (re) insurer, where, subject to the payment of a mutually agreed sum to the (re) insured, the (re) insurer is discharged of all past, present and future claims arising from the contracts ceded by the insured or reinsured, which form the subject of the commutation.

For the purposes of this paper we will consider commutations from the point of view of a reinsurance company commuting either its inwards reinsurance business ceded by insurance or other reinsurance companies, or its outwards reinsurance business placed with other reinsurers, as shown in the diagram below.
Clive O’Connell (Barlow, Lyde & Gilbert) suggested in an article in The Review (December 1995) that for the reinsured a commutation provides certainty of collection in a market occupied by an increasing number of run-off or insolvent companies, and that for the reinsurer a commutation provides certainty against deterioration in the account.

The commutation payment made by the reinsurer is in respect of all past, present and future claims. It will, therefore be made in consideration of all unsettled balances, outstanding claims, incurred but not enough reported (IBNER) and incurred but not reported (IBNR) claims. Once the parties to a commutation have agreed on the undiscounted value of these elements the payment to be made in settlement should be discounted to reflect the fact that settlement has been made in advance of the time when the payments would have become due, were the treaties allowed to run to extinction. Therefore, when a commutation is negotiated, the reinsured will wish to maximise the final settlement and the reinsurer will wish to minimise it. Ideally any settlement should be equitable, although considerations, such as each party’s reason for completing the commutation, may mean that this is not always the case. The reasons for commuting reinsurance contracts will be discussed in Section 2.

As the 1980s drew to a close it became apparent that commutations would be more widely used in the future. As a result the Institute of Actuaries General Insurance Research Organisation (GIRO), now known as the General Insurance Study Group (GISG), set up a working party to consider the actuarial implications of commutations. The working party’s report, published in 1990, described a commutation as “the means outside litigation, arbitration, repudiation or liquidation, whereby both parties to a potential dispute can arrive at an acceptable financial settlement.” The report recognised the importance of commutations in resolving issues which might otherwise lead to lengthy and costly legal actions.

Subsequently a number of other working groups have released publications relating to the commutation process. Notably, Advanced Study Groups set up by the Insurance Institute of London have published two books: “Developments in Excess of Loss Reinsurance”, May 2000 (Lucy Simpson was a co-author of this publication) and “Run-off Management and Commutations in Practice”, December 2006.
Achieving Finality: The Commutation Process

This paper will first consider, in detail, the reasons companies have for wanting to commute with each other. It will then consider the processes involved in negotiating a commutation. Section 3 analyses each stage of the commutation process and discusses some of the problems that can be encountered. Section 4 details some of the ongoing implications of commutations and finally Section 5 provides a summary and look at some suggestions which have been made regarding the major problems which can be encountered during the negotiation of a commutation.

2. Why commute?

There are a wide variety of reasons why a cedant or reinsurer may wish to end a contractual relationship by effecting a commutation, but it should be noted that neither party would, under normal circumstances, wish to commute business when the financial and administrative integrity of each party is high.

Commutations are far more likely to occur in situations where a perceived weakness exists on one or both sides. In short, commutations offer a solution to a potential problem.

Whatever one party’s motivation for entering into commutation negotiation, they should also be aware of the counterparty’s motivation, as this information may help with the formulation of the negotiation strategy.

Commutation is widely used as a solution to any of the following problems:

- The cedant knows or suspects that the reinsurer is in financial trouble
- The reinsurer is in financial trouble and wishes to reduce the potential for deterioration of results
- The reinsurer suspects or knows that the cedant is in financial trouble, not reserving correctly or is incompetent
- The reinsurer disputes a treaty
- A treaty is producing unexpectedly bad results and the cedant offers commutation to the reinsurers in order to protect market reputation
- The cedant or reinsurer wishes to reduce administration costs

Each of the above reasons is considered in more detail below.

2.1. The cedant knows or suspects that the reinsurer is in financial difficulty

In this case, the cedant is commuting with poor reinsurance security. There are various signs that a cedant can look for when considering whether or not his reinsurers represent bad security. These signs can include the following:
2.1.1. Ring fencing

A reinsurance operation that is part of a large group is able, to some degree, to rely on the strength of the group. However, when the reinsurance portfolio is simply given its own capital and left to fend for itself there may be cause for concern for its reinsureds. The reinsurer now has limited resources from which to pay future claims. Once these resources are exhausted they will not be replenished, therefore the reinsured must consider whether to take the risk that the reinsurer will be unable to settle future claims, or negotiate a commutation that will guarantee some level of settlement.

2.1.2. Poor payers

On occasions reinsurers may lose the support of their shareholders and as a consequence experience cash flow problems. Spotting delays in the settlement of claim by a reinsurer who has previously paid due balances promptly may alert a cedant to such problems. This can be assessed by reviewing an aged debt analysis.

2.1.3. Loss makers

Poor reinsurance results have already, or may in the future cost many companies and their shareholders a great deal of money. Many shareholders have realised that they had taken on greater liabilities than originally intended, and in many cases continued to write reinsurance business in an attempt to recoup losses. This could be seen during the early 1990s as the reinsurance cycle turned upwards and premium rates began to increase in response to the losses suffered by the market. However, the evidence of subsequent renewal seasons suggests that quite quickly the cycle turned again and rates began to reduce dramatically for all classes of business. As a consequence, any recovery of past losses slowed down considerably and rates returned to levels, which may have persuaded some shareholders that their companies could not generate profits.

Following the events of September 2001, rates were observed to have increased substantially again, but as has been seen in the past, these increases were too late for some shareholders whose companies have been unable to operate at a profit for a number of years. They therefore, decided to withdraw their financial support and force companies into run-off.

In the aftermath of the GFC we are again starting to see an increase in both insurance and reinsurance rates, with the market responding in a similar way to the previous two cycles. It remains to be seen whether or not these rate increases will be sustained.
2.1.4. Loss of reputation

Many reinsurance organisations are owned by insurance giants. It is a traditionally held view that such reinsurance companies will always be supported, because their owners would not wish to suffer a loss of reputation if the associated company was allowed to fail. However, logic dictates that an ultimate finite loss any shareholder could support exists. If one insurer were to allow its subsidiary reinsurance company to go into liquidation many others may feel able to follow suit.

It should be noted though, that many shareholders have, thus far, shown a commitment to supporting their reinsurance operations that goes beyond purely financial considerations and reflects a strong moral obligation.

2.1.5. Group connections

If one company within a group looks weak and appears to be about to fail, the financial position of all other companies within that group must be considered.

2.1.6. Shareholding unclear

If a reinsurer’s shareholders are not shown clearly in their Report and Accounts, or they prove to be only a shell company, whose main assets are amounts due from other companies of a similar type, the credibility and the ability of the company to pay future claims must be questioned.

In all the above cases, commutations can be used as a method of credit control or bad debt management. It is important for a cedant to be aware of the identity and financial condition of their reinsurers. It is important to identify any reinsurers whose ability to pay future claims is doubtful. These are the companies that should be targeted for commutations.

2.2. The reinsurer is in financial trouble and wishes to reduce the potential for deterioration of results

A reinsurer may wish to reduce the potential for deterioration on their inwards portfolio. This can enable a reinsurer to avoid run-off, or assist a reinsurer already in run-off to remain solvent and speed up the run-off. In general, this will involve concentrating on long tail classes of business, where the potential for reduction is greater.
2.3. The reinsurer suspects or knows that the cedant is financially compromised

This is another situation where a reinsurer may wish to reduce the potential for deterioration on inwards business. If the information received from the cedant is unreliable, the reinsurer will find it very difficult to quantify actual and potential liabilities. The negotiation of a commutation could provide certainty.

2.4. The reinsurer disputes a treaty

Where a dispute exists over the terms of a treaty, the cedant faces the choice of litigation, arbitration or doing nothing. Many treaties contain an arbitration clause requiring arbitration to take place before litigation can be instigated. However, the arbitration process can be slow, expensive and unpredictable and arbitration against a reinsurer of dubious financial standing may achieve little. For these reasons, commutation is often a more attractive prospect as commutation of a specific liability may often solve the problem. In addition a reinsurer may be more willing to settle at a level acceptable to the cedant on one particular treaty if the reinsurer can also commute all his exposure from that cedant at the same time.

2.5. Protecting the cedant’s market reputation

If a treaty is producing unexpectedly bad results, the ceding company may wish to protect its reputation by commuting the treaty in question. In most cases, the reinsurers concerned would be willing to consider a reasonable commutation offer to reduce their potential exposure.

2.6. Reducing administration costs

If a reinsurance treaty is considered “non-dangerous” and has little or no potential for future claim deterioration, then it can be commuted, with both sides benefiting from reduced administration costs. In such cases, the cedant is taking back a degree of exposure but the risk of loss should be extremely small and offset by the reduction in costs, a positive cash flow and the removal of uncertainty from any security risk on the outwards business. However, because of the time and resource required in negotiating a commutation the reduction of cost is rarely a prime motive for commutations, unless the saving will be significant.

