- **Claims reviews** – When significant claims are notified to the claims department, the claims manager should consider consulting lawyers to obtain advice on any coverage issues which may develop in light of the policy language.
- **Policy interpretation** – Interpretation of reinsurance contracts or specific clauses as they relate to the claims process. Lawyers can be instrumental in advising claims managers on issues such as "follow the settlements" or the duty of utmost good-faith.
- **Reviews of reinsurance reserves** – Lawyers can be instrumental in assessing the viability of certain incoming claims (see claims monitoring, below) and advising on the potential liability and extent to which reinsurance reserves are adequate.
- **Claims monitoring** – It is often helpful for lawyers to assist in monitoring complex (e.g., multi-party, multi-jurisdictional) claims.
- **Settlement / commutation of claims** – Lawyers are often involved with the negotiating, structuring and documenting of settlements and commutations.
- **Inspection of records** – Lawyers may also be helpful in carrying out inspections of records and/or dealing with the legal issues which arise therefrom such as the scope of the inspection rights and the sight of so-called privileged documents.

Criteria which claims managers might consider when selecting lawyers include:

- how many years have they been qualified?
- how specialised are they in insurance and reinsurance issues?
- are they easy to deal with?
- are they recommended?
- how contactable are they? If they are too far away to meet with, or too busy to take calls, this may make cause concerns.
- is their approach likely to be pragmatic and commercial, or dogmatic and legalistic?

- do they have strong analytical skills and attention to detail?
- what level of support and back-up do they have in their office?
- is there a readiness to undertake work quickly and to a budget?
- do they have the ability to understand and assist in costing out the legal critical path analysis and the stages up to and beyond the offer to settle, if appropriate?

3.12 Commutation

3.12.1 Definition

A commutation can be defined as:

> **"An agreement to release the insurer from all past, present, and future liability under the (re)insurance contract in return for a lump sum cash payment now"**[xciii]

The lump sum cash payment reflects the net present (i.e. discounted) value calculation of all past, present and future liabilities including unsettled balances, outstanding losses, IBNER, IBNR as well as premium reserves and all kind of deposits withheld by the reinsured. It is used by insurers and reinsurers alike to bring the liabilities under insurance and reinsurance contracts to an end, changing them from ongoing contracts to crystallised sums of money which will never alter.

3.12.2 Introduction

For reinsurers, commutation is wonderful because it means there are no more claims to agree, no more accounts to book, and no possibility of adverse loss development. It provides the rare ability to draw a line under past business. As well as a rebate on outstanding losses, there is the added bonus of reduced administration costs. For cedants, commutation brings the lure of quick settlements, cash in hand and an end to exposure to poor payers. Which commercial companies could refuse such an attractive proposition? Well, it seems that claims management departments in almost every country are in on the act, so that carrying out commutations is now commonplace for both live and run-off companies. In brief, today's commutations are viewed as a

[xcii] See Simon Wilkinson "Why reinsurers use commutations", Insurance Day

[xciii] Peter Wedge *"Insurance and Reinsurance Run-off"* Witherby's 2001.

sensible basis for managing a reinsurer's balance sheet – on both the asset and liability side – and commutation is now a traditional tool in the strategy of a both financially strong company and a financially challenged one.

One exception is in the US, where cedants are more reluctant to commute because of the uncertainty over the development of claims (predominantly asbestos claims) and the letters of credit which often exist to cover the possibility that reinsurers fail to pay their claims.

A clearly defined Commutation Strategy is a complement to claims management. The aim is to extinguish all liability, whether present or future, arising out of one or more reinsurance contracts. The process includes a comparison of open balances and a discount for the time value for money in respect of reserves and perhaps IBNR, if applicable. However, successful commutation of reinsurance contracts is not as easy as it sounds. It takes more than just paying the discounted value of outstanding losses and requires significant resources and time. The actual commutation strategy adopted will depend on the goals of the company in question such as exiting liabilities in a certain country or a line of business.

