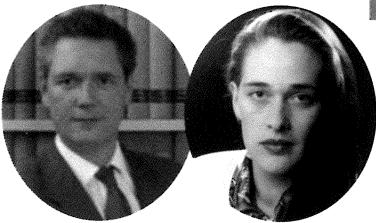


Commutations and audits in Europe



Dr Hubertus W Labes and **Charlotte Echarti** of Chilton International* describe how attitudes towards commutations and audits differ between the various countries in mainland Europe

Commutations and audits – sometimes two interlocking issues – have both developed in the European marketplace with its country-specific characteristics and different approaches. Technically there is not much difference when considering commutations in Continental Europe compared to the UK – no matter whether we are talking about opportunistic or strategic commutations. European companies use the same tools, the same tactics and the same form of negotiation.

However, there is no consistent European attitude towards commutations or audits – one can indeed find different expectations and experiences within Continental Europe. This article will look at commutations, the volumes involved in Europe and developments with special regard to the cultural aspects involved, as well as audits¹ in their different implementations.

Commutations

1. Volumes involved

Commutation² is still likely to be the most widely accepted and used tool to finalise accounts in European insurance and reinsurance markets. In terms of volume, commutation activities in Europe have significantly increased in recent times. The reason

is, of course, the immense increase in run-off during recent years.

Taking Germany as an example, not only have a significant number of professional reinsurance companies stopped writing active reinsurance business, but also many primary insurers which in the past actively wrote some reinsurance alongside their own direct business.³ Therefore, the commutation volume in Germany grew from about €700-800 million in 2003 to more than €1 billion in 2005⁴. It is, however, questionable whether these figures are accurate. Global Re, the former reinsurer Gerling Globale Reinsurance AG, published in 2006⁵ that they alone commuted more than €3.5 billion of loss reserves since going into run-off in 2002.

The run-off volume in Europe in 2005 was estimated at €130 billion

(the UK accounted for about €90 billion) and just recently⁶ as a total amount of €204 billion in 2007 (as to the allocation country-wise see diagram below). For the German speaking countries (Germany, Switzerland, and Austria) another study extrapolated the run-off volume to €66.5 billion in 2007.⁷

Further consolidation in the European insurance markets will bring more portfolios into run-off and therefore produce more commutation volume. Every time another company goes into run-off it adds to the list of those willing and actively seeking to commute. This will also increase professionalism in Europe.

2. Cultural differences

Commutations are increasingly accepted in Europe as standard industry practice and as part of pro-

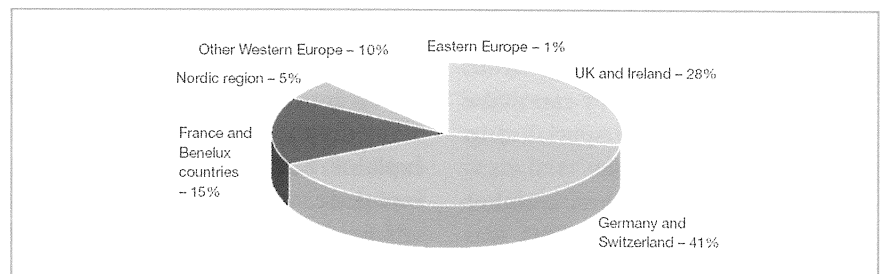


Figure 1. Run-off / discontinued insurance business in Europe

Source: PWC, *Unlocking Value in Run-Off – A Survey of Discontinued Insurance Business in Europe* (February 2007)

essional claims management. Compared with the UK and US markets, Continental Europe is perhaps more conservative in underwriting and reserving, however to some degree less developed in claims management. The London market especially has always been more open to accepting very difficult, delicate business. On the other hand, London was always in the lead with regard to insurance innovations and solutions. Run-off has become an industry of its own in London, with a high level of outsourcing of run-off services. Furthermore, London has the advantage of the same language, culture, and regulation. The London market is, therefore, certainly more developed and experienced in relation to commutations.

Europe as such is not a single and centralised marketplace. The insurance and reinsurance industry in Europe is spread over various countries with various languages, legal environments and behaviours. And in any commutation the particular company's country specifics and/or cultural differences are to be taken into account. Moreover, some European markets provide for a high level of security via reserve deposits, such as – for the time being – cash deposits in Belgium, France or Greece.⁸ Companies in these markets are not really focusing on commutations. Also the different market maturity has to be considered.

It is, therefore, not surprising that the attitude with regard to commutations differs to a large degree within Europe. As a general rule one can say that Southern European companies are more reluctant to accept commutations than companies in Northern European countries. And in Italy, Spain or Portugal for example, insurers and reinsurers generally have less experience and are less familiar with commutations.

