

The art of the deal

It's that time of the year again, when delegates flock to Norwich for the Cavell Commutations Rendez-vous. So what accounts for the growth in popularity of commutations, and how have attitudes to them changed over time? **Derek Austin** reports

Broadly speaking, it seems that the more people come to be familiar with the commutation process, the more they feel comfortable with it. While some remain suspicious, over time many more have come to recognise the benefits to be gained.

Bevan Killick, assistant director at Chilton International, was formerly with Equitas whose progressive commutations strategy had a big influence on the London market. 'Eight years ago the attitude was this is all very much new territory, and if you approached someone to do a commutation the other side would think, are we going to sell ourselves short? Now the market views it as a normal method of doing business and the benefits of doing a commutation are much better understood by the whole market,' says Killick. 'It's generally accepted now that it's a commonsense way of doing business.'

Andy Godwin, head of audit and commutations with Cobalt Solutions, says: 'Over the past few years the market in general has become far more educated on the subject, and many companies have started to set up specific departments to manage the commutation process. In addition, most organisations now have a strategy in place which addresses the benefits of actively commuting all or part of its portfolio.'

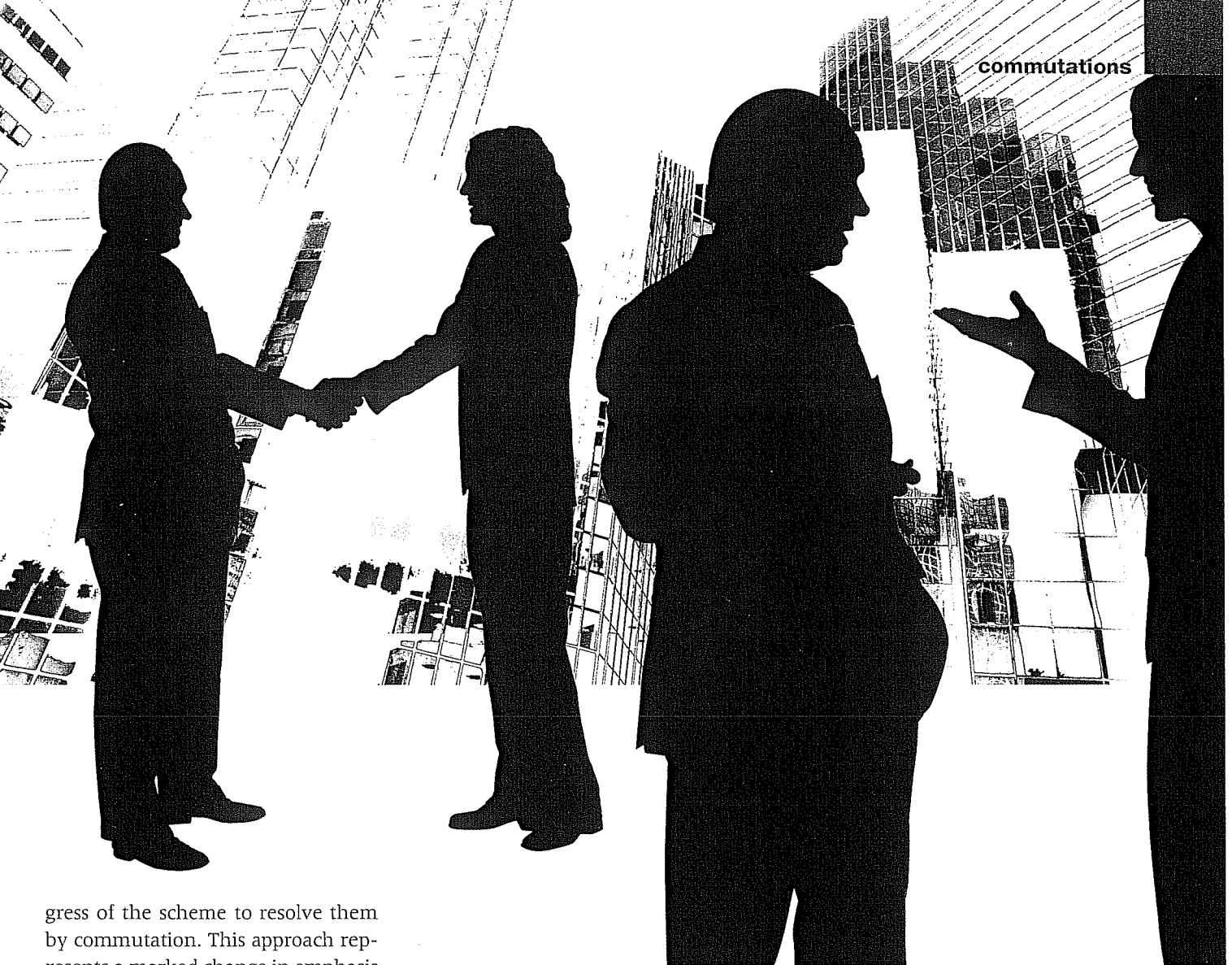
Jim Moran, commutations and credit control manager at Cavell, echoes these comments. 'Commutation used to be seen as something that went on in a corner somewhere, now people are realising it is a major part of the market.' For the live market, the reduced number of reinsurers has been a factor, he adds: 'Live companies buying reinsurance often set themselves limits on how much they can place within any one reinsurance group. That might make it

difficult to place next year's business if they have already placed a lot of exposure with that group in previous years. So by commuting out some of the old business they actually give themselves a greater capacity to place business with a strong reinsurer in the forthcoming years.'