Short-sighted cynics sometimes argue that commutations at the instigation of the reinsurer are primarily in the reinsurer's interest, but this overlooks the fact that commutation requires the agreement of both parties and cannot be imposed unilaterally. Besides this, the commutation price offered by the reinsurer may be above the eventual development of the losses under the contract. It is more the case that commutations are generally in the interests of both parties, but of course it is up to each party to negotiate the best deal which they can get for themselves.

3.12.3 Types of commutation

A commutation is not necessarily limited to a specific reinsurance contract, but can be extended to a variety of reinsurance agreements or the whole inwards and/or outwards business with the other party. Single claims can also be subject to commutation. We can therefore distinguish between four types of commutation:

- single claim;
- single contract (e.g. a single excess of loss treaty);

- multi-contract;
- whole relationship, that is every single inwards and outwards contract between the reinsurer and a certain cedant or retrocessionaire (this is known as a "global commutation"). A global commutation between two parties may incorporate a large number of reinsurance or retrocession treaties involving potentially thousands of ledger transactions.

3.12.4 Phases of a commutation

In general, we can divide the commutation process into seven distinct phases:

- pre-commutation activities – A lot of research is required in advance of the actual negotiations. These include identifying the contracts to be commuted, evaluating, inter alia, the financial strength of the counterparty and its cash flow position (if possible), and formulating the offer. Micro-phases:
  - Strategy.
  - Identification and segmentation.
  - Contact.
  - Reconciliation and analysis.
- commutation negotiations – Face to face talks certainly help both parties to understand each other's views. Negotiations should be conducted within predefined parameters so that one is not caught up in the frenzy, since the success of a commutation can be determined during this phase. If the deal proposed is not close enough to one's expectations, then it might make sense to walk away.
- reviewing and signing the commutation wording – this usually requires input from lawyers (either in-house or external). The agreement needs to be carefully drafted to protect against one of the parties seeking to overturn it in the future. The key clauses are the list of contracts, payment details, release, confidentiality, and jurisdiction and proper law.
- post-commutations activity – this includes accounting and attempting to recover from reinsurers.

3.12.5 Motivation

There are many motives for pursuing commutations, whether from the perspective of the cedant or the reinsurer. Although the commutation concept is widely used by companies in run-off, it is also suitable and valuable for live companies and the discontinued business of active companies.

From the perspective of the cedant, a commutation may be practical for the following reasons:

- **resolution of claim disputes** and avoidance of the attendant legal expenses.
- saving of **administration costs**, since outward recoveries need no longer be processed (especially if all reinsurers on one programme commute).
- improved **cash-flow** via the collection of outstanding debts.
- collection of debts from **troublesome reinsurers** – some reinsurers (especially those in run-off) refuse to pay claims unless a complete release of future liability can be obtained
- **avoidance of bad debt** where the cedant's reinsurers seem to be facing financial difficulties.
- avoid costly and **time-consuming** collection of old reinsurance recoveries which some brokers do not follow up very closely on behalf of cedants.
- receipt of payment for **IBNR**, where appropriate.

From the perspective of the reinsurer, a commutation of inwards contracts may be practical for the following reasons:

- **avoid adverse claim development**, especially for long-tail business. Liability is extinguished and finality is obtained. At the same time, reputational risk associated with the reporting of large adverse claim development will be avoided.
- **portfolio cleansing** (for example after deciding not to write certain business or business in certain markets). This cleansing may enhance a company's competitive advantage – important in these days of increased rating agency scrutiny.
- **unsatisfactory performance** by the cedant – for example claims management; technical accounting; or under-reserving.

- saving of **administration costs,** since inward claims no longer have to be processed.
- **resolution of claim disputes** and avoidance of the attendant legal expenses.
- **capital** will be freed up.

As can be seen, it is to the advantage of both parties if a commutation helps to:

- save administration costs, especially if the future exposure is limited.
- resolve disputes of any kind.

3.12.6 The quality of the data

Although commutations are becoming more commonplace and may bring significant benefits to the parties, it is essential that they be handled in a professional manner. A prerequisite is the possession of accurate data (both with respect to the contracts to be commuted and their associated liabilities.) Whilst files are unlikely to be complete, there may come a point when the quality of data will severely affect the reliability that can be placed on any analysis undertaken. In addition, it is useful if ledgers are maintained on a principal to principal basis (that is, ledgers maintained per policyholder/reinsurer) as well as per broker, as a support. When considering the financial data held by the parties on both inwards and outwards policies, it should be borne in mind that the accounting position in the parties' books may well be distorted or confused by broker funding of premiums and/or claims.

