

AIRROC matters

LEVERAGING LEGACY LIABILITY



The Fracking Debate

DOES RUN OFF = GOOD FAITH? • LIMA LIFTOFF • CHERISHED COLEMAN CLASSIC
BEARS AND BOARDS • MEET THE MEDIATION DRP • AIRROC AND IAIR ALIGN

Commutations – A Historical Perspective

When the opportunity arose to put together an article for AIRROC Matters on the historical perspective of commutations, I agreed as long as: (a) it could be a bit irreverent to the sacred beliefs of our industry, and (b) I could seek collaboration. As you will see, they agreed to both points.

I decided to go back to 1986 when I was hired at Continental Insurance as the Director of Reclamations. You may ask, as I did, “what’s a Reclamation?” (Imitate Groucho Marks “Viaduct? – Why not a Chickena?”) While it was a fancy word for collections, settlements and disputes, it is where I experienced commutations for the first time.

My first commutation was a relatively small one, at the time being just under \$600k. I recall that it was comprised of \$100k in balances, \$350k in undiscounted reserves and \$250k of something called IBNR (which for a while I believe meant I Bought No Reinsurance! – I have now come to know that IBNR is determined with a blindfold and a dartboard!). We had to do something called “discount the reserves for the time value of money”. Not really knowing how to do this I found that one of the guys in the office had a piece of shareware software on a 5 inch floppy disk (hey, remember – it was 1986) that allowed you to calculate mortgage rates and present value (the other side had Ms. Pacman). Well, we did it and got the deal done for \$575k. We never looked back from there – well maybe a bit! So, to be fair to you, the reader, I reached out to some of my peers to divulge a few of their memorable commutations. Some of the responses were unprintable, while others expressed quite a bit of anger (so much for the “win-win” school of thought!). Others though, hit the mark right on the head.

The first entry comes from someone you all know, but has pleaded anonymity, as have the rest of the contributors.

Some years ago, I was working for a ceding company that was engaged in a dispute

with a number of its reinsurers on a particular treaty. An arbitration was pending, but in the spirit of good faith and reconciliation, the parties agreed to meet to consider commuting the treaty participations. The reinsurers had been acting callously and with considerable disregard for their obligations, I thought; I am sure that they thought our company had treated them poorly (or worse) in how the treaty was operated. Nevertheless, old bonds of friendship (and business-like pragmatism) prevailed, and we scheduled our meeting.

Early in my career I was told once that reinsurance was defined as an honorable engagement between two parties.

The meeting was to take place at the office of the reinsurers’ lawyers. Twelve representatives of the reinsurers were to attend, plus two of their lawyers ... and me. Clearly, the logistical planning had been unsound.

I was met in reception by the junior lawyer on the case. It seemed like a ten-minute walk through maze-like corridors to get to the conference room. As he was about to open the door, this lawyer looked me in the eye and said, “Ah, I am now bringing the lamb to the slaughter.” I then entered the room where the twelve reinsurance men were all smiling broadly. They may have been pleased to see me, or optimistic of a conciliatory settlement, but I had no ability to recognize any of that. The two lawyers were also smiling, as if to suggest: “This dispute will put our children through college.” The meeting lasted twenty minutes and was an absolute fiasco. Approximately a month later, we met again. Lawyers were forbidden from any participation in the meeting, which was held in one of the reinsurers’ offices. We commuted the treaty.

Early in my career I was told once that reinsurance was defined as an honorable



engagement between two parties.

I later heard reinsurance defined as an honorable engagement between two parties, their auditors, lawyers and external actuaries. I think the latter definition speaks to how our business really works.

Our next submission comes from one of the great collection/commutation people in the industry.

In the 1980s, an alien pool closed down and sent a letter telling us we needed to go direct. We dutifully broke out the pool and started sending direct notices of loss and bills. One of the smaller players sent us a letter from their President saying he was going to be in Chicago and would like to meet us. When he arrived, he was accompanied by two other gentlemen who were there to translate for him.

We calculated the value of the deal, paid, case and IBNR at about \$3,000. After the preliminaries and the revelation of the amount he asked his cohorts if they happen to have \$3,000 on them so we could do the deal. My colleague who was also in the meeting had earlier pointed out that the President was sporting a rather nice Rolex Crown Ambassador watch.