This is even more the case for pre-commutation audits which Southern European companies still con-

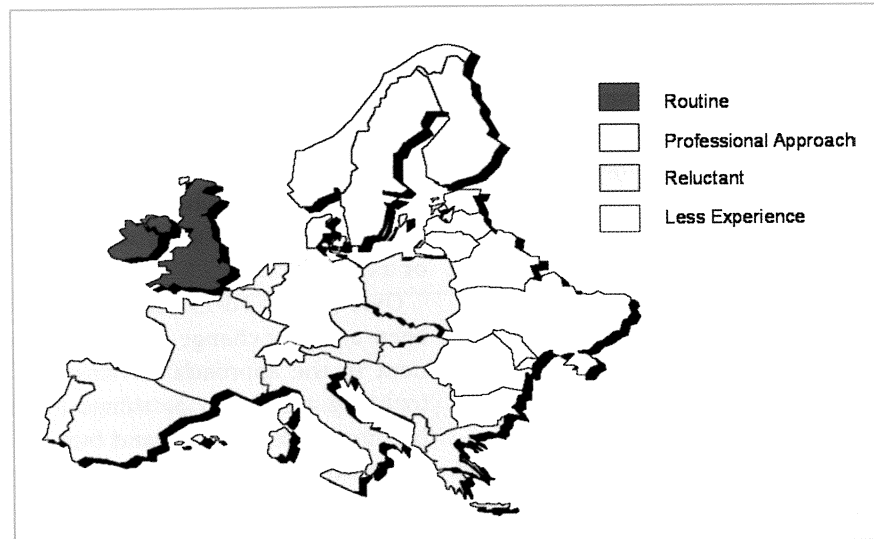


Figure 2. Attitudes towards commutations and audits vary from one country to another

sider to be an expression of mistrust. The same is true, however to a lesser degree, for example in Austria, Belgium, France or Greece; whilst in Germany, Switzerland, Holland, and Scandinavia insurers and reinsurers react more professionally to these procedures. Nevertheless, there is a potential for future development as a consequence of Solvency II, the new EU regulation on reserve deposits, and due to a new generation of management.

Attitudes towards commutations and audits in Europe

In France run-off management, and therefore also the attitude towards commutations, is rather hesitant and reluctant. The reason is mainly the existence of the National Indemnity Pool (asbestos) as a governmental guarantee as well as the requirement for reserve deposits. Outsourcing or selling of run-off portfolios is not common practice and for commutation activities it is still highly relevant to have personal relationships. France still has a very technical approach and negotiations between involved parties need intensive communication, whereby the role of brokers in commutations varies from case to case.

In Spain the National Catastro-

phe Pool and a pool for terror events serve as governmental guarantee. The companies' organisational structures do not reflect run-off or commutation as a speciality. Run-off portfolios are hidden and there is no open communication despite substantial UK involvement, leading to a significant lack of transparency for outsiders. Looking at commutation attitudes, personal relationships between negotiation partners and evaluation of future economic aspects might result in an interest to commute the business, technically negotiated but with consideration of the credit risk (the 'fear factor'). Brokers are generally not involved in commutations and reserve deposits reduce interest in commutation.

In Italy, run-off portfolios are not outsourced, not even actively handled; on the contrary, they are hidden as much as possible. Companies do not admit to the corresponding challenges. Commutations are accepted for run-off companies in the first place and often conducted emotionally, personal relations being very important. Brokers are just involved in a few cases and if so as support for data reconciliation only.

In Switzerland – being a rather small, transparent, and mostly international and UK related portfolios

market – and also in Germany, the attitude towards commutation is open, the management mostly professional and proactive, with most cedants responding positively to requests to sit down and talk. Outsourcing or selling of run-off portfolios is common practice, though to a lesser degree in recent years. This is due to the fact that Swiss or German reinsurers consider themselves to be sufficiently reserved.

As normally a buyer of such a company in run-off will pay only a lower percentage per Euro premium in order to cover the risk of default, running off the portfolio financially makes more sense than selling, as there is often more economic value in the company than a purchaser is willing to pay.⁹ The commutation attitude, nevertheless, can be described as a streamlined, going forward process, with a mainly technical approach in negotiations. Brokers are of almost no relevance, though the reason for this in Switzerland is the mainly direct placed business.

Audits

There are a number of important reasons for a reinsurer to carry out an audit and therefore audits can take various forms, such as due diligence reviews, full technical inspections, specified audits related to claims, underwriting, accounting, and/or cash-flow, for example. The same is true for insurers with agency business who have a diligent interest in regularly reviewing their Managing General Agent (MGA).

