Reinsurance Commutation

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When an insurer and a reinsurer enter into a contract, they expect a lengthy relationship. The contract may cover policies written by the primary insurer over (for example) a 12-month period, but it may be years before the last claim covered under such policies has closed and final reimbursement has been made from the reinsurer to the insurer.

Sometimes, as this process unfolds, one party or the other will want to terminate the relationship early. When this happens, the parties have the option of executing a *commutation agreement.* The International Risk Management Institute defines a commutation agreement as "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".[1] The reinsurer typically makes an immediate payment to the primary insurer. In return, the reinsurer is absolved from all future involvement with the claims or policies covered by the agreement.

Commutations present challenges to the actuary in the areas of pricing, reserving, and accounting. This study note will focus on the accounting for, and taxation of, commutations. However, in order to understand the accounting, we will need to look at least briefly at the motivations of the parties to a commutation, and at pricing and reserving.

Motivations of the Parties

Commutations arise for many reasons:

(1) Either the primary insurer or the reinsurer may wish to exit a particular line of business. The reinsurer exits at once by commuting. For the primary insurer, commuting may be a first step, followed by a *loss portfolio transfer* to a third party. Loss portfolios may be easier to transfer without the uncertainty of a reinsurance overlay.

(2) Either the primary insurer or the reinsurer may have concerns about one another's solvency. If the reinsurer is shaky, commutation eliminates credit risk to the primary insurer. If the primary insurer is shaky, commutation provides an immediate cash infusion, and allows the reinsurer to avoid potential future problems with a liquidator who may take over the primary insurer.

(3) The relationship between the primary insurer and reinsurer may have frayed over time. There may have been disputes over claim resolution, or over contract provisions. The parties may prefer a single negotiation over commutation price, followed by termination of the relationship, to protracted argument over other issues.

(4) Even in the absence of acrimony, the primary insurer and reinsurer may have different ideas about loss development under the underlying policies. If actuaries for the two parties are setting drastically different loss reserves, a commutation at an intermediate price may leave each side convinced that it is getting a good deal.

[1] http://www.irmi.com/online/insurance-glossary/terms/c/commutation-agreement.aspx