2.7. The alternatives

There are many alternatives to commuting a treaty or block of business, but the appropriateness of each depends largely on the purpose of the commutation. Some of these are described below.
2.7.1. Schemes of arrangement

In the situation where a commutation cannot be agreed upon due to the number of parties involved, a scheme of arrangement may be possible. It involves a commutation deal through a majority vote of cedants, forcing the reinsurer to commute. When schemes of arrangement are used it is often because the reinsurer is insolvent and the scheme provides a mechanism for the insolvency administrators to achieve finality and allocate the entity’s remaining assets equitably between all the creditors.

2.7.2. Novation

In the context of reinsurance, novation generally means a transfer of liability from one reinsurer to another with the consent of the cedant. It is also known as ‘assumption’ or ‘portfolio’ reinsurance. Despite there being no actual commutation, a novation has the same overall effect of a commutation by removing the contractual obligations between reinsurer and cedant, but replacing them with a similar, if not identical arrangement between the cedant and an alternative reinsurer.

As stated above, it can only work if the cedant is willing and then only when there are few parties involved in the transfer as permissions that need to be gained for each contract and from each cedant.

Once the above two conditions are satisfied, it can be useful when:

• A cedant suspects that the reinsurer is in financial trouble, with this resulting in a reduction of credit risk for no additional insurance protection to the cedant.
• A reinsurer wishes to transfer a cedant to another reinsurer, especially if a price can’t be struck for a commutation.

2.7.3. Statutory transfer

Statutory transfer is essentially a novation ordered by a court. With the prerequisite consent of the relevant authorities, an insurance or reinsurance may undertake a statutory transfer of the ultimate liability for business written from the transferor to the transferee.

A recent example for consideration involved Equitas. Equitas was established during 1993 to ring-fence the liabilities of Lloyds names for the 1992 and prior underwriting years. While Equitas administered the run-off of the portfolio of business, ultimate liability for claims settlement should Equitas run out of funds remained with the individual Names.
Achieving Finality: The Commutation Process

In 2007, Equitas entered into a reinsurance contract with National Indemnity Company (a member of the Berkshire Hathaway Group of companies) with the ultimate aim of providing finality to the Lloyds Names. With effect from 30 June 2009, following the court approval of a statutory transfer, liabilities were assumed by National Indemnity in place of the Names.

2.7.4. Recapture clause

In the situations where the impetus for change is the reinsurer’s solvency, a recapture clause may allow a cedant to rest assured that its reinsurer will pay the necessary recoveries.

Addition of a recapture clause allows the cedant the right to recapture the business if the reinsurer’s financial condition deteriorates. Upon recapture, the cedant recovers reinsurer assets sufficient to cover the ceded liabilities and the reinsurer is released from the liability. The effect is an option to the cedant of a commutation later rather than performing a commutation now.

While the administration cost of simply adding a recapture clause to an existing contract appears attractive, the downside is that for the recapture clause to have any worth, the cedant needs to remain in a position to be able to exercise the option including having staff and physical resources to manage the recaptured business.

To further secure a recapture of reinsurer assets, it is possible to require that the reinsurer hold assets in a trust account. Generally, these assets will be less than the value of the full ceded liabilities when the reinsurer is financially strong but requiring additional deposits when the reinsurer’s solvency is in question.

2.7.5. Securitisation

While this paper is not about alternative risk transfer methods, securitisation is relevant to the extent that it may be used to in place of a reinsurer. Catastrophe bonds have been issued since the 1990s and provide a way for large risks to be capitalised through the capital markets. They invariably are expensive to create with investment bank expertise required, which results in a greater suitability for very large risks that are difficult to diversify.
3. How to commute

When a commutation is to be executed between two parties for one of the reasons discussed, there are seven main stages to be considered:

<table>
<thead>
<tr>
<th>Stage</th>
<th>Approximate allocation of time</th>
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</thead>
<tbody>
<tr>
<td>1. Marketing</td>
<td>5.0%</td>
</tr>
<tr>
<td>2. Treaty identification</td>
<td>10.0%</td>
</tr>
<tr>
<td>3. Reconciliation of data</td>
<td>40.0%</td>
</tr>
<tr>
<td>4. Actuarial evaluation</td>
<td>15.0%</td>
</tr>
<tr>
<td>5. Negotiation</td>
<td>5.0%</td>
</tr>
<tr>
<td>6. Legal agreement</td>
<td>5.0%</td>
</tr>
<tr>
<td>7. Post commutation administration</td>
<td>20.0%</td>
</tr>
</tbody>
</table>

The percentage figures shown above indicate the proportion of time which may be engaged in each of these activities. These figures were suggested by the 1990 GIRO Commutations Working Party and should only be considered a rough guide. The actual proportional split may vary considerably from deal to deal depending on the complexity of the reinsurance arrangements.

Personal experience suggests that the 20% allocated to post commutation administration may be too high and that 5 to 10% would be more appropriate with the difference spread between treaty identification and actuarial evaluation.

The development of suitable models can vastly reduce the amount of time that has to be spent on the actuarial evaluation phase for each commutation, particularly where the reinsurer is considering commutations with a large number of other parties.

Although the results obtained from the actuarial models will need to be evaluated and reviewed from a commercial deal perspective, taking into account of all the qualitative factors which need to be considered, the investment in time spent developing appropriate models should significantly reduce the work involved in this phase.

Each of the seven stages will be considered in turn in the following sub-sections.
3.1. Marketing

It is at this stage that the decision of whether or not to pursue a commutation is taken. Commutations are considered for a variety of reasons, (as discussed in Section 2), but we must be aware that the commutation is not the only option open to a cedant or reinsurer. It is therefore vital for the senior management of the companies involved to become acquainted with all the problems and their possible solutions under a variety of scenarios, before taking the final decision of whether to commute.

Consideration will need to be given to the basis of the commutation, for example whether specific treaties will be commuted with all reinsurers or all contracts between two parties will be commuted, as illustrated in the diagrams below:

**Commutation of specific contracts**

Reinsurer 1 wishes to commute an outwards reinsurance contract placed with a panel of other reinsurers

**Commutation of all contracts between two parties**

Reinsurer 1 wishes to commute all inwards and outwards reinsurance contracts with reinsurer 2
Achieving Finality: The Commutation Process

Such commutations can be effected for inwards treaties only, outwards treaties only or on a net basis, which allows for the commutation of both inwards and outwards reinsurance contracts.

Once the decision to embark on a commutation has been made, it is essential that a strategy be developed. It should be decided which specific treaties and / or reinsurers or cedants should be targeted. If individual reinsurers or cedants are to be targeted, meetings should be arranged to discuss solutions to mutual problems. Prior to an initial meeting with the company targeted by the commutation strategy, the following issues should be considered in any potential commutation:

- The advantages to be gained by each party
- The contracts to be included in the commutation
- The procedures to be followed in order to effect the commutation
- Who will take responsibility for each task
- The deadlines for completion of each stage of the commutation
- The cut-off date of the commutation

Each of the above should be reasonably self-explanatory, perhaps with the exception of the final point. At the commencement of negotiations it is important to establish a cut off date to avoid negotiating a commutation with the potential for moving goal posts.

For example, suppose two companies decide to negotiate a commutation and begin to gather information relating to the treaties involved. If a cut off date is not agreed and the commutation is not concluded by the end of the year, then new accounts will be issued to the reinsurer early in the following year. Balances due, outstanding claims and IBNR would all potentially change and as a consequence the reconciliation and actuarial evaluation may need to be updated before the negotiations can continue. However, if a cut off date is agreed during the marketing stage, the reinsurer would either issue no further accounts to the reinsurer in question, or would agree to make a final adjustment in respect of any additional accounts issued, prior to the final commutation settlement being made, thus ensuring that the commutation process is not delayed by any recalculations.
3.2. Treaty identification

Once a reinsurer has decided that the way forward is via commutation, it is necessary to define and gather certain information about the treaties forming the subject of the commutation. For each of the treaties to be commuted the following information is required:

- Reinsurer’s treaty reference
- Cedant’s treaty reference
- Broker’s treaty reference (where applicable)
- Underwriting period of treaty
- Treaty description
- Limit, deductible and aggregate deductible of the treaty (where applicable)
- Number of reinstatements (where applicable)
- Written line %
- Signed line %
- Class of business
- Cumulative gross premium
- Cumulative gross paid losses
- Cumulative gross unpaid losses
- Current gross outstanding claim estimates
- Current IBNR
- Date of last processed account
- Type of reinsurance (e.g. Fac, XOL, quota share, surplus, etc.)
- Details of funds retained
- Details of existing Letter of Credit arrangements

This type of information is usually held in spreadsheet format, and is often used as the basis for the commutation models. Appendix A includes examples of such spreadsheets.

Some of the information gathered in the spreadsheet or model may be used as the appendix to the final commutation agreement. This will be discussed in Section 3.6.

Occasions may arise when it may simply be too large an exercise to commute all treaties with one cedant or reinsurer simultaneously. In such cases it often more sensible to adopt a phased approach to the commutation, identifying one manageable block of business to be commuted before moving onto another block. For example by completing the commutation of all marine treaties before moving on and beginning the commutation of casualty treaties.

