

EXAM 6 – UNITED STATES, FALL 2013

29. (3.25 points)

a. (0.75 point)

Define commutation.

b. (1 point)

Describe two reasons a reinsurer might pay more than the nominal reserve recorded on its balance sheet to commute a book of assumed workers compensation business.

c. (1 point)

Describe two reasons, excluding those provided in part b. above, that a primary insurer might accept less than the amount it is recording on its balance sheet as reinsurance recoverable to commute a book of business.

d. (0.5 point)

Describe how a reinsurer's balance sheet would be affected by a commutation.

- Premium Amounts (if change with contract provisions) could use:
  - a. Initial – can be manipulated easily
  - b. Expected – overstates risk transfer if not adjusted up with losses
  - c. Actual – from simulation. Most difficult and best

## 28. Examiner's Report

This is a straightforward question asking candidates to recall basic elements of risk transfer.

- a. Common errors included:
  - Only answering that it failed the risk transfer test without briefly describing why.
  - Stating that the contract passed the threshold test.
- b. The most common error was answering the question with deposit accounting, but failing to describe the accounting impact on the ceding company's statutory balance sheet.
- c. Common errors included:
  - Candidate listed practical considerations but did not briefly describe them.
  - Candidate listed considerations relating to the ERD threshold. The question asked the candidate to identify and briefly describe practical considerations when calculating the ERD, not the threshold.
  - Candidate listed general considerations but was not specific in the description of those considerations (i.e. commissions, assumptions, etc.)
  - Candidate listed the same consideration multiple times with different explanations.

## 29. Sample Answers

- a. Any one of the following:
  - A process where all future obligations are current valued, taking into account financial and non-financial aspects, to speed up run off and pay out
  - A contract where future obligations of one party is current valued, taking into consideration financial, legal, administration and taxes to accelerate payment and close claims
  - Commutation is where an insurer accepts payment from reinsurer to be responsible for the entire reserve amount and development on those reserves for a payment (usually ambivalence point). Effectively ends the reinsurance agreement/contract
- b. Any two of the following:
  - Reinsurer wants to accelerate settlement
  - End relationship with insurer not paying premium or reporting on time
  - The reinsurer values "perceived" wealth when considering financial & non-financial aspects
  - Reinsurer may lack attractive investment opportunities in the funds held, so it's better off paying off the obligation
  - Concerned about future legislative changes that could increase costs of WC claims
  - Reinsurer is willing to pay extra to avoid the uncertainty of how the losses will develop in the future
  - Reinsurer may save loss adjustment expenses due to the sale of the contract
  - ALAE and ULAE savings
  - Reduce admin cost

- Tax benefit – loss observed will give income tax relief
  - To aid the insurer in exiting a market
- c. Any two of the following (if unique from those provided in part b above):
- Insurer may want accelerated settlement over disputed obligations between both parties
  - Insurer's actual wealth would increase because it now holds more cash
  - The insurer is looking for cash flow for investments or liquidity reasons
  - Increase in cash – ceding may need cash to meet current claim payment badly
  - Certain payments – no worry about reinsurer insolvency
  - Insurer has concerns about the financial strength of the reinsurer and its ability to pay
  - The insurer wants to reduce administrative costs associated with monitoring and collection efforts
  - Potential tax savings from underwriting loss
  - Believes it can settle claims for less than current values
  - Price is greater than the calculated ambivalence point so thinks it is a good decision
- d. Any one of the following:
- Loss reserves would be reduced and asset would be reduced since cash/consideration is paid
  - Cash reduced and reserve set to 0 to reduce liabilities

## 29. Examiner's Report

This question required some extrapolation from the syllabus material.

- a. Candidates generally did not answer this part of the question in enough detail. However, most candidates received some credit. Common incorrect answers included:
- Insurer re-assumes business previously ceded – does not provide sufficient information
  - Agreement by which reinsurer and reinsured agree to settle the reinsurance contract's outstanding obligations and finalize their duties – does not provide sufficient information
- b. Candidates generally responded well to this part of the question. An explanation was needed if a listed reason was not self-evident. Common incorrect answers included confusing the reinsurer and primary insurer roles in commutation and assuming that discounting would increase the commutation price.
- c. Candidates generally responded well to this part of the question. An explanation was needed if a listed reason was not self-evident. Common incorrect answers included confusing the reinsurer and primary insurer roles in commutation and listing the same reasons from part b.
- d. Most candidates received some credit on this part. The most common error was that candidates answered with effects on the income statement instead of the balance sheet. Some candidates listed an increase in paid loss but did not mention a decrease in assets.