The right of inspection outlasts the duration of any reinsurance agreement and subsists until closure of the respective underwriting year. And that is exactly the time that a pre-commutation audit might be of interest.

1. Audits / inspection of records

Almost all reinsurance contracts with European jurisdictions clauses permit a reinsurer to inspect the

books and records of the cedant relative to the losses notified¹⁰. In many policies, even greater right attaches, permitting more extensive inspection under a broader set of conditions or triggers, when there is, for instance, a claim cooperation clause or a control clause.

Over the last 10-15 years there has been a steady change on the Continent in the approach of reinsureds to being inspected, as things have become more legalistic and bureaucratic. Where an audit is conducted the attitude in Europe is rarely aggressive, as audits and inspections have become routine in most of Europe, the contractual right of inspection being accepted.

2. Pre-commutation audits

The availability of full and reliable information about the business to be commuted is of utmost importance for both parties involved. Even having a sophisticated IT system, the data stored and processed may not be up to date in order to provide a full picture of the business. Pre-commutation audits provide a view of claims quantum, a better understanding of reserving expectations and therefore facilitate developing a strong bargaining position prior to commutation negotiations. Also, where problem areas are identified, these can be brought into commutation discussions to add weight to negotiations.

Only in some cases, eg. where the remaining open exposure is of subordinate size, may pre-commutation audits be dispensed with as being respectively – with regard to the cost and manpower required – disproportionate. Otherwise, pre-commutation audits always pay out.

The attitude towards pre-commutation audits is sometimes difficult and still viewed with suspicion by some cedants, especially in Southern Europe. Of course, the size of the company, whether still active or in run-off, also makes a difference. When conducting a review the staff

deployed should always match the countries to their cultural specifics, and professional specialists as well as native speakers may provide added value, especially where subsequent negotiations tend to be complicated.

3. Pre-underwriting audits

Before considering a risk-participation respectively before entering into a new business relationship a pre-underwriting audit provides the reinsurer with an insight on how the potential cedant is underwriting and administering the business, is handling claims, etc. The reinsurer gets a better understanding of the cedant's book of business in order to set a fair and reasonable premium. Nevertheless, since there is no signed contract in place, a pre-underwriting audit is not a vested right of inspection.

Pre-underwriting audits are rather rare in Europe and very much a trust issue, especially in Southern Europe. However, due to the influence from UK and US companies, some in the meantime being shareholders of European reinsurers, these kinds of audits will also become market practice in Europe.

Summary

Europe has huge volumes to be commuted and commutations are becoming an important tool, as most cedants are generally no longer as commutation adverse as they might have been in the past. Though this 'emerging market' is catching up, run-off is for the time being still mostly done in-house, rather hiding run-off portfolios, and consequently implementation of new trends takes a lot more time. Conducting commutations and audits is broadly speaking easier in Northern Europe compared to Southern Europe.

Some of these markets are five to ten years behind in terms of understanding that commutations and audits are part of professional claims management. Just as commutations are becoming more and more

indispensable but routine, audits are accepted – although not always welcome – as part of the business in most of Europe as well.

Finality through commutations can be achieved in Continental Europe as well but, next to the require-

ment of a clear and defined process and consideration of the differences between active companies – where responsibilities for commutations and audits are generally not being designated – and those in run-off – where commutations and audits are

rather common – it requires different market approaches, awareness of the cultural differences and country specifics on preference supported by local knowledge. This is even more important for audits than for commutations. ●

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1 *Inspections and reviews included when talking about audits.*

2 *As to the definition of a commutation see Huber, Commutation leicht gemacht?, in: ZfV 2003, pp. 628 et seq., as well as Managing run-off today, in Run Off Business – Special Supplement – Autumn 2006, p 5.*

3 *A comprehensive list was published in: The German Run-Off Market, in: Run-Off in Europe, pub. by Run Off Business, London 2005, pp. 40 et seq.*

4 *John Sanders, Run-Off Business 12/2005.*

5 *Freudenstein, C5 Conference "Reinsurance Claims", June 2006.*

6 *Source: PWC, Unlocking Value in Run-Off – A Survey of Discontinued Insurance Business in Europe (February 2007).*

7 *KPMG, Run-off-study 2007, p. 8.*

8 *The same applies where Letter of Credit (LoC) or Commercial Paper (CP) deposits are granted and in general at least when the level of security appears sufficient to cover the ultimate claims expectation, e.g. due to conservative reserving.*

9 *Handelsblatt newspaper article 19.10.2004: Fristen wie beim Atomkraftwerk.*

10 *The contract provision may be called an 'Inspection of Records' clause or an 'Access to Records' clause or an 'audit' clause. Sometimes the inspection is limited to certain documents like premium and loss records.*

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