The reason a reinsurer or reinsured considers a commutation is achieve finality, often because the financial strength of one of the parties is in doubt. For example a cedant may wish to commute when it believes a reinsurer may be unable to pay future claims, or a reinsurer in run-off may seek a commutation in order to achieve finality or crystallise losses. In such situations, it is advisable to consider those treaties with
large actual or potential claims as a first priority. These will be the treaties where the claims are most likely to deteriorate over time and it is probable that concerns over claims to these treaties prompted the commencement of commutation discussions. Treaties where little or no exposure exists (e.g. old underwriting years for property classes) can be commuted at a later date, as it is unlikely that any significant deterioration of claims will take place.

3.3. The reconciliation of data

Treaty identification and data reconciliation are the most time consuming parts of any commutation and are critical to its success.

The first stage to be completed is to reach agreement on the treaties to be included in any commutation. This may require the assistance of the brokers / intermediaries if identification of policy details proves to be a problem.

Once the list of treaties to be included has been agreed, the reconciliation of factual financial data can begin.

It would appear, on the face of it, that the reconciliation of items such as unpaid balances, outstanding claim liabilities, letters of credit and liabilities retained should be relatively easy. Unfortunately for those involved in the task of reconciliation this is often not the case.

If we consider the example of an American cedant placing a casualty excess of loss contract in the London Market, there are typically four players involved:

• The ceding company
• An Australian intermediary
• A UK intermediary
• The reinsurer

Each of these four players can, because of unavoidable time delays, potentially hold different information about the treaty. To illustrate this, unpaid balances can be broken down into four categories:

• Balances due which have been agreed by reinsurer and cedant
• Balances paid by reinsurer but not received by cedant
• Balances due to cedant, but for which the reinsurer not received advices
• Balances funded to cedant by intermediary (i.e. balances paid to the cedant by the broker, who has not received settlement from the reinsurer)
Achieving Finality: The Commutation Process

The process of reconciliation is of great importance to the actuarial analysts involved. It is imperative that they are aware of all the differences that exist between the cedant and the reinsurer’s statistics, and that they are provided with details of the true balances due to the cedant once all processing is updated and any errors corrected.

Outstanding claim liabilities must also be reconciled and any differences understood. It is important that the statistical database is updated, if necessary, and that any actuarial evaluation is based on the correct paid and outstanding amounts.

Letters of credit (LOCs) are another area where reconciliation is essential. Often commutations are settled by drawing down existing letters of credit and thus it is important that the necessary information is reconciled. For example if a LOC of X is set up, the cedant can draw on this amount to settle balances due. If a reinsurance settlement of Y is agreed this could be drawn from the existing LOC, leaving a LOC value of (X - Y). It is therefore important that the reinsurer knows the current value of LOCs to ensure that they are sufficient to cover the commutation settlement. Following final settlement the LOCs must be closed if all treaties between the reinsurer and cedant have been commuted.

Unless all data is accurately reconciled any actuarial advice given, and the results generated by our commutation models can be flawed. At all times it should be remembered that a commutation is a final cash call. This means that any settlement agreed between the parties cannot be revisited or revised as claim liability figures can.

This leads us on to what, for a long period of time, has been most contentious issue in commutations. Can a reinsured make recoveries in respect of outstanding claims and IBNR from its outwards reinsurers following the commutation of inwards business?

Unfortunately there is no definitive answer to this question. The subject will be discussed in more detail in the next subsection, Actuarial Evaluation, but we should note at this point that the financial consequences of a commutation on future reinsurance recoveries should be taken into account when deciding whether or not to commute.
3.4. **Actuarial Evaluation**

It has already been mentioned, but does no harm to re-emphasise that when a commutation is being discussed, the companies involved cannot afford to get their calculations wrong. A fundamental difference exists between the factors considered for an actuarial evaluation of a commutation and the valuation of insurance liabilities for other purposes, such as year end accounts. Once a commutation is settled there can be no recalculation or adjustments made. Therefore the evaluation process must aim to produce an equitable, once and for all settlement to be applied to the treaties being commuted. This usually means that a cedant will take a more pessimistic or conservative view of a valuation for commutation purposes and a reinsurer a more optimistic view that for a year end valuation on a central estimate basis.

Before the commutation discussions commence it would not be unusual for the person completing the evaluation to know very little about the individual treaties involved. However, in order to complete the process, the evaluator must become familiar with and fully understand the details of the business being commuted. They cannot rely on the laws of averages as heavily as when evaluating insurance liabilities for the entire portfolio. To this end, it is vital that during stages two and three, all possible information has been accurately collated and reconciled for use in the actuarial evaluation.

There are four main actuarial aspects which must be considered in any commutation.

- **Determining the ultimate settlement values**: The actuary must assess the treaties involved in the commutation and determine the ultimate expected claim cost which would be incurred were the treaties allowed to run to extinction. The ultimate expected claim figure will be made up of paid claims, outstanding claims and IBNR. At the time of the commutation the values of paid and outstanding claims are known. Therefore, the analysis involves assessing the IBNR element.

- **Estimating payment patterns**: Once the ultimate settlement values have been determined the payment pattern for the outstanding claims and IBNR should be estimated.

- **Estimating net present values**: Once the expected ultimate settlement values and the estimated payment patterns have been determined, the net present value (NPV) of outstanding claims plus IBNR must be calculated.

- **Providing a guide to uncertainty**: There is no definitive answer to the question of how much should be paid for an equitable settlement. Too many variables and assumptions are used in the calculations for all uncertainty to be removed. However by using a variety of evaluation techniques and assumptions, the reinsurer can be provided with a guide to the level of uncertainty by determining a range of values within which settlement should be negotiated.
Achieving Finality: The Commutation Process

The actuarial evaluation can be broken down into four main parts.

- The evaluation of inwards business
- The allocation of inwards commutation settlements to the outwards reinsurance programme
- The evaluation of outwards business
- The consideration which needs to be given to common account covers

3.4.1. Inwards reinsurance contracts

The 1990 GIRO commutations working party suggested four different types of assessment could be used when the commutation of inwards business is considered. When building a commutation evaluation model as many of these techniques as possible should be considered and the results assessed. Each of these four evaluation techniques will now be considered in turn:

3.4.1.1. Class of business evaluation

This type of evaluation involves applying statistical projections to the combined development of the treaties being commuted.

In order to avoid the data being distorted, the treaties must be grouped by class of business for the evaluation. For example, casualty excess of loss treaties must be considered separately to property proportional treaties, because of the fundamental differences between the two types of business. Casualty business has a much longer tail than property business and the two types of claim have different reporting and settlement patterns, which will not be clear if the data for the two types of business is combined.

Typically this evaluation is undertaken using link ratio or BF techniques.

3.4.1.2. Booked costing

This second type of evaluation assesses the financial contribution currently being made by the treaties being commuted to the company’s statutory accounts. The method allows a proportion of the booked IBNR held in the company accounts to be allocated to the treaties being commuted, but does not include any true actuarial analysis. The allocation is often made pro rata to either outstanding or incurred claims.
**An illustrative example:**

The table below shows an extract of the revenue account in respect of three underwriting years for XYZ Reinsurance Company:

<table>
<thead>
<tr>
<th>All figures in $000s</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Booked premiums</td>
<td>100</td>
<td>150</td>
<td>200</td>
</tr>
<tr>
<td>Commission</td>
<td>10</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Total paid claims</td>
<td>500</td>
<td>675</td>
<td>1,000</td>
</tr>
<tr>
<td>Outstanding claims b/f</td>
<td>15,000</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>IBNR b/f</td>
<td>10,000</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Outstanding claims c/f</td>
<td>20,000</td>
<td>19,500</td>
<td>24,000</td>
</tr>
<tr>
<td>IBNR c/f</td>
<td>9,000</td>
<td>14,500</td>
<td>20,000</td>
</tr>
<tr>
<td>Increase/decrease in funds</td>
<td>(250)</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
</tbody>
</table>

Suppose a commutation of some of the business ceded to XYZ is being negotiated and the treaties being considered for commutation currently have the following outstanding claims:

<table>
<thead>
<tr>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding claims</td>
<td>2,500</td>
<td>4,000</td>
</tr>
<tr>
<td>% of total outstanding claims</td>
<td>15.9%</td>
<td>20.5%</td>
</tr>
</tbody>
</table>

As a benchmark, if IBNR is paid at the following levels the outcome of the commutation will be an equitable settlement:

<table>
<thead>
<tr>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Booked IBNR</td>
<td>9,000</td>
<td>14,500</td>
</tr>
<tr>
<td>% of booked IBNR</td>
<td>15.9%</td>
<td>20.5%</td>
</tr>
<tr>
<td>Commutation IBNR</td>
<td>1,429</td>
<td>2,974</td>
</tr>
</tbody>
</table>

The method merely provides a benchmark for senior management by demonstrating the apparent profit/loss of the commutation from an accounting perspective. Although it is a useful tool and should be considered, it is important to note that the booked costing has no real actuarial substance, since the IBNR associated with the commuted business in any year may command a larger proportion of the booked IBNR for that year.
3.4.1.3. Individual costing

Where data of suitable quality and quantity exists a more precise assessment can be made by individual treaty or even individual claim. This is often possible when considering classes such as personal injury, workers compensation or motor.