We therefore proposed we would do the deal for his watch (which we figured we could fence on Van Buren Street for a least \$5,000). The guy laughed and said he was serious about the deal and we said we were serious about taking his watch!

Many years later his cohorts were in our offices on another matter and I went in to say hello. We had a good laugh over the failed “watch deal” but I had to ask why the President wouldn’t do it. They told me it was because the watch wasn’t insured!!

Art Coleman (with a little help from his friends)

This article originally appeared in the Summer 2007 AIRROC Matters.

Step-by-Step

The following is an excerpt from the "Practical Guide to Commutations" which breaks down the process into simple step-by-step instructions.¹

1. Evaluation

A commutation will affect each party's financial condition, which should be measured before entering negotiations. For example, if the reinsurer is not carrying adequate reserves or IBNR provisions, the settlement amount could adversely impact the reinsurer's surplus.

2. Qualification

Both parties should set a cut-off date to be used in the presentation of balances, reserves and IBNR. Additionally, a timetable should be agreed incorporating:

- Who will reconcile liabilities and by what date?
- Who will prepare the IBNR study & when will it be ready for review?
- When will negotiations commence?
- Who will prepare the Commutation Agreement?
- By what date should the commutation be concluded?

3. Identification

All the information regarding each pertinent contract, policy or certificate must be gathered prior to valuation. In identifying exposures consider the following:

- Do the contract years run concurrently? Are there gaps and can they be explained?
- Have the parties to the contract changed names or was the business fronted?
- Was the reinsurer part of a pool or represented by an MGA?
- Does the broker have complete records that could fill any information gaps, such as reference numbers?
- Is the broker holding any pipeline adjustments or funds?
- Are there current Letters of Credit ["LOCs"]?

4. Valuation

When pricing the commutation, valuation usually consists of four components:

1. Paid Loss Recoverables
2. Outstanding Loss Recoverables
3. Incurred But Not Reported ["IBNR"]
4. Cash Credits (LOCs, Trusts, Cash-onhand, etc.)

Reconciling Paid Loss Recoverables at the agreed cut-off date should be an area of little contention unless there is a contractual dispute. It is usual for an actuarial or claims team to review the reasonableness of established case reserves. Understanding the cedant's reserving philosophy will help to determine future case reserve development and IBNR.

An actuarial or claims team can help to determine projected frequency and severity of claims for IBNR purposes by reviewing the following:

- Loss Development Analysis (Triangulation)
- Inception-to-date experience
- Type of business (proportional, treaty or facultative)
- Class of business (property, casualty, accident & health, etc.)
- Limits and attachment points (working or high layers)

There needs to be credit for the time value of money. This and other credits should be treated as a deduction to the net commutation amount or discounted accordingly.

5. Negotiation

Successful negotiations are performed by those who know the business, as well as other factors such as:

- Know your counterpart – how knowledgeable are they of the business being commuted?
- Be prepared — have all the material available in an organized manner.
- Have a number in mind — establish the highest and lowest amounts you consider acceptable. Your target figure should be somewhere in the middle.
- Understand the other side's strategy — consider their motivation for cutting a deal, their financial condition, or issues that will affect their position.

For the deal to be successful there should appear to be a "win-win" scenario for both sides.

6. Agreement

It is advisable to get legal counsel to draw up or at least review the Commutation Agreement, which should include:

- An exhibit identifying the contracts to be commuted.
- Incorporate any name changes the parties may have undergone.
- Restrict circulation of the document and terms, via a confidentiality clause, to those that have a right to know.
- Specify the date, method or payment and terms for execution of the agreement, including releasing any LOCs or Funds Held.
- Name the jurisdiction that would apply in the case of a dispute to the agreement. Mistakes are costly and difficult to undo, so careful consideration and planning is necessary at each stage to produce a favorable outcome.

¹ These notes should not be treated as a substitute for obtaining legal advice specific to a particular commutation.

Another funny point; we submitted the deal to our central corporate HQ for approval ... and it was REJECTED!!

Well, like they say, timing is everything! Knowing the two guys referenced in the story, they certainly would have received more than \$5,000 for the watch.