Schemes

As for run-offs planning to go into a scheme, they need to look at commutations first: 'It might be some of your inwards business that needs to be taken out of the picture in order to make the scheme more likely to go through. But more likely than that is that you will start to commute your reinsurance asset because it's difficult to tie it in within the scheme itself,' explains Moran.

Godwin at Cobalt notes: 'Where problems or issues exist with certain creditors, particularly material ones, it may be advantageous to the pro-



gress of the scheme to resolve them by commutation. This approach represents a marked change in emphasis from a conventional strategy where size and volatility would be the primary focus.'

Paul Upperton, commutations manager with Compre Administrators, also detects a greater willingness to commute, and thinks schemes have been a factor. With Compre-owned Figre, he notes, prior to it going into a solvent scheme last year after several years of commutations activity, 'there was a tendency, on the inwards book of business, for companies to want to commute before the scheme took effect, because they thought they would get a better price on the commutation than they would through the scheme.' Many companies, he thinks, are 'slightly nervous of schemes', fearing penalties that could block their claims, such as time bar, or that the run-off might become insolvent.

Conversely, Peter Matthews, MD

of Global Reinsurance Consultants, suggests that 'there are so many schemes lately, people often don't get the chance to commute beforehand. In fact there are so many solvent schemes now that some companies are having to employ extra people to work on them. That still leaves recoverables out for people like us to work on.'

Another change Matthews notes in the market is a hardening of attitudes by reinsurers to claims put to them by run-off cedants, which can lead to commutation or even legal action. 'We always try to resolve things amicably and in 95 per cent of cases they will be. But we find that an amicable negotiation is not always possible and we have to work in conjunction with lawyers on occasion to reach a conclusion with some companies. The problem lies with reinsurers that are not prepared to pay claims or commute on a realistic

level.' Reinsurers, he adds, are increasingly making use of time bar, a practice he feels goes against the spirit of negotiations: 'It's one of those grey areas - it hasn't been tested very much in the courts.'

Such 'difficult companies' are not restricted to any geographical area, he notes: 'There are quite a lot across the globe; there are difficult companies in the London market, there are difficult companies in the Far East...'

But clearly the acceptance of commutations is more widespread in some parts of the world than others. 'Each market has a different understanding of what commutations offer to them,' says Godwin at Cobalt. 'The Australian market is slowly coming to realise the benefit of using this strategy. We have managed to complete some significant commutations with our fellow Australian companies, but this has been achieved through persistence and >

considerable effort in building key relationships, not because commutations have become a market norm.'

London's influence

The UK has unquestionably led the way in commutations. Killick at Chilterington thinks this is partly due to Equitas and partly because of the complexity of the London market: 'The benefits are clearer to see because of the number of players.'

Compre's Upperton comments: 'In the UK we always have been ahead of everybody else, Europe is not too far behind, but the US is not very geared up to commutations.'

Moran notes that Cavell has been successful in attracting some of the bigger US companies to the Norwich Rendez-vous, but still has some way to go to reach the medium sized carriers, such as the farming and industrial mutuals. 'I don't think these companies are very keen on the idea of commutation even now,' says Moran.

In Germany, he adds, first Gerling Global Re and then Gothaer Re going into run-off have caused a massive change in market attitudes. 'So there's a strong impetus in Germany at the moment and I think that might help to carry along some of the other Continental insurance markets.' In France, he says, interest in commutations has been building



Paul Upperton, Compre: Extracting the data can still be difficult

for some years but many companies have a problem with gathering adequate data.

Data quality

Data has always been key in commutations negotiations and, in general, the quality of available data has been steadily improving, says Moran. 'There are different reasons for it, one of them is potential weakness in security, and people are realising they need principal-to-principal systems; auditors might be putting more pressure on them to improve their provision for bad or doubtful debt, which means initially that they have to have the information required.'

Also, specifically with commutations, he notes that where companies in the past might have carried out one or two commutations a year, now they are doing more and want them to be more professional and more accountable. 'That has led to an improvement in the overall quality of the data that we use to calculate commutation amounts and also to allocate them back into the accounts of the company.'