The analysis considers individual claims to a particular treaty. By using details of past inflation, and making assumptions regarding future inflation and interest rates, along with calculated average settlement periods for the type of business, an actuary can determine the indexed values of the treaty limit and deductible at the time of the expected settlement. The ultimate expected claim to the treaty can then be calculated and discounted to obtain a net present value.

This type of analysis can result in a very precise evaluation of the projected ultimate claims cost and allows a range of different scenarios to be produced by changing the assumptions used.

An example of an individual costing is included in Appendix B. This example considers an inwards motor claim to the XYZ Reinsurance Company of $2,450,000 from an original insured A Smith.

XYZ participated on the cedants motor excess of loss programme, with varying shares of the following layers:

- $50,000 xs $100,000
- $350,000 xs $150,000
- $500,000 xs $500,000
- Unlimited xs $1,000,000

XYZ have made no payments in respect of the claim, which has still not been settled by the end of June 1995, despite being in respect of an accident which occurred during 1989. Using a paid claims run-off from a similar book of business (i.e. UK motor excess of loss), the actuary at XYZ is able to determine an average settlement period for a 2004 claim which is still open in the middle of 2010. In this case an average settlement period of 2.5 years has been assumed.

The motor excess of loss treaties in question have indexed limits and deductibles. By using known inflation factors the current values of the limit and deductible for each year can be calculated, and then by applying the average settlement period and an estimated future inflation rate of 4% the value of the limit and deductible at settlement can be determined, along with the ultimate expected claim to each layer.
For the top layer, the deductible is expected to increase to $1,468,340 by the time the claim is settled. The claim to the layer would therefore be $2,450,000 less $1,468,340, which is equal to $981,660. XYZ’s share of this is 20%, or $196,332. Currently XYZ are holding an outstanding claim in respect of the unindexed limit and deductible, which for the layer in question is equivalent to $290,000.

If the treaty were allowed to run to a natural extinction, XYZ would pay a total amount of $196,332 in respect of the top layer for this particular claim. However, if the treaty is commuted, the amount the cedant would receive could be invested and would be worth more by the time it was needed to settle the claim with the original insured. Thus XYZ would offer a discounted payment to allow for the investment income they would lose and the cedant would gain from the commutation. The discounted amounts in the example in Appendix B would be calculated using an agreed commercially derived risk discount rate future interest rate.

3.4.1.4. Using the other party’s costing

This involves analysis of the IBNR claims and possibly the booked costings of the other party to the commutation negotiations. It should be acknowledged that exchange of information between the parties can help the negotiations. The ultimate aim of any commutation ought to be to agree an equitable settlement for all those involved and co-operation between the players can only help to achieve this.

Wherever possible, a reinsurer should obtain a measure of the insurance liabilities held by the ceding company. If the IBNR put forward by the cedant appears too high to the reinsurer it should not necessarily be discouraged.

If the length of the paid claims run-off used by the cedant is longer than that used by the reinsurer, then the discounting of the outstanding claims and a higher IBNR over a longer period of time may actually result in a similar level of discounted insurance liabilities. If this is not the case and it appears to the reinsurer that the cedant may have overstated his IBNR, either accidentally or deliberately, then the reinsurer must be able to justify his own IBNR calculations and demonstrate that the cedant’s IBNR is too high. However, before challenging the IBNR calculations of the ceding company, the reinsurer should bear in mind that the ceding company will almost certainly have a better knowledge of and more information about the business ceded and therefore will be in a better position to accurately calculate the IBNR involved.
With any of the methods of evaluation discussed above the inherent uncertainty of the data must be remembered, in particular with reference to the following points:

- Age of development
- Late reporting of claims
- Changes in administration
- Changes in claims handling
- Changes in mix of business
- Lack of data
- Legal environment
- Inherent uncertainty

No single method should be used in isolation, and by considering a range of methods and a number of different scenarios for each of the methods, the client will be in the best possible position to judge the level of settlement which is required.

The different methods which can be used to evaluate a proposed commutation have been discussed. However, there is a further area where actuarial expertise is required when an inwards commutation is being considered. It is essential that consideration is given to the impact that the commutation will have on future reinsurance recoveries.

### 3.4.2. Reinsurance recoveries in respect of inwards commutations

In Section 2 the problems associated with making recoveries from a reinsurer following the commutation of inwards business were briefly mentioned. We have now reached an appropriate place to return to this matter in more detail.

It is advisable to contact any outwards reinsurers in advance of an inwards commutation. If the company commuting its inwards business is fortunate, reinsurers may indicate their support for the deal. On the other hand they may not be supportive and may simply invite their reinsured to “act as a prudent un-reinsured”.

It is not altogether uncommon for such reinsurers to treat a commutation as an opportunity to reduce their own liabilities by refusing to pay their share of a claim, which includes settlements in respect of outstanding and IBNR claims.

One solution is to incorporate a structure into the commutation settlement which will preserve the reinsured’s liability to ongoing claims in such a way as to allow continued accounting to the reinsurers as and when the outstanding claims and IBNR elements of a claim become paid.

This suggestion, which will be discussed further in the closing section of the paper, would not be necessary if IBNR was recoverable. Unfortunately no case law exists in
Achieving Finality: The Commutation Process

any country to give the definitive answer that the market requires. It has been stated for a number of years that in the present climate of run-offs and insolvencies, it cannot be long before this issue must be addressed. However, to date this remains an unresolved issue.

If a reinsurer decides to commute inwards business then consideration must be given to the way in which any claims liabilities and IBNR would be allocated to the reinsurer’s own retrocessionaires.

Four different methods of allocating the commutation payment to a reinsurance programme will be considered.

In the example, used to illustrate the different types of allocation, the reinsurance programme is made up of three excess of loss layers:

- $500,000 xs $500,000
- $1,000,000 xs $1,000,000
- $1,000,000 xs $2,000,000

All figures quoted in the following tables are in $ 000s. Each allocation is based on the following pre-commutation position:

<table>
<thead>
<tr>
<th>FGU Claim</th>
<th>Cedant</th>
<th>1st Excess</th>
<th>2nd Excess</th>
<th>3rd Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid claims</td>
<td>300</td>
<td>300</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>O/S claims</td>
<td>1,200</td>
<td>200</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>IBNR</td>
<td>1,000</td>
<td>-</td>
<td>-</td>
<td>500</td>
</tr>
<tr>
<td>Total</td>
<td>2,500</td>
<td>500</td>
<td>500</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Note: FGU = From Ground Up

If a commutation is now effected, with the settlement based upon payment of 50% of claim liabilities, giving rise to the following post commutation position:

<table>
<thead>
<tr>
<th>Cedant recovery</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid claims</td>
<td>300</td>
</tr>
<tr>
<td>Commutation price</td>
<td>1,100</td>
</tr>
<tr>
<td>Total</td>
<td>1,400</td>
</tr>
</tbody>
</table>
Each of the four post commutation allocations of the settlement value is discussed in the sections below.

### 3.4.2.1. Vertical allocation

The post-commutation position using a vertical allocation is illustrated below:

<table>
<thead>
<tr>
<th>Post commutation position – vertical allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Paid to date</td>
</tr>
<tr>
<td>Commutation price</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The vertical allocation combines the commutation price with the original paid losses and recovers on a simple vertical basis.

It is important to consider whether the reinsurers involved would be likely to agree to this allocation:

**First Excess**  **Very unlikely**
The reinsurers on the first excess layer will still be asked to pay a total loss to the treaty and there is no reason why they would or should agree to accelerated recoveries. There is no advantage to the reinsurers to pay the cedant amounts on which interest could have been earned.

**Second Excess**  **Possibly**
The panel of reinsurers on the second excess layer would have been aware of a potential loss and will now only be required to pay 80% of the outstanding losses previously advised and no IBNR. They will assess whether this saving outweighs the loss of investment income.

**Third Excess**  **Yes**
The reinsurers of this layer may possibly have received some precautionary advices but are now guaranteed that they will never have to pay a claim on this layer. Therefore they will therefore certainly agree to the allocation.
3.4.2.2. **Pro-rata to the ultimate loss**

This second method of allocation involves splitting the commutation price pro-rata to the projected net loss. In the example being considered, the total amount of $1.4m is to be allocated in respect of the expected ultimate net loss of $2.5m. Thus each layer is allocated $1.4/2.5 = 56\%$ of its total cover, as shown below:

<table>
<thead>
<tr>
<th>Post commutation position – pro-rata to ultimate loss</th>
<th>Cedant</th>
<th>1&lt;sup&gt;st&lt;/sup&gt; Excess</th>
<th>2&lt;sup&gt;nd&lt;/sup&gt; Excess</th>
<th>3&lt;sup&gt;rd&lt;/sup&gt; Excess</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid to date</td>
<td>280</td>
<td>20</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Commutation price</td>
<td>-</td>
<td>260</td>
<td>560</td>
<td>280</td>
</tr>
<tr>
<td>Total</td>
<td>280</td>
<td>280</td>
<td>560</td>
<td>280</td>
</tr>
</tbody>
</table>

Again, it is necessary to consider whether the reinsurers involved would agree to this allocation:

**First Excess** **Yes, probably**
Although the payments are accelerated they only represent 56\% of the previously advised total loss.

