

**EXAM 6 – CANADA, SPRING 2014**

29. (1.5 points)

Various mechanisms are available to a reinsurer to transfer insurance obligations to another entity. Two of these options are commutation and novation.

a. (0.75 point)

Define “commutation” and describe the impact on the balance sheets of the two entities involved in this type of transaction.

b. (0.75 point)

Define “novation” and describe the impact on the balance sheets of the two entities involved in this type of transaction.

**CONTINUED ON NEXT PAGE**

## SAMPLE ANSWERS AND EXAMINER'S REPORT

<b>QUESTION 29</b>	
<b>TOTAL POINT VALUE: 1.5</b>	<b>LEARNING OBJECTIVE: C4</b>
<b>SAMPLE ANSWERS</b>	
<b>Part a: 0.75 point(s)</b>	
<p><b>Sample 1:</b>            Commutation: All future cash flows are current valued with the intent to accelerate settlement of obligation.</p> <p style="padding-left: 40px;">Seller:            Assets: Cash decrease for payment to buyer            Liab: Reduce unpaid claims by amount of obligation</p> <p style="padding-left: 40px;">Buyer: Reverse process            Assets: Increase cash            Liab: Unpaid increase for obligation</p> <p><b>Sample 2:</b>            Commutation: Process by which the future unpaid claims and adjustment expