26. (2 points)

a. (0.5 point)

Describe a commutation agreement.

b. (1.5 points)

Describe three potential motivations for a ceding insurer to commute a reinsurance contract.

END OF EXAMINATION

A common error was stating a disadvantage of the ERD method without stating how the 10-10 method corrects for it.

FALL 2018 EXAM 6US, QUESTION 26	
TOTAL POINT VALUE: 2	**LEARNING OBJECTIVE: E**
SAMPLE ANSWERS	
Part a: 0.5 point	

Sample 1
An agreement b/t a ceding insurer and a reinsurer that provides for the valuation, payment, and complete discharge of all obligations b/t the parties under a particular reinsurance contract.

Sample 2
When a ceding company is paid a price to undo a reinsurance contract. The ceded reserves are zeroed out for the ceding company. The ceding company records the commutation as a negative paid loss. The reinsurer records the commutation as a positive paid loss. The price is determined based on the discounted loss reserves.

Part b: 1.5 points

- A ceding insurer may wish to exit a particular line of business. Commutation may be a 1^{st} step followed by a loss portfolio transfer to a 3^{rd} party.
- The ceding insurer has concerns about the solvency of the reinsurer. Commuting will eliminate the credit risk associated with the reinsurer.
- The ceding insurer wants to end a troubled relationship with the reinsurer. There may have been disputes over claim resolution.
- The two parties may have different estimates of future liabilities so each may see a benefit from commuting.
- A ceding insurer may receive tax relief by re-assuming the ceded reserves and thus a decrease to taxable income (assuming a price less than the reserves).
- The insurer's IRIS 4 ratio of surplus level is getting out of normal range. They might want to decrease their surplus relief to be good with the regulators.
- It has been spending significant resources on disputes over claim payments with the reinsurer and believes it would be more cost effective to end the contract.
- The ceding co may need the cash inflow it receives from the commutation for liquidity reasons.

EXAMINER'S REPORT

Candidates were expected to describe a commutation agreement and then describe three motivations for a ceding insurer to commute a reinsurance contract.

Part a

Candidates were expected to know that a commutation agreement is an agreement between a ceding insurer and the reinsurer and that it results in the discharge of the obligations between the parties.

Common errors include:
- Not identifying who the agreement was between or that it was in relation to a reinsurance contract
- Not stating that it resulted in a discharge of the obligations between the parties or demonstrating the financial changes to the paid loss and ceded reserves for both the ceding insurer and reinsurer
- Describing a traditional reinsurance agreement instead of a commutation agreement

Part b

Candidates were expected to list and describe 3 motivations for a ceding insurer to commute a reinsurance contract.

Common errors include:
- Listing 3 motivations without elaborating or describing each
- Describing motivations from the reinsurer's perspective rather than the ceding company's perspective