**Second Excess** **Possibly**
The reinsurers were aware of outstanding claims reserves of $500,000 and are now being asked to pay $560,000. They must consider whether they consider the IBNR added to be appropriate and whether the discount they would receive for early settlement is great enough.

**Third Excess** **Unlikely**
The IBNR was calculated by the cedant and no outstanding claims reserves would have been advised to date.

The reinsurer’s decision would be dependent on whether they believe that an appropriate level of IBNR and discount has been applied. It should be noted that in this case the cedant’s retention is less than the current paid losses, and so part of the paid loss is transferred to the 1<sup>st</sup> excess layer.
3.4.2.3. **Pro-rata to the liabilities**

In this case, since the commutation was based on payment of 50% of reserves on inwards business, 50% of reserves are allocated to each layer of reinsurance. For example the retention of the cedant originally included $200,000 of outstanding claims liabilities, thus post commutation the cedant’s retention would be $300,000 plus 50% of $200,000, a total of $400,000.

| Post commutation position – pro-rata to liabilities |
|-----------------|-----|-----|-----|
| Cedant | 1st Excess | 2nd Excess | 3rd Excess |
| Paid to date | 300 | - | - |
| Commutation price | 100 | 250 | 500 | 250 |
| Total | 400 | 250 | 500 | 250 |

Again, consider the question of whether the reinsurers involved would agree to this allocation method.

Their responses are likely to be the same as for the previous example, as the figures under the second and third scenarios are very similar.

If the commutation had been settled at a level below the 50% of the value of outstanding claims and IBNR, then the third excess reinsurers may have been more likely to accept a payment request on this basis. However this would be dependent on their perception of the likelihood of the claims actually reaching the level projected by the cedant and how much value they place on the certainty achieved.

3.4.2.4. **Actuarial allocation**

This allocation is, as its name suggests, based on true actuarial analysis. It involves using an appropriate distribution to allocate the commutation price to the layers of reinsurance. The method allows for the fact that the probability of a claim hitting any particular layer diminishes as the deductible increases. In our example, the cedant holds 87.5% of the original insurance liabilities, the first excess 60%, the second excess 45% and the third excess only 35%.

| Post commutation position – actuarial allocation |
|-----------------|-----|-----|-----|
| Cedant | 1st Excess | 2nd Excess | 3rd Excess |
| Paid to date | 300 | - | - |
| Commutation price | 175 | 300 | 450 | 175 |
| Total | 475 | 300 | 450 | 175 |
Would the reinsurers involved agree to this allocation?

The answers from the various reinsurers are likely to be the similar to those given for the previous two examples, but this method can be presented to reinsurers as an actuarially based allocation and, as such, may be better received.

3.4.2.5. Comparison of allocation methods

The chart below provides a visual comparison of the four methods of allocation discussed:

![Allocation of commutation payment chart]

In summary, it can be concluded that the recovery of non-proportional reinsurances following the commutation of inwards business will always present difficulties. There has been no legal ruling determining how any recoveries should be allocated, or indeed whether recoveries can be made at all.

Wherever possible the agreement of excess of loss reinsurers should be obtained before an inwards commutation is concluded. One alternative to this is to ensure that the settlement paid on the inwards deal is adequate, even if no recovery on the outwards can be secured. Another option is to ensure that outwards treaties are commuted before inwards. However, this course of action offers no real solution to what is a global problem, as one company’s outwards business must be, by definition another’s inwards.

It is important for all parties involved in commutations to remain flexible and allow compromise to prevail in reaching agreements.
It has been suggested that, as a rule of thumb, no more than 10% of outstanding claim liabilities should be non-proportionally reinsured when considering the commutation of inwards business. However, this is not a practical suggestion in the light of today’s market, where commutations are become ever more desirable, but it should be noted that non-collection of reinsurance recoveries can turn what might otherwise have been an excellent deal into a very poor one.

3.4.3. Outwards reinsurance contracts

The actuarial analysis of outwards is not exactly the opposite of inwards business, as might be assumed. This is because the motivation for commuting outwards business is often vastly different to that for commuting inwards business, as we discussed in Section 2.

Just to recap, outwards treaties are likely to be commuted for one of the following reasons:

- The cedant suspects or knows the reinsurer is in financial trouble.
- Treaties are under dispute.
- Treaties are producing bad results and ceding company wishes to protect its reputation.

In the majority of cases, insurers and reinsurers do not commute their reinsurance treaties when they are placed with good security. Commutations are usually considered when the security of the reinsurer is in doubt. In cases such as these the reinsured will enter negotiations with the knowledge that the final amount he will receive in settlement may be less than an equitable amount. In the majority of cases therefore, the main objective of the reinsured is to obtain a settlement as close as possible to the equitable amount and thus offset any bad debt provision held as much as possible.

When considering a commutation of any size it is essential to be able to estimate the net present value of any future reinsurance recoveries which would be made were the commutation not to take place. Very rarely will it be possible to produce a definitive answer; a range of possibilities will usually exist. The class of business under consideration will affect the range of possibilities. It will be much easier to predict a range of outcomes for short tail classes of business than for long tail classes, where latent claims such as asbestos and pollution may exist.
In general, it is both necessary and possible to perform a more detailed analysis on a portfolio of outwards rather than inwards business. As mentioned earlier, when we considered the “Other Party’s Costing” analysis performed by a reinsurer commuting inwards business, a cedant will have better knowledge of and information about the business being commuted than his reinsurers. The reinsurer will only have the benefit of data supplied by the cedant and it is likely that the cedant will be in possession of far more information about the underlying treaties and claims to them.

It is very important not to underestimate the exposure on outwards treaties. The potential for deterioration of existing claims, the notification of new claims and the emergence of latent claims must all be considered. However, there should be far more in-house information available for use in the analysis of outwards treaties and confidence in the accuracy of such data ought to be higher.

In order for the evaluation process to be as complete as possible a wide range of actuarial techniques should be employed. In the section detailing the evaluation process for inwards commutations the methods listed below were discussed. These methods should be considered in relation to outwards business too:

- Class of business evaluation
- Booked costing
- Individual costing
- Other party’s costing

In addition to these areas the 1990 GIRO Commutations Working Party suggested three further areas which should be examined when considering the commutation of outwards business:

- Total limit or aggregate evaluation.
- Frequency and severity analysis.
- Analysis of precautionary advices.

Each of these three methods will now be considered in turn:
3.4.3.1. **Total limit or aggregate evaluation**

By considering the aggregate limit of the individual treaties under evaluation, a maximum potential IBNR can be calculated, providing the treaties are not excess of loss reinsurances with either unlimited layers or unlimited reinstatements. For each treaty the maximum liability is the product of the treaty limit and the number of covers available.

\[ \text{i.e. Maximum Liability} = \text{Limit} \times (1 + \text{Number of Reinstatements}) \]

It is therefore a simple calculation to subtract the reported claims from the maximum liability to determine the maximum possible IBNR. It should be remembered that if claims expenses are in addition to a claim, a separate analysis of these expenses will be required.

Once the maximum IBNR has been determined for each treaty, a probability factor can be applied and by using a paid claims run-off, the net present value can be determined for a variety of interest rates.

An example is included in Appendix C.

3.4.3.2. **Frequency and severity analysis**

This analysis involves considering the number of claims which can ultimately be expected to hit each layer of a reinsurance programme, and the average size of any such claims.

The actuary considers, for each layer of the programme, the number of claims developing over a period of time. The trend can be extrapolated and the ultimate number of claims to each layer can be estimated. This allows the frequency expectation to be determined.

The next stage of the analysis is to consider the average size of each currently reserved claim. Using an assumed interest rate and a paid claims run-off, the average net present value for each policy year can be determined.

The product of future claims numbers and the present value of the average claim gives a discounted level of IBNR.

This technique is frequently used to project ultimate APH claims.
It is important to be aware that this calculation will only produce a range of estimates for true IBNR claims and not incurred but not enough reported (IBNER) claims, since the average claim size is determined on the basis that the allowance for currently reported claims is adequate and is applied only to new claims. IBNER must be calculated using one of the other methods discussed.

3.4.3.3. Analysis of precautionary advices

Often potential new claims are advised to a reinsurer long before they hit the layer of reinsurance in question. Under the circumstances which have been discussed thus far, any such claims will not have been included in the analyses. It is therefore possible that some of the techniques we have considered will have understated the potential losses arising from known claims. This is of particular importance when considering asbestos, pollution and other similar claims.

A very simple way of evaluating the potential of precautionary advices is to apply probability factors. The factors will decrease as consideration is given to higher and higher layers within a reinsurance programme. We will now consider an example:

A precautionary advice is given when a claim reaches $100,000

The reinsurer covers the cedant for a layer $300,000 xs $200,000

If experience shows that for every 100 precautionary advices, 50 will hit the layer at an average cost of $150,000, then there is a 50% probability of each precautionary advice costing $150,000, or 50% of the treaty’s limit.