3.12.7 Current Commutation Environment

The commutation concept is widely accepted within the London market and Europe. Commutation conferences in London, New York, and even Norwich, see more participants every year, and even markets not known for being commutation-friendly, such as Japan or other Asian countries, are becoming more receptive to the idea.[xciv]

There are various reasons for the increasing interest in commutation. Obviously, more parties have recognised the advantages of finalising old reinsurance contracts. Additionally, the growing run-off market

[xciv] Sanders, Fear fuels commutation In Run off business, Summer 2002, p. 10

and the consciousness of the vulnerability of the reinsurance industry following the events of September 11, 2001 and the concern that business partners might encounter financial difficulties, may also have encouraged companies to rethink their commutation strategies and become more pro-active. Along with this increasing appetite to commute, a more professional approach is evident. The standard response to a commutation offer is no longer a simple "yes" or "no". The recipient of such a proposal is more likely to make a counteroffer or use the opportunity to achieve a global commutation, that is, commuting all inwards and outwards business with the company.

APH exposed contracts and commutation of long-tail business is a particular concern for most market participants. Because of the uncertain future development, it is more and more difficult to commute such exposures, or at least it is becoming more and more expensive. IBNR requests for asbestos exposed contracts of up to 600% of case reserve from US cedants are common, and some have even been seen up to 1,200%!

The higher the value of a commutation, the higher the need to commute at the right price and based on the right figures. As shareholders start to take an increased interest in a reinsurer's commutation activities, there is a growing use of pro-active commutation strategies being adopted, more pre-commutation audits, and more aggressive recovery of commuted balances from retrocessionaires.

3.12.8 Pre-commutation Audits

Whether a pre-commutation audit is advisable or not very much depends on the amounts which are claimed and the nature of the book of business. The actual business relationship with the potential audit target is also to be considered prior to a request to audit. All audits cost money, whether carried out internally or externally. In order to reduce costs, it probably makes sense to restrict pre-commutation audits to those cases where problems are known to exist or where the amounts at stake are large. It may be cheaper to use external consultants where they are geographically well-placed or have experience of the cedant, and to use internal resources in all other cases. Depending on the nature of the claims involved, the length of the audit does not need to be the traditional one week. One or two days may suffice for experienced claim reviewers, especially if the cedant is co-operative.

Although inspections are common (but far from popular) within the London market, it can be regarded as distrustful in other markets, although this attitude is slowly changing. However, any audit will disturb a cedant's day-to-day work and cause extra effort which is not appreciated in any culture. Therefore, the audit request should be well thought out and the audit itself needs to be well prepared to minimise disruption. The first step is to review one's own files and then to check the following during an on-site inspection:[xcv]

- coverage
  - Does the book of business reflect what was presented on placement ?
  - Claims – check exclusions, allocation, late notice issues, subrogation, etc.
- exposure
  - Nature of book of business.
  - Reserving practice.

Following this exercise, and after considering the amounts at stake, an actuarial review of the claims may be required in order to prepare a reasonable offer or, depending on the findings, one might raise questions regarding coverage and request a discount. The audit will provide more comfort about how best to proceed.

3.12.9 Collection of commutation payments from reinsurers

One issue that reinsurers should bear in mind before proposing a commutation is whether a commutation payment made to the cedant will be recoverable from retrocessionaires. Normally, a reinsurer's only contractual obligation under a reinsurance agreement is to pay solely ascertained or agreed claims (i.e. claims which have, at least, been quantified and agreed by the reinsured, even if the reinsured has not paid). Critically, it is not contractually obliged to make payments to the cedant in respect of outstanding losses or IBNR. Therefore, there remains no certain or legally enforceable method of recovering amounts paid in commutation of outstanding loss reserves and IBNR.

[xcv] Blair, Commutation – audit or not ?, www.jtw-re.com, 05.01.2005