Dr. Hubertus W. Labes/Ricardo Cantilo, Hamburg/Buenos Aires *

Increasing interest in commutations

Attitude towards commutations in Europe and Latin America

1. Introduction

Commutations between cedants and reinsurers are at one of their greater peaks at the present time as commutation activity has increased significantly in the last years. The Twin Towers attack on September 11th, 2001, and several natural catastrophes that hit the market in the past five years have had as consequence the search of exposure- and uncertainty reduction.

A commutation can be defined as an agreement to release insurers from all past, present, and future liabilities under the reinsurance contract in return for a lump sum cash payment. The lump sum cash payment normally reflects the net present (i.e. discounted) value calculation of all past, present and future liabilities including unsettled balances, outstanding losses, and IBNR as well as premium reserves and all kind of deposits withheld by the reinsured.

Commutations are used by insurers and reinsurers alike to end-up liabilities under insurance and reinsurance contracts. Side benefits may be that the reinsurer gets updated loss advices and reserves are made redundant.

A commutation is not necessarily limited to a specific reinsurance contract, but can be extended to a variety of agreements or the whole inwards and/or outwards business with the other party. Single claims can also be subject to commutation as a whole relationship involving every single inwards and outwards contract between a cedant and a reinsurer or retrocessionaire (known as a „global commutation").

2. General observation

One of the greatest incentives for the number of commutations to have increased in the last few years is the need to clean up balance sheets. This trend has become clear as from the Enron case but is also due to the increasing influence of rating agencies and in view of Solvency II. Solvency margin and efficient usage of capital has become more important than ever as there is a clear pressure to receive good ratings from the specialist agencies, which is increasingly being achieved through commutations.

In this sense, commutation may well serve the purpose to improve the asset position of a cedant or to clean a reinsurer's contingent liabilities. Commutations have, therefore, proved to improve solvency margins. Even still active reinsurers start to develop strategic commutation programs not only looking at liabilities anymore but seeking to clean balance sheets by using commutation as a financial tool.

Further trends supporting the importance of commutations are a significant consolidation in the insurance and reinsurance markets as well as the fact that the number of companies ceasing underwriting and retrieving from the business is increasing. It has been common to see much commutation activity in cases of underwriters who left certain markets or lines of business. Every time another company goes into run-off it adds to the list of those willing to actively seeking to commute.

Other drivers for an increase in commutation have been:

- Conflicting claims handling policy between cedant and reinsurer;
- Collection difficulties especially since reinsurance brokers in the post Spitzer era have put an important pressure to control their costs and are less willing to contribute to collections without receiving an additional fee;
- Need to deal with decreasing liquidity;
- Minimization of insolvency risk;
- Reduction of the administrative costs.

Commutation will, therefore, become more important then ever.

However, one has to distinguish between companies with an ongoing concern and those in run-off which of course have a different approach towards commutation. Until the late 1990s, companies with an active business going on were rather reluctant to commute and were only interested in commutations for special cases such as a commutation with Equitas for example. But during the past five to seven years commutations are increasingly accepted as standard industry practice and part of claims management to the extent that cedants and reinsurers face negotiations in an increasingly professional manner including actuarial support as well as claims valuation by external lawyers.

Technically, commutations in Europe and in Latin America are not handled differently from commutations in UK, the US or elsewhere in the world. Parties to commutation negotiations are in the same way as everywhere talking about the same tools, the same tactics, the same arguments depending on the underlying business, such as net present value calculation, discounting or loadings. But there are special developments in these markets which will be highlighted in the following.

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3. Attitude towards commutation in Europe

The run-off volume in Europe was estimated to be over 130 billion Euros in 2005. Compared to that, the 2005 run-off volume in UK was about 90 billion Euros. Insiders see a worldwide increase of 10% per year.

In Germany, the commutation volume grew from 2003 with approx. 700 to 800 million Euros to 2005 with 1 billion Euros. Global Re (formerly Gerling Global) says that they alone commuted 3.8 billion Euros since going into run-off in late 2002. The number of people involved in run-off only in Germany is estimated with over 500.

The London market has always been much more open to accept very difficult, delicate business and many London market companies and syndicates are now faced with the negative result of that. Compared to that, European companies have been more conservative but, of course, there are also homemade problems in Europe. Some lines of business such as credit and bond business in Italy or architectual liability in France caused massive problems. Asbestos was also used in Europe of course.