Therefore for each precautionary advice $0.5 \times 0.5 \times 300,000 \text{ (treaty limit)} = 75,000 \text{ should be reserved as IBNR.}$

The results of such calculations have the potential to add an extraordinarily high amount to the total IBNR and so great care must be taken in assessing the validity of the results produced and in deciding a credible margin to add to the IBNR in respect of precautionary advices.
3.4.4. Common account covers

Another aspect which must be considered when commuting outwards business is the fact that it is common, particularly in the London Market, for the gross to net structure of a reinsurance programme to include common account reinsurance covers. A diagram illustrating this is included in Appendix D.

The example shows a reinsurer whose own reinsurance programme involves first ceding losses to specific and general excess of loss reinsurance covers and then being covered by proportional reinsurers on a quota share basis.

Suppose the reinsurer has an inwards claim of $10,000,000, which can be ceded to the reinsurance programme. The claim is protected by reinsurance layers above $300,000. Thus after the excess of loss reinsurances the cedant’s retention is $300,000, which can be ceded to the 50% quota share treaty. The retained amount of $300,000 is further reduced to $150,000, with the quota share reinsurers paying $150,000.

If the reinsurer commutes with all his specific excess of loss reinsurers an agreed payment will be received. If the quota share reinsurers agree to the commutation they will receive a proportion of this payment. The retention after excess of loss reinsurances is now $1,500,000 and the quota share reinsurers’ maximum share of any future claims would amount to $750,000 with the cedant receiving a similar amount. The quota share reinsurers would have to be satisfied that the reasons for the commutation are sound and that the money received in respect of the commutation will be adequate to offset their increased future liabilities.

Although this is a much-simplified example, it again highlights the debate over the problems, which can be encountered when commuting business that is further reinsured.

Even when the commutation being negotiated is of outwards business, it is important to attempt to obtain the approval of other reinsurers prior to the conclusion of the commutation. It is advisable to consult quota share reinsurers prior to the commutation of any shared excess of loss protections.

In practice, provided there is a sound reason for the commutation, for example the financial weakness of the non proportional reinsurers, most quota share reinsurers would be prepared to support the actions of the reinsured.
3.4.5. **Actuarial evaluation - summary**

This section relating to the actuarial analysis that must take place has been rather long and this is an appropriate place to stop and summarise some of the points discussed:

- Actuarial analysis is a fundamental part of all inwards and outwards commutations.
- Actuarial analysis can assist in the negotiation process.
- Actuarial analysis enables negotiations to take place from a point of greater, although not complete, certainty.

Actuarial analysis gives a point of reference for an equitable outcome.

3.5. **Negotiation**

The dictionary definition of negotiation is “conferring with another with a view to compromise or agreement”.

With this definition in mind, it can be seen that the negotiations which take place when considering a commutation begin with the first contact between the reinsured and reinsurer and only end when agreement is finally reached. So it can be said that the negotiation process actually encompasses many of the other stages discussed.

Because each commutation, and all the processes it involves, is unique, it is impossible to give a timetable which would apply to all commutations, but the following stages were suggested by the 1990 GIRO Commutations Working Party:

1. **Greetings** The initial contact between reinsurer and reinsured, initiated by the party seeking commutation.
2. **Marketing the purpose and the reason for the commutation** This and the greeting stage allow the parties to get to know each other and develop a rapport, as well as gaining an insight into each other’s social, technical and intellectual skills.
3. **Data collection and collation**
4. **Reconciliation of data**
5. **Negotiation of price**
6. **Agreement of the legal contract**
7. **Payment of monies**
8. **Farewells** As with greetings and marketing this is a very important part of the overall negotiation. Ideally the result of the commutation should be considered to be to the mutual advantage of both parties and no ill feeling should exist. The reinsurance world is a very small one and you never know when you may have to deal with someone again. Thus it pays to develop a rapport with those you deal with even when it appears a relationship is being terminated.
Although we have seen that there are many different stages to the negotiation of a commutation those surrounding the fixing of the price are perhaps the most important and therefore the remainder of the discussions in this section will be dedicated to this area, with particular reference to the continuing role of the actuarial analyst. It is important for the actuary to be aware that one of the following situations may arise and be prepared for the consequences:

- Reinsurer will have a good grasp of the issues and will wish to handle the negotiations either with or without the actuarial analyst as part of the team. This scenario presents no problems.
- Reinsurer appreciates the complexities of the situation and asks the actuarial analyst to play a major role in the final stages of the negotiations. The reinsurer is well briefed but aware of their own limitations. This scenario also presents no problems.
- The reinsurer does not have the in-depth knowledge or understanding necessary, yet nevertheless decides to conduct the final negotiations alone. Whereas the first two situations presented no cause for alarm, this is a worrying scenario. Under such circumstances it is unlikely that the best deal will be obtained.

Whether or not it is decided that the actuarial analyst will play a part in the final negotiation of the commutation settlement value, the following information must be readily available to those involved:

- The impact of a range of settlements in both real and accounting terms
- The range of acceptable settlements
- Estimates of the range of settlements which will be acceptable to the other side
- Assessment of the likely course and outcome of the negotiation
- Answers to any arguments which it can be anticipated that the other party may use to negotiate the settlement in their favour

Once the negotiation strategy is set, those involved should not, without good reason, be prepared to settle for a deal which falls outside the predetermined parameters. If the reinsurer feels that the price is too high, or the cedant that it is too low, they should walk away from the negotiations, at least to reassess their situation.

The diagram below illustrates an example where the parties are considering walking away from the commutation negotiations:

![Diagram](image-url)
However, it is apparent that in one way commutations are no different to many other types of business deal. Frequently, where the situation is not such that the parties walk away from negotiations, the ultimate settlement in a commutation is half way between the opening positions of the two parties involved. In other words they often agree to “split the difference”.

This situation is illustrated in the diagram below:

3.6. The legal agreement

Once the basis for the commutation has been agreed it is necessary for a legal document or contract to be drawn up and then signed by both parties. This document sets out the terms of the commutation and provides protection for both parties against future disputes.

An illustrative example of the type of global agreement currently in use in the London Market is included in Appendix E. The sample agreement is worded to cover the commutation of both inwards and outwards business. Paragraph 1 of the agreement refers to Appendices A and B. These appendices are listings of the inwards and outwards treaties, which form the subject of the commutation and will include many of the details discussed in the Treaty Identification section.

This agreement should be amended as necessary for each individual client. Each client should then be provided with sample inwards, outwards and global commutation agreements.
3.7. Post-commutation administration

The administration necessary after a commutation can be quite time consuming and it is equally as important as any other stage in the commutation process. Once both parties have signed the legal agreement, it may appear that the commutation has been completed, but this is far from the truth. A number of procedures must be completed before the commutation can reach its absolute conclusion.

These procedures are summarised below:

- All third parties must be notified of the commutation
- All brokers, intermediaries and managing agents must be notified and provided with details of the commutation, so that their accounting entries can be set to nil and the treaties closed. In most cases a copy of the appendices attaching to the legal agreement, sorted by broker code, will provide sufficient information.
- The amount received/paid in respect of the commutation must be allocated to the treaties involved. In most cases the actuarial evaluation model can be used to determine an appropriate allocation.
- For an inwards commutation, all insurance liabilities must be set to nil and paid losses increased by the allocated proportion of the final settlement amount.
- For an outwards commutation, the settlement received must be allocated to the appropriate covers and any surplus, once all balances have been cleared, can be used as a fund to service future recoveries as they would have become due.
- All reinsurers must be notified of the final implications of an inwards commutation. Any reinsurers should have been made aware of the commutation potential well in advance of any final settlement.
- Details of the commutation should be programmed onto the relevant computer systems. Inwards treaties which have been commuted should be flagged, to aid identification at a later date when they may need to be considered in, or omitted from statistical evaluations. This will be covered in more detail in the next section. Retrocession percentages of commuted outwards treaties should be flagged, to enable future tracking of unrecoverable commuted reinsurance, and ensure that future recoveries will not be requested from reinsurers who have commuted their cover.

All broker ledger entries should be updated, reconciled and cleared.

3.8. Summary of the commutation process

We have now considered the seven main stages of a commutation, but even when all these stages have been completed, the parties involved cannot just forget about the treaties commuted. The implications of a commutation deal are far reaching. Just as every live treaty on a database provides information for analysis, so details of commuted treaties can become a valuable source of information, particularly when evaluating future commutations. Section 4 will consider the impact of commutations on actuarial statistics in greater depth.
4. **The impact of commutations on actuarial statistics**

Any statistics produced in respect of a block of business containing commuted treaties may appear to be distorted. Therefore, care must be taken when interpreting any figures.

Many company information systems were not designed with actuarial requirements in mind and as commutations have increased in prominence it has become increasingly difficult to obtain information about past commutations, or to omit the details of commuted treaties from data, leaving only statistics relating to ongoing business. As mentioned earlier, the more that is known and understood about the account being analysed, the more likely that useful conclusions will be drawn from the data.

