



# COMMUTATIONS: PARTNERING FOR SUCCESS

Casualty Loss Reserve Seminar  
September 15, 2014

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# Agenda

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1. Considerations in Valuing Commutations
  2. Common Pitfalls in Commutation Process
  3. Drivers of Successful Commutation
  4. Impact of Commutations

## Considerations in Valuing Commutations: Beyond an Estimate of Nominal Reserves

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- Outstanding balances
- Loss sensitive contract features
  - Contingent commissions
  - Premium adjustments
- Discount rate
  - Risk free?
  - After-tax?
- Payout pattern
- Risk load

# Considerations in Valuing Commutations: Business Cases Beyond the Numbers

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- Administrative cost/relief
  - Dispute resolution
  - Credit risk reduction
  - Reinsurance collection
  - Cash flow
  - Reserve risk reduction

## Common Pitfalls in Commutation Process: Getting Started

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- Commutation authority
    - Decision-makers
    - Application to full scope
  - Commutation scope
    - Too narrow or too broad
    - Agreed to by both parties
    - Clearly defined
  - Up to date view of claim status and case reserves

# Common Pitfalls in Valuing Commutations: Valuation

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- Understanding reinsurance structure and contract terms
  - Understanding exchanged data and its completeness
    - TPA involvement
  - Addressing previously commuted claims
  - Using inconsistent assumptions
  - Discounting excess losses
    - Layer then discount
    - Discount then layer
  - Ignoring/forgetting loss-sensitive contractual features
  - Reconciling balances

# Common Pitfalls in Commutation Process: Closing the Deal

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- Failing to involve retrocessionaires
  - Failing to consider recovery/settlement potential
  - Failing to consider cut-through agreements
  - Change in management and/or their philosophy about commutations
  - Change in decision-makers
  - Negotiating individual parameters versus overall price

## Drivers of Successful Commutations: Partnership

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- Relationships!
  - Engagement and commitment by both parties
    - Active, frequent dialogue
    - Information exchange
    - Committed resources
    - Plan to proceed
  - Understanding motivations
  - Knowing decision-makers and approval process
  - Aiming for win-win outcome



# Financial Impact of Commutations:

Assumes Commutation Payment is Less Than Estimate of Undiscounted Reserves



## Cedent

- Settlement booked as ceded paid loss
- Ceded reserves reduced to zero
- UWing income hit
- Cash inflow
- Asset increase
- Liabilities increase more
- Surplus hit
- Tax implications
- AS Note 23E: Commutation of Ceded Reinsurance

## Reinsurer

- Payment booked as assumed paid loss
- Assumed reserves reduced to zero
- UWing income benefit
- Cash outflow
- Asset decrease
- Liabilities decrease more
- Surplus gain
- Tax implications
- Recoveries from retrocessionnaires

# Reserving Impact of Commutations:

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Cedent	Reinsurer
<ul style="list-style-type: none"><li>▪ Truncated ceded loss development</li><li>▪ Distorted ceded (and net) triangles</li></ul>	<ul style="list-style-type: none"><li>▪ Truncated assumed loss development</li><li>▪ Distorted assumed triangles</li><li>▪ Reduced ULR</li><li>▪ Shorter average claim settlement time</li></ul>

Solution: exclude entire history of commuted business from loss development triangles



# Thank you for your attention!

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