Some deals have happy endings (for some) as can be seen in the next entry.

Back in the late 1980s I was in the rural UK doing an audit trying to support

what we believed to be an exorbitant Commutation offer from the Cedant. We knew they were hurting but the price \$55M they were asking was ridiculous! Unfortunately, our review of the claims was telling a story that supported their position. Then our fortunes changed!

It was Friday and after a quick (?) lunch at the nearby Pub, we were back at the office and attending to the after effects of the Pub in the "Gents". As we were doing

our business, two fellows, who I later found out were from the Accounting Department, were talking and one said, "You know, I don't think we're going to be able to make payroll next week due to cash flow." A smile came across my face.

We walked into the MD's office and offered \$20M by close of business the following Monday, \$10M the following January 3rd and \$10M the January 3rd after that.



Citadel Risk

INSURANCE | REINSURANCE | SERVICES

WHEN BIG ISN'T ALWAYS BEAUTIFUL!

If you are looking for a reinsurer who can handle small deals and really 'partner' with you, come and talk to us.

- A rated Bermuda carrier
- Niche reinsurance
- Fronting
- Captive support
- Legacy and finality solutions



Contact Citadel:

Art Coleman
+19736286060
art.coleman@citadelrisk.com

Mike Palmer
+44 (0)207 042 7969
mike.palmer@citadelrisk.com

www.citadelrisk.com



Historical Perspectives (continued)

We did not mind the 8 hour flight home that evening!

They say that the doctrine of “caveat emptor” means, “let the buyer beware”. Knowing the two parties involved, this was certainly a “win-win” scenario.

This next story was one of my favorites and shows that there really is a humane side to our industry (it’s not frequently shown — but it is there nonetheless).

Late 1980s lower Manhattan, mid-afternoon and I had a 3 p.m. appointment with a gentleman from a German reinsurer that was in run-off. There is a monsoon of a thunder storm going on and I realize that the meeting will probably be late.

I had been going over my financials and was thinking that I would have a hard time getting the \$300K that was my wish list amount never mind my walk-away number of \$250K from this reinsurer.

At 2:58 p.m. I receive a call from the front desk advising that my visitor has arrived.

When he gets to my office there is a man that could not have been wetter if he stood for an hour under Niagara Falls without an umbrella. We tried to dry him off with paper towels but why bother!

Anyone who thinks that the business of run-off is boring just is not having enough fun!

This gentleman sits down in my now replaced chair and states that his company is in run-off and while appearing to be (and probably was) very uncomfortable he advises that he is only willing to pay \$500K for the commutation.

This could have been the fastest commutation on record. We asked if he had reviewed the business and if he was sure of his price. He then advised that if pushed there was probably a bit more that could be had but he would have to go back to management for approval.

My associate and I stepped outside on the premise of getting him more towels and some coffee. We agreed that to take more than \$400K from him would be in really bad form. We actually had to argue with him to get him to pay the lower amount!

It seems that today, we use phrases such as exit strategies, solvent and insolvent schemes and that the business seems like more of an exact science than it was back in the day. The best lesson we can probably learn from the past is that the best deal is not necessarily the one where the numbers are right – the lesson is that this is still a people business and relationships make for better deals.

Anyone who thinks that the business of run-off is boring just is not having enough fun! ●

Art Coleman is President at Citadel Risk Management, Inc. and American Millennium Insurance Company.
art.coleman@citadelrisk.com

Have you thought about a Vermont LIMA run-off transaction? You should.

EWI Re, Inc. has been involved with Vermont LIMA since its inception and can help you find an innovative investor-backed resolution for certain non-strategic books, liabilities in run-off, and a resolution for dormant captives.

EWI can harness the benefits of putting certain liabilities into run-off for you to create a more focused insurance business model.

These benefits include:

- Exit lines of business that are not your core competencies
- Unleash capital for better emerging opportunities
- Free management attention and oversight for more immediate return on equity growth initiatives
- Mitigate future tort risk as the legal field evolves – by using commutations and novations as a strategic tool to laser out exposures.

Grasp the strategic opportunity around run-off that the future brings.
Let EWI Re, Inc. tighten your grip.