As the 1990 GIRO Commutations Working Party stated, “At least if the actuary has been put on warning that the statistics which he has been given may contain major commutation transactions, he can limit the conclusions which he draws.”

As commutations have become a more prominent method of resolving problems, computer systems have been developed by many companies which enable the statistics relating to commuted treaties to be flagged, allowing them to be separated from those relating to live treaties.

We will now consider, briefly, some more specific points relating to the commutation of inwards and outwards reinsurance treaties.

4.1. **Inwards reinsurance contracts**

Once a commutation has been completed the reinsurer will never know what would have happened had the treaties involved been allowed to run to extinction. The only information a reinsurer has is the amount paid in final settlement of the commutation. This amount, usually recorded as a paid claim has been paid in respect of the discounted value of the outstanding claims and IBNR, as well as any balances due for payment. If the commutation has been concluded on an equitable basis then the amount paid in respect of the commutation should equal the balances due plus the discounted value of reserves held by the reinsurer. However many reinsurers outside Australia have not historically held discounted insurance liabilities and therefore a surplus will emerge once the commutation has been completed. In many markets, for example the London Market, this surplus should not be regarded as a profit made by completing the commutation, it arises only because insurance liabilities are held on a non-discounted basis and it should be of equivalent value to the future investment income which would have been generated by the amount paid in settlement.
Following a commutation any claim development statistics will reflect a shorter average time to settlement of claims than if the commutation had not occurred. This will distort paid claims development factors. The ultimate loss ratio will also appear to be lower as a result of the discounting incorporated into the settlement.

If completed commutations have a material effect on the statistics for past underwriting years then care must be taken when applying any deductions which have been made to future claims development, during the valuation process. It is also possible that if commuted treaties are included in the main body of the statistics, IBNR may be generated in respect of commuted treaties, thus overstating insurance liabilities.

For example, if the average settlement period to be applied to future commutation discounting calculations has been shortened, the final discount applied to the settlement will be reduced and consequently the final amount paid could be higher.

These examples again emphasise the need to flag commuted treaties wherever possible. Any reinsurer can split the total of all inwards treaties into two groups such that:

\[
\text{ONGOING} + \text{COMMITTED} = \text{TOTAL}
\]

Initially the ongoing group will be much the larger, but as more and more commutations are completed the ongoing group will shrink as the commuted group grows. So, over a period of time it will become more and more important to consider and allow for the impact of commuted treaties on any statistics produced.

### 4.2. Outwards reinsurance contracts

The commutation of outwards business does not have as large an impact on actuarial statistics as the commutation of inwards business, although in order to minimise any impact there is, it is equally important for computer systems to be able to distinguish between ongoing and commuted reinsurance covers.

Generally a cedant does not commute with a reinsurer who represents sound security and it can be assumed therefore, that a commutation of outwards business will usually produce a loss for the cedant.

Unlike an inwards commutation, it is possible to assess what would have happened if a commutation had not taken place and thus by undertaking a form of actual versus expected analysis the deal’s success can be measured.
Usually recoveries are regarded as being made when they would have been made had the commutation not occurred and rather than a recovery from the reinsurer being made, the equivalent amount is simply transferred from a commutation account, which holds the payments received in respect of commutations. This practice ensures that any claims development patterns revealed by statistics will contain a minimum of distortions due to non-collection of reinsurance recoveries. Any distortions will only occur when the commutation account is empty.

Using this procedure it is possible to monitor the profit or loss generated by a commutation and use any information to assist in negotiating future deals.

The final section of this paper will recap what has been discussed thus far, highlighting the major controversies regarding commutations and put forward suggestions regarding their solution.

5. Summary and conclusions

This final section will begin by recapping what has been discussed so far, before re-identifying the main problems encountered in commuting reinsurance treaties and attempting to put forward some solutions.

A commutation is a commercial agreement between two parties, (re) insured and (re) insurer, where following payment of an agreed sum the insurer or reinsurer is discharged of all past, present and future liabilities arising from the contracts which are the subject of the commutation.

A commutation provides certainty. For the (re) insured, certainty of collection and for the (re) insurer, certainty against deterioration in the account. The reasons why cedants and reinsurers would wish to use a commutation to end their contractual relationship have been discussed. The main reasons were identified as follows:

- Cedant knows or suspects that the reinsurer is in financial trouble.
- Reinsurer is in financial trouble and wishes to reduce the potential for deterioration.
- Reinsurer knows or suspects that the cedant is in financial trouble, is not reserving correctly or is incompetent.
- Reinsurer disputes a treaty.
- Cedant wishes to protect their market reputation.
- Reduction in administration costs.

Once the reasons why the parties may wish to execute a commutation were established we turned our attention to how they might do so. Seven different stages of a commutation were then identified and discussed.
1. **Marketing** Deciding which reinsurers or cedants to discuss commutations with and how to approach the commutations.

2. **Treaty identification** Identifying and defining the treaties to be commuted.

3. **Reconciliation of data** Reconciliation of unpaid balances, outstanding claim liabilities, letters of credit and reserves retained, to ensure that all parties to the commutation are basing their calculations on the correct figures.

4. **Actuarial evaluation** The use and implications of different types of evaluation for inwards and outwards commutations.

   - Inwards
   - Business class analysis.
   - Booked costing.
   - Individual costing.
   - Other party’s costing.

   - Outwards
   - Business class evaluation.
   - Booked costing.
   - Individual costing.
   - Other party’s costing.
   - Total limit or aggregate evaluation.
   - Frequency and severity analysis

Also considered in this section were:

   - Allocation of settlements to outwards reinsurers.
   - Analysis of precautionary advises.

5. **Negotiation** The negotiation process from first contact to completion of the commutation.

6. **The legal agreement** The signing of a legally binding agreement detailing the terms of the commutation.

7. **Post commutation administration** The administration requirements of a commutation following the signing of the legal agreement.

After each of these stages of the commutation process was considered, we discussed the impact of commutations on actuarial statistics. Wherever appropriate, the discussions have been from an actuarial perspective and it is apparent that although all stages in the commutation process are important, and that a commutation cannot be successful if any one of the stages is omitted, the actuarial evaluation is the most complex and therefore probably the most important part of any commutation.
5.1. Conclusions

Throughout the course of this paper, while discussing and analysing various aspects of the commutation, it has become apparent that one major problem faces the parties to any commutation discussion. Namely the question of whether a reinsured can recover from his own reinsurers following the commutation of his inwards business.

In many cases recoveries can be made from proportional reinsurers, although this is dependent upon the exact wording of the policies concerned. A “Follow the Fortunes” clause will allow a reinsured to make recoveries from a proportional reinsurer following the commutation of that reinsured’s own inwards portfolio. However, where reinsurances are on an excess of loss basis, or the proportional wording does not contain the appropriate clause, the answer to this question is far from clear. Not everyone in the reinsurance market would give the same answer.

It has been said that over recent years that commutations have become an increasingly popular way of finding certainty in the uncertain world of long tail reinsurance. While this is true to an extent, reinsurers will only be able to achieve absolute certainty when it is made clear whether or not recoveries relating to inwards, commuted business can be made.

5.1.1. Continued accounting

In Section 3 a possible solution was mentioned. It was suggested that the formal commutation agreement could be worded in a way which would preserve the original reinsurer’s liability to ongoing inwards claims, thus enabling him to continue accounting to his own reinsurers, as and when the outstanding claims and IBNR elements became known paid claims.

This would indeed provide a solution to the problem but would probably not be welcomed by the original cedant. This solution would increase the administrative burden on both parties to the original commutation. While the reinsurer would gain some benefit from this procedure, the cedant would not and may be inclined to refuse any such request.

This solution would also mean a more complex legal agreement would need to be drawn up. However a further potential benefit to both the cedant and reinsurer would be that they would be able to track the commutation and therefore, would be able to assess whether the settlement ultimately represented a good deal or not.
5.1.2. Commute outwards reinsurance contracts before inwards contracts

Commuting outwards reinsurance contracts before inwards contracts is a solution which is often suggested.

If a reinsurer wishes to commute his inwards business, but knows or suspects that his own reinsurers will not support any such commutations, it could consider commuting his outwards reinsurances first. The reinsurer would then be free to commute his inwards business.

However, there are two major flaws in this suggestion. The first is that while the reinsurer may wish to commute some of his inwards business, for the reasons discussed in Section 2, it may not intend to commute with all his cedants. In such a case, the reinsurer would wish to leave his own reinsurance covers in place to protect him against deteriorations in his remaining portfolio. Thus, commuting all outwards treaties before making inwards commutations would only be a practical solution if the reinsurer concerned intended to commute all, or at least the vast majority of his inwards business.

The second major flaw was mentioned briefly in Section 3. While commutations do not provide a universal cure to all the reinsurance market’s problems, they do provide a method of solving specific problems, which arise between companies. However, the problems for which commutations offer a solution are extremely widespread and an ever-increasing number of companies are turning to commutations. Therefore any commutation must be considered not as an isolated deal between two parties, but as an arrangement which impacts on the reinsurance market as a whole. Reinsurers and their cedants are seeking a solution to a problem which to a greater or lesser extent impacts on all companies in the current market, be they solvent, in run-off or in liquidation.