Cobalt's Godwin is a little more cautious. 'Whilst we have seen an improvement in the general quality of data used in our commutation activity, this improvement is not reflected across the entire market. Some companies do not fully understand the scope of the company-to-

company relationships that they have on their books. The last decade has seen an extraordinary level of mergers and acquisitions, both in the live and run-off environment,' he adds. 'This has made it very difficult for companies to monitor accurately all of their relationships.'

Cobalt undertook a principal-to-principal project on the Gordian book which he says greatly enhanced the quality of data available: 'From a commutation perspective it has made it considerably easier to understand the full scope of each relationship that we are working to finalise.'

Upperton at Compre notes that while the quality of data may have improved, it can still be difficult to extract, especially where it has moved from one company to another and via a broker, and there are often differences in what a cedant and a reinsurer have in their respective books.

Crunch points

'The three main issues in any commutation are the level of IBNR, the size of the time value of money discounts and the underwriting and claims issues that may be disputed between the parties,' observes Godwin.

The greatest scope for haggling lies in the IBNR. 'Unpaid balances and outstanding losses tend to be agreed on both sides, so normally the argument about price in the commutation is in the IBNR,' says Upperton. 'The tendency is for both sides to view the IBNR totally differently. The cedant with a high IBNR factor will look to justify it while the reinsurers are looking to pay far less, so of course the larger the IBNR the harder it makes commutation.'

Nonetheless, says Upperton, if both companies are intent on finalisation, commutation can sometimes be done very quickly, but not if one side takes a highly technical approach. 'It is much harder to reach a meeting of minds where one side



Bevan Killick, Chilterington: The benefits of commutations are much better understood by the market now

wants to do a commercial deal but is facing an actuary who takes a totally different approach. That's where you get a lot of delay.'

ARC Protocol

One attempt to reduce disputes was the ARC Commutations Protocol, intended to ensure commutations could be recovered from the outwards reinsurance programme in the same way as paid claims. Published last year after a lengthy drafting period, it met with murmurings of approval but no actual signatories.

'I don't think it has gone completely by the wayside but there has not yet been a spirit in the market that would lead to it being taken up by a lot of carriers,' says Moran. He remains hopeful that it may yet be picked up, but adds: 'I think it's just not appropriate at the moment, too many people are nervous of having, as they see it, commutations imposed on them, so they choose not to sign up.'

Nonetheless, Chilton's Killick does see some positive benefits from the protocol, if only by promoting discussion within the market. 'I think there are a lot of points that people agreed with, and they agreed with the spirit of it. Just to have people round a table getting a market view of accepted practice does move things in the right direction.'

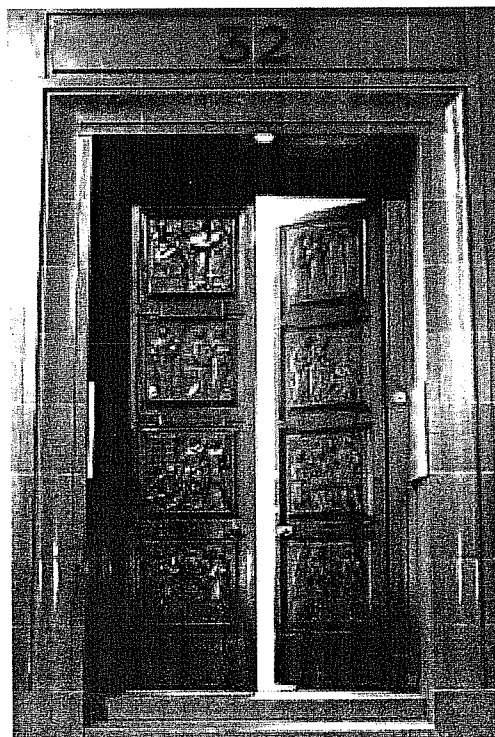
Role of the rendez-vous

Getting people together is of course the prime function of events such as the Norwich Rendez-vous. There are other options: companies like Global Reinsurance Consultants specialise in travelling to far flung places on behalf of their clients, while others like Chilton have an established international network of offices and experts to draw on. But for many the rendez-vous concept offers the opportunity to meet with counterparties from around the globe at a fraction of the travelling cost that would otherwise be incurred.

'They present a good opportunity to meet with representatives from companies who we are already in commutation discussion with,' says Godwin at Cobalt. 'If the agenda for such a meeting is agreed in detail beforehand and if the necessary work has been completed, these face-to-face meetings can prove invaluable. The rendez-vous is also an opportunity to seek out potential commutation targets for the future,' he adds.

'I don't think the rendez-vous would continue to grow in the way they have if they weren't proving useful,' says Cavell's Moran. 'We've certainly managed a great number of commutations over the years by being able to talk face-to-face with counterparties.' And quite apart from the saving on travelling costs, he notes: 'There is an unexpected value for delegates in that the networking events give them opportunities to meet people they didn't even realise they needed to meet!'

Old doors



new ideas

Innovative run-off solutions

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