26. (2.75 points)

a. (0.5 point)

Describe a commutation agreement.

b. (1 point)

Identify how each of the following items are impacted by the commutation of a reinsurance contract, and briefly describe the rationale:

i. Net loss reserves for ceding insurance company

ii. Paid losses for reinsurance company

c. (0.75 point)

Identify the section of the Annual Statement in which a ceding insurer should disclose a commutation agreement, and identify two specific items that must be included in this disclosure.

d. (0.5 point)

Describe one reason why a ceding insurer is required to disclose information about commutation agreements in its Annual Statement.

CONTINUED ON NEXT PAGE

Common errors include:

- Redundant answers with respect to recoverables and discounting
- The word "Reinsurance" alone did not receive credit, a description was needed
- "Is the data including LAE" was not accepted; needed to specify the type of LAE that was included
- Disclosures listed that were not related to "stated basis of reserves"

Part b

Candidates were expected to identify four disclosures in the SCOPE section of the SAO not related to the basis on which reserves are stated.

Common errors include:

- Mentioning disclosures related to basis of which reserves are stated
- Loss evaluation data is not required in SCOPE
- Appointed Actuary's role in stated reserves is not in the scope
- Intended user and audience are not disclosures required in the scope
- Identifying the reserves instead of disclosures related to the reserves or data
- Data testing is not disclosed in the SAO

Part c

Candidates were expected to identify and justify two types of opinion that may be issued.

Common errors include:

- Defining the opinion type but not providing justification
- Not using materiality (or describing materiality) when deciding which type of opinion to issue

FALL 2019 EXAM 6U, QUESTION 26	
TOTAL POINT VALUE: 2.75	**LEARNING OBJECTIVE: E1**

SAMPLE ANSWERS

Part a: 0.5 point

A commutation is an agreement between a ceding insurer and the reinsurer that provides for the valuation, payment, and complete discharge of all obligations between the parties under a particular reinsurance contract.

Part b: 1 point

Sample 1

i. The ceded reserve recoverables are set to zero, so the net reserves are set to gross reserves;

ii. The commutation payment is booked as an increase in paid loss;

Sample 2

i. The reserve net loss reserve will increase since there are no expected recoverables;

ii. The paid loss will increase due to the commutation price being recorded as a loss

Part c: 0.75 point
Sample Response Notes to Financial Statements, Reinsurance disclosure *Must include two include two of the following:* • A list of reinsurers • The amount of loss • Loss adjustment expense • Earned premium commuted from each to the ceding company during the year • Amount of reserves taken back • Price received for commutation • Consideration paid
Part d: 0.5 point
Sample 1 Some Schedule P will be distorted by a commutation (e.g. Net paid losses, net incurred losses, and claim closure rates). Actuaries must take such distortions into account when calculating loss development factors (or assessment of reserve adequacy), when assessing reserve adequacy, or when using Schedule P to review claim severity or closure trends. *Sample 2* Some exhibits will be distorted by a commutation (e.g. Net paid losses, net incurred losses, and claim closure rates). This can mislead users of the Annual Statement of they are unaware of the commutation. *Sample 3* The commutation will have impact on the primary and reinsurer's statutory income statement and surplus. Normally, this results in a drop in pretax income for the primary and an increase for the reinsurer. The user must consider this when assessing the annual statement.
EXAMINER'S REPORT
Candidates were expected to understand the definition of a commutation contract, how it impacts the paid loss and loss reserves for both the ceding company and the reinsurer as well as the how it impacts the different schedules financial statements. Candidates were expected to identify the section of the Annual Statement to disclose the commutation and describe the distortion as a result of the commutation.
Part a
Candidates were expected to understand the definition of a commutation agreement. Common errors included: • Reversed the party who is responsible for paying the consideration • Stating that the primary insurer will be discharged of all liability
Part b

Candidates were expected to understand how the commutation impacts the paid loss and loss reserves.

Common errors included:

- Stating that no impact on the reinsurer
- Stating that the paid loss will decrease for the reinsurer due to discounting of the loss reserves in the commutation price
- Stating the reason for reinsurer's paid loss increase is the reinsurer is paying future losses

Part c

Candidates were expected to identify the section of the Annual Statement to disclose the commutation and the items need to be disclosed.

Common errors included:

- Stating the disclosure has to be made in an incorrect statement
- Listing the following as required items for disclosure: effective date of the commutation, accident year, coverage (or line of business), reason for commutation.
- Stating the reinsurer has to make the disclosure.
- Simply stating that the commutation amount needs to be disclosed without specifying what the amounts are related to such as loss reserves, alae reserves or consideration paid.

Part d

Candidates were expected to demonstrate understanding for the disclosure of commutation and describe the resulting distortion in the annual statement.

Common errors included:

- Stating the annual statement will be adjusted by the commutation instead of distorted.
- Simply stating the annual statement will be distorted without explaining the distortion mislead the user.
- Simply stating that it could be misleading without naming specific exhibits that will be distorted such as net paid, net incurred triangles etc.

FALL 2019 EXAM 6U, QUESTION 27	
TOTAL POINT VALUE: 2	**LEARNING OBJECTIVE: E1**
SAMPLE ANSWERS	
Part a: 0.5 point	

<u>*Sample 1*</u>
A transaction qualifies as having risk transfer under the "10-10" rule if there is at least a 10% chance of the reinsurer experiencing a loss of 10% or greater.

<u>*Sample 2*</u>
Rules that risk transfer exists if there is at least a 10% chance for the reinsurer to realize a >= 10% underwriting loss from the contract.

<u>*Sample 3*</u>
Probability[((Ceded loss - Ceded Premium) / Ceded Premium) >= 10%] >= 10%