If one company commutes its outwards business, the treaties involved, by definition, must form part of another company’s inwards book of business. That company will, in turn, have its own reinsurers and will be faced with the very problem the original company was trying to solve. An extreme example could lead to a pattern similar to the London Market Excess of Loss (LMX) spiral developing.

This demonstrates that commuting outwards business prior to embarking on a programme of inwards commutations does not solve the problem we are considering. It merely transfers it from one company to another.
Appendix A

Example of a treaty identification spreadsheet prepared by XYZ Reinsurance Company in respect of treaties ceded by ABC Insurance Company:

<table>
<thead>
<tr>
<th>Broker</th>
<th>Treaty description</th>
<th>U/W year</th>
<th>Limit ($000s)</th>
<th>Deductible ($000s)</th>
<th>XYZ Share</th>
<th>Premium ($000s)</th>
<th>Paid claims ($000s)</th>
<th>O/S claims ($000s)</th>
<th>Last processed</th>
<th>Funds retained ($00s)</th>
<th>LOC ($000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marsh</td>
<td>Casualty First Excess</td>
<td>2002</td>
<td>750</td>
<td>1,250</td>
<td>5.0%</td>
<td>150</td>
<td>50</td>
<td>200</td>
<td>Dec 2009</td>
<td>Nil</td>
<td>100</td>
</tr>
<tr>
<td>Marsh</td>
<td>Casualty Second Excess</td>
<td>2002</td>
<td>2,000</td>
<td>2,000</td>
<td>2.5%</td>
<td>200</td>
<td>40</td>
<td>500</td>
<td>Dec 2009</td>
<td>Nil</td>
<td>200</td>
</tr>
<tr>
<td>AON</td>
<td>Property Catastrophe</td>
<td>2004</td>
<td>1,000</td>
<td>1,000</td>
<td>10.0%</td>
<td>100</td>
<td>300</td>
<td>50</td>
<td>Dec 2008</td>
<td>Nil</td>
<td>50</td>
</tr>
<tr>
<td>Willis</td>
<td>Marine Quota Share – 50%</td>
<td>2006</td>
<td>n/a</td>
<td>n/a</td>
<td>5.0%</td>
<td>400</td>
<td>100</td>
<td>150</td>
<td>Jun 2010</td>
<td>400</td>
<td>Nil</td>
</tr>
<tr>
<td>AON</td>
<td>Casualty Second Excess</td>
<td>2007</td>
<td>2,000</td>
<td>2,000</td>
<td>5.0%</td>
<td>225</td>
<td>80</td>
<td>200</td>
<td>March 2010</td>
<td>Nil</td>
<td>150</td>
</tr>
</tbody>
</table>

Details of other treaties to be included

| Total | 1,075 | 570 | 1,100 | 400 | 500 |


This example shows motor claims submitted to the XYZ Reinsurance Company by its cedant ABC Insurance Company Limited in respect of the 2005 underwriting year treaties. Using a analysis of paid claim development an average settlement period of 2.5 years has been determined. By applying known inflation factors from treaty inception to date and an estimate of future inflation of 4% per year the limits and deductibles of the treaties have been indexed. The FGU claims have been applied to the indexed limits and deductibles to obtain ultimate expected claims to each layer. Using the average settlement period in combination with a future interest rate assumption of 7% per year the discounted value of future claim payments is calculated.
Appendix C

Example of a Total Limit or Aggregate Limit Evaluation prepared by XYZ Reinsurance Company in respect of treaties ceded by ABC Insurance Company:

<table>
<thead>
<tr>
<th>Treaty Description</th>
<th>U/W Year</th>
<th>Total Limit ($000s)</th>
<th>Deductible ($000s)</th>
<th>XYZ Share</th>
<th>Number of Reinstatements</th>
<th>Maximum Liability</th>
<th>Incurred Claims to Date ($000s)</th>
<th>Potential Deterioration</th>
<th>Probability</th>
<th>Expected IBNR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Casualty Excess of Loss 2001</td>
<td>2001</td>
<td>750</td>
<td>250</td>
<td>5.0%</td>
<td>4</td>
<td>187.5</td>
<td>120</td>
<td>67.5</td>
<td>5.0%</td>
<td>3.4</td>
</tr>
<tr>
<td>Casualty Excess of Loss 2003</td>
<td>2003</td>
<td>1,000</td>
<td>1,000</td>
<td>20.0%</td>
<td>3</td>
<td>800.0</td>
<td>357.2</td>
<td>442.8</td>
<td>10.0%</td>
<td>44.3</td>
</tr>
<tr>
<td>Casualty Excess of Loss 2004</td>
<td>2004</td>
<td>500</td>
<td>500</td>
<td>15.0%</td>
<td>2</td>
<td>225.0</td>
<td>-</td>
<td>225.0</td>
<td>25.0%</td>
<td>56.3</td>
</tr>
</tbody>
</table>

The potential deterioration for each treaty above is the maximum possible IBNR which could apply. By applying a probability factor which has been determined by considering an appropriate distribution, the expected IBNR is calculated. Finally by using a paid claims run-off) the present value of IBNR can be obtained.
Example of the Gross to Net structure of a reinsurance programme:

Company:  
XYZ Reinsurance Company Limited
Class of business:  
Casualty Excess of Loss

Retrocession and protection programme 2007

Notes:  
The final net retained percentages for the retro codes concerned are shown above. These percentages will be exact only in the absence of any protection recoveries. Unless otherwise indicated, all excess of loss treaties are assumed to incept at 1st Jan and run for a twelve month period. In this example all inwards casualty excess of loss treaties are coded 1 or 2. The code determines which proportional reinsurance covers it is appropriate to make recoveries under.
Appendix E

An illustrative example of the type of commutation agreement typically used in the London Market:

**Global Commutation Agreement**

**BETWEEN**

**XYZ REINSURANCE COMPANY LIMITED** of (include address)

(hereinafter referred to as ‘XYZ’)

and

**ABC REINSURANCE COMPANY LIMITED** of (include address)

(hereinafter referred to as ‘ABC’)

**WHEREAS**:

A. Under various Reinsurance Contracts specifically identified in Appendix A attached, XYZ participated in the reinsurances of ABC.

B. Under various Reinsurance Contracts specifically identified in Appendix B attached, ABC participated in the reinsurances of XYZ.

C. XYZ and ABC have agreed to a full and final release of their existing and/or future liabilities under the Reinsurance Contracts on the terms of this Agreement in exchange for payment as set out in paragraph 4 below.

**NOW IT IS AGREED AS FOLLOWS:**

1. All Reinsurance Contracts between XYZ and ABC specifically referred to Appendices A and B are the subject of and are commuted by this Agreement.

2. XYZ hereby fully and finally release ABC from all past, present and future liabilities of whatsoever nature arising at any time out of or in connection with the Reinsurance Contracts referred to in paragraph 1 above, and will not make a claim of any nature against ABC in connection with said Reinsurance contracts, other than under this agreement.

3. ABC hereby fully and finally release XYZ from all past, present and future liabilities of whatsoever nature arising at any time out of or in connection with the Reinsurance Contracts referred to in paragraph 1 above, and will not make a claim of any nature against XYZ in connection with said Reinsurance contracts, other than under this agreement.

4. In consideration of XYZ and ABC’s agreement to release and discharge their liabilities as set out in paragraphs 2 and 3, ABC/XYZ will pay the sum of US$ xxxxxxx.xx to XYZ/ABC within 30 days of the date of this agreement.

5. XYZ at the date of execution of this Agreement, has not assigned, sold or transferred any interest in or any claim it has asserted or may be able to assert under the Reinsurance Contracts (either now or in the future) against ABC or its predecessors or successors, and at the date of this agreement XYZ is the sole owner of all rights and interest under the Reinsurance Contracts.

6. ABC at the date of execution of this Agreement, has not assigned, sold or transferred any interest in or any claim it has asserted or may be able to assert under the Reinsurance Contracts (either now or in the future) against XYZ or its predecessors or successors, and at the date of this agreement ABC is the sole owner of all rights and interest under the Reinsurance Contracts.
MISCELLANEOUS:

1. Each party shall keep the terms of this Agreement confidential save, after consultation with the other party, where such party is required to disclose them for accounting purposes or by operation of law or the requirement of any governmental authority or any regulation or rule of any Stock Exchange on which its shares are listed or traded or for the purpose of seeking advice or for the collection or reconciliation of recoveries under its own reinsurance arrangements.

2. This Agreement may only be amended by a written document duly executed by the parties hereto.

3. This Agreement and any of its rights and obligations may not be assigned in whole or in part.

4. This Agreement shall be governed by and construed in accordance with English law and the parties agree that the Commercial Court in London will have jurisdiction to hear any dispute arising out of or in connection with it.

DATED this __________ day of _______________ 200_.

Signed for and on behalf of XYZ Underwriting by:
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