Apart from that, massive consolidation in the European insurance and reinsurance markets took place during the past years – just recently Swiss Re was taking over GE Frankona, Talanx was taking over Gerling or in Italy Fondiaria merged with SAI and took over many smaller companies such as Liguria. French SCOR took over German Revios, in Austria Vienna Insurance Group bought insurance companies all over Eastern Europe. In Scandinavia TBI sold its re insurance portfolio to Sirius and there are a lot of further examples like these in Europe. Further consolidation is to be expected.

A number of companies in Europe ceased underwriting during the past 15 years. Only in Germany the minimum of 14 professional reinsurers went into run-off since the late 1980s. Further 7 direct insurers stopped underwriting reinsurance during this time period. The German market became used to run-off. When Hamburg International Re went into run-off in 1990 the market was shocked. Cedants had no experience with this situation. When in 2002 Gerling Global went into run-off the market was used to run-off situations like that already and one was only surprised because of the sheer size of this new run-off. And also this trend will go on in Europe.

Furthermore, there are cultural differences within Europe. Reality is that there is not just one Europe but that there are various countries with various cultures, languages and mentalities.

As a general rule, commutations are less a trust issue in Nothern Europe but probably more difficult in Southern Europe. Smaller companies especially in Southern Europe do not really know how to handle commutations and some of them, therefore, prefer to keep hands off. Some companies never commute as a matter of principle, but there are less and less. And it is even more difficult to approach these companies with a request to conduct a pre-commutation audit. In this part of Europe this is often still considered as an expression of mistrust.

In countries like Germany, Holland, Switzerland and most of Scandinavia for example most companies are prepared to professionally deal with commutations. It's also less a problem in Belgium, France and Greece for example but commutations are sometimes more difficult in Austria, Italy or Spain.

In Europe it is, therefore, very important to know about the local specifications of the various markets, to understand the culture, to speak the language, to be acquainted with the local industry, and therefore to be accepted in the markets. It is essential to have experienced staff for these markets and native speakers on board.

Finally it needs to be considered that some countries in Europe do not have a single and centralised insurance and reinsurance market-place such as London or Paris for example. Germany has got insurance centers in Munich, Cologne, Hannover, and Hamburg, Italy in Rome, Milano, and Triest, and Spain in Madrid, Barcelona, and Bilbao.

4. Attitude towards commutation in Latin America

Attitudes are different in Latin America compared with those from the rest of the world.

In Latin America cedants tend to be more conservative than in the US and Europe. This might be explained by the fact that in most of the Latin American countries a reinsurance monopoly existed until the early 1990s which is the reason why the local experience in the field of commutations is not as important as that of the US or Europe.

Even within Latin America there are different realities, for instance, a number of countries like Chile, Mexico, Ecuador among others do not face high burdens in liability business (i.e. motor, professional liability). In contrast, Argentina faces extremely high loss ratios in the liability business. In the context of this business, which reinsurers are normally in favour of commuting different strategies need to be implemented within the region.

Another point that affects the total expansion of the commutation process in all the Latin-American market is the existence of a reinsurance monopoly in Brazil (by large the main force in the region) with whom the Brazilian cedants are just not used to commute.

A typical characteristic of Latin America for the last 15 years has been the economical instability. In order to cope with the effects of economic cycles (i.e. devaluation, high inflation, political crisis) cedants and reinsurers have gradually realized the benefit of using commutation as a remedy.

However, the commutation activity in Latin America in most of the countries has increased in the last years. Cedants and Reinsurers have reinforced their relationships through the different crisis and both parties realized the importance of dealing with clean accounts, for which commutation proved to be an effective instrument in Latin America.

Despite all the obstacles, Latin American cedants respond positively to commutations. Nevertheless, cedants are increasingly paying as much attention to the quality of their security as to the type of business at the time of analyzing a commutation.

There is a clear understanding among local cedants that a commutation is to be undertaken on a professional and careful fashion and above all it is clear to Latin American cedants that what is important in a commutation is to do it at the right price. Finally, in the Latin American region commutations have been a vital tool to reduce the high costs of administering reinsurance contracts.

5. Conclusion

Commutations are increasingly used world-wide. In the meantime, reinsurers do not just look for a release in liability but start to use commutation as a financial tool, i.e. to clean up their balance sheets.

Therefore, commutations are becoming more and more important and are accepted as part of the business. This goes along with the fact that most cedants are willing to commute their outwards business. And this is increasingly the case also for companies with an ongoing concern.

Commutation volumes world-wide are huge. Experts calculate a further increase of 10% of the world-wide existing volumes. Last but not least, commutations can be done in Europe and in Latin America but require awareness of the cultural differences and should be supported by local knowledge.