Commutation Contract Clauses – Risk Transfer and Accounting Considerations

Lynne Bloom

September 15th, 2014

pwc

Overview of Discussion

- Purpose of Clauses
- Mandatory Commutation Clauses
- Unilateral Commutation Clauses
- Open Commutation Clauses
- Other Challenges

Purpose of Commutation Clauses

- Benefits to Reinsurer:
  - Reduce volatility due to unexpected escalation of frequency or severity of covered losses or ALAE by capping adverse experience
  - Can enable a reinsurer to minimize or eliminate ultimate liabilities on its books at an early date by making a present value cash payment
- Benefits to Insurer
  - Get cash sooner
  - Reduces insolvency risk
- For example, workers comp, especially clash covers with long term periodic payments there may be escalation of indemnity payments, inflation in medical costs or increased life expectancy

pwc

Mandatory Commutation Clauses

- Specified date of commutation
- Purpose
  - Limits uncertainty to reinsurer
  - Limits Insolvency risk to ceding company
- Relatively rare (high layer WC usually)
- Can be advantageous to ceding companies in liquidation (with little bargaining power)

pwc

Mandatory Commutation Clauses

- Ceding Company will estimate as of that date with total reserves including IBNR and discount
  - May be challenged by assuming company
  - Type of calculation may be specified via the following:
    - Various escalation and discount percentages for index-linked benefits, un-indexed or fixed benefits and future medical costs.
    - Tables for use in calculating impaired life expectancies, survivors' life expectancies and remarriage probabilities.

Mandatory Commutation Clauses

- Accounting
  - Typically will not affect risk transfer directly
  - Will affect the payment stream used to evaluate present value of payments
  - Will affect Ceding Company asset and Assuming company's liabilities must reflect discount implicit in commutation clause

pwc

Mandatory Commutation Clauses

- Numerical example of Discount effect
  - Last claim will payout in 10 years for $10 million
  - Mandatory Commutation will occur in 5 years
  - Discount rate of 5% (risk free rate)
  - Present Value at time of commutation will be $7.835 million
  - Nominal Ceded reserves for this claim therefore = $7.835 million not $10 million
  - Net reserves in Layer are now $2.156 million

pwc

Unilateral Commutation Clauses

- More common
- Exercised at the option of the ceding company
- Often with a specified date
- Usually for a prospective reinsurance contract
- Can be used for a situation where regulatory framework might change like a Mortgage insurance contract
  - Good economy, good profits . . May want to cancel reinsurance

pwc

Unilateral Commutation Clauses

- Ceding company has incentive to commute when there is a profit commission clause (based on nominal losses)
- Ceding company can receive payment sooner if they opt to commute
- Corresponding benefit to Assuming company is settlement of liabilities
- Alternatively ceding company can keep protection in tail and can book ceded losses at nominal value

pwc

Unilateral Commutation Clauses

- Accounting
  - Typically clauses optional to ceding company will not affect or impair risk transfer
  - Accounting Treatment can be complicated because profit commission should be booked at its expected value in a manner that is consistent with how ceded losses are recorded
    - If they expect to execute optional commutation, booked ceded should be consistent.
    - Profit commission expected based on same value

pwc

Unilateral Commutation Clauses

- Example

COMMUTATION

A. As respects all losses, known or unknown, that may cause a claim under this Contract, the Company may request, not less than three years after the inception date of this Contract, the losses to be commuted. As promptly as possible after such date, the Company shall submit a statement of valuation of the outstanding claim or claims showing the elements considered reasonable to establish the commutation amount, and, if the Reinsurer concurs with the Company's calculation, the Reinsurer shall promptly pay the amount requested.

pwc

Unilateral Commutation Clauses

- Sample Dispute Resolution Clause

B. In the event the Company and the Reinsurer cannot agree on the commutation value, the Reinsurer and the Company shall mutually appoint an independent actuary who shall investigate and determine the commutation value. In the event the Reinsurer and the Company cannot reach an agreement on an independent actuary, each party shall appoint an actuary within 30 days after receipt of the written request for commutation. Upon such appointment, the two actuaries shall appoint a third actuary. If the two actuaries fail to agree on the selection of a third actuary within 30 days of their appointment, each of them shall name three individuals, of whom the other shall decline two, and the decision shall be made by drawing lots. The actuaries shall then investigate and determine the commutation value of such losses. All actuaries shall be fellows of the Casualty Actuarial Society or the American Academy of Actuaries, and shall be disinterested in the outcome of the commutation.

Unilateral Commutation Clauses

- "No Commutation" Fee
  - Should be considered in Risk transfer

C. If the Company does not request the losses to be commuted within four years after the inception of this Contract, or earlier with mutual agreement, or the Company does not agree with the commutation value determined by the actuaries per paragraph B above, the Company shall have no obligation to commute and, in addition to premium ceded to the Reinsurer, the Company shall pay the Reinsurer a Maintenance Fee. The Maintenance Fee shall be calculated at 1.50% of ceded premium hereunder, and shall be payable within 30 days after January 1, 2015.

pwc

Unilateral Commutation Clauses

- Reinsurer Can Refuse

D. If the Reinsurer does not agree with the commutation value determined by the actuaries per paragraph B above, the Reinsurer shall have no obligation to commute and the Maintenance Fee, stated in paragraph C above, shall be waived.

- Will keep uncertainty
- Will Lose Maintenance Fee For doing so

pwc

Open Commutation Clauses

- Specifies the Terms but each party has the same rights and options under clause
- Relatively Vague
- Put in for Clarity

COMMUTATION

At any time after 120 months following the end of the Period of this Agreement, the Company or the Reinsurers may express their wish to the other party to commute all liability for losses applicable to this Agreement that remain unsettled at that time. In such event the Company and the Reinsurers shall mutually determine and evaluate such losses and the payment to the Company by Reinsurers of their proportion of the amount so ascertained and mutually agreed to be the value of such losses will constitute the full and final settlement of all losses hereunder, both known and unknown, and a complete release of Reinsurers' liabilities under this Agreement. If the Company and Reinsurers are unable to agree to commutation, or are unable to agree upon the value of losses to be commuted, no commutation shall be made.

Challenges

- Third Party Arbiter may be appointed directly in contract
  - Parties may be stuck with decision
- Losses may not be easily estimable (Excess Comp)
  - One estimate can be double another
  - Medical Inflation Rate effect for example
- Commutation clause may limit the reinsurer's options on how the calculations are performed to determine commutation values (Agreed Value Commutation)
- Intercompany Reinsurance Transactions

pwc

Commutation Price for Intercompany Transactions

- When Ceding company and assuming company are affiliated
- When ceding company and assuming company are in two different taxing jurisdiction
- Transfer Pricing rules apply to commutation price
- Not as simple as taking NPV of losses

pwc

Commutation Price for Intercompany Transactions

- Prices must be “arm’s length”
- Therefore price must consider the following
  - – NPV of expected losses
  - – An Appropriate Risk Margin
    - Market prices not available due to unique nature of remaining losses
    - Can use Return on Capital methods to determine

pwc

Commutation Price for Intercompany Transactions

- Companies often try an and use Book Value to price
  - Done this way for statutory accounting to keep statutory surplus (book value) neutral to keep it as a prospective
  - However must be an “arm’s length” price for taxing authorities
    - Depending on relationship between discount and Margin, may be greater or less than Book value
    - Should be priced (and documented) consistently with other transactions of both companies including original reinsurance contract
      - Consistent expected Rate of return
      - Consistent measurement of capital
      - Consistent method for determining discounted losses

pwc