



Commutations and its effects on Solvency II

By Alan Prime, Senior Director, Axiom Consulting Limited

Commutations are big business in the UK and increasingly in continental Europe. You only need to look at the size of the run off market to understand why there is so much interest in commutations and other finality solutions. According to PricewaterhouseCoopers the European run-off market is now worth some Euros 202 billion and their annual run-off survey says that 40% of continental European and 50% of UK respondents see strategic commutations as the exit mechanism that will be used most frequently over the next five years. This demand was underlined in early June when over 400 delegates descended on Norwich for the annual commutation Rendezvous.

The commercial drivers behind commutations are well established. The ongoing cost of administering reinsurance assets, in some cases for many decades, is a drag on reinsurers' resources, especially when many older year reinsurance collections are difficult to achieve. Brokers are also less interested in committing resource to administering legacy business as they focus their attention on reducing costs and increasing income.

The biggest driver, however, is the need to reduce the amount of capital committed to run-off and many of the discussions at Norwich this year focused on the problem of reserves tied up in long-tail business which could be directed to more profitable live underwriting. The problem is not going to go away. Reserve volatility is increasing and with Solvency II just around the corner the amount of cash which needs to be committed to long-tail run-off business is increasing all the time.

While Solvency II is unlikely to be implemented until at least 2010 its impact is being felt already as the industry prepare themselves for its more stringent reserving requirements. The new Solvency Capital Requirement (SCR) will require insurers and reinsurers to measure their risks and ensure that they have sufficient capital to cover them. The industry is likely to have two options in calculating their SCR, either using an internal modelling route, which will be expensive and time consuming to produce, or using the standardised approach which, although simpler, has the drawback that it is

less precise, and therefore, it is likely to build in an additional capital requirement. Solvency II will also aim to identify firms with a higher risk profile who will either need to hold reserves above the SCR level or take steps to reduce the identified risks. Both the increased capital requirement and the risk-based assessment means that many insurers are keen to identify finality solutions which can take unquantified run-off liabilities off their balance sheets before they need to commit even more capital.

While there are a number of finality options open to the industry, a commutation is a popular and highly effective solution for both cedant and reinsurer. It provides the cedant with cash which it can direct into writing new business or helping the balance sheet if in run off and it enables the reinsurer to identify and remove individual exposures, releasing it from all its future obligations and reducing its reserving liabilities under Solvency II.

While it is not possible to completely eliminate uncertainty from a commutation, particularly for the cedant which is disposing of its reinsurance asset, its great strength is the ability it gives both parties to negotiate a fair settlement based on known facts and the ability to judge the transaction on its own merits. In comparison, other routes to finality, such as solvent schemes which have an element of compulsion about them a commutation is a negotiated settlement between two willing parties. The fact that both sides reach a mutually agreed outcome virtually eliminates the risk of the agreement subsequently being challenged or overturned.

In some cases, the barrier for cedants and reinsurers to enter into commutation negotiations is the perceived complexity of the transaction. This is coupled with a concern about the amount of time which will be committed to reviewing policies and assessing claims, in order to understand the appropriate price stalls negotiations. This fear in most cases is overstated. It is true there are a series of steps which the parties need to go through to reach an equitable agreement, however by breaking down the process into its constituent parts it is relatively straightforward for participants to establish which of the stages they can complete using their own resource and those where outside expertise will be necessary. Few (re)insurers have all the skills they need in house to undertake all elements of the chain, yet they all have highly skilled personnel who are experts in particular aspects of the process. By combining internal and external outsourced expertise the process of undertaking a commutation can be far less painful than feared. Alternatively the entire process can be outsourced to specialists.

There is no doubt that market conditions and regulatory changes, such as Solvency II, are driving an increased demand for commutations right across Europe. This is an effective and proven form of finality and one which has the advantage that it is a negotiated agreement between two willing parties. Fears about the complexity of the commutation process are overstated and by approaching the process methodically, with additional external resource when

required, a commutation can deliver a win-win result for both reinsurer and cedant.

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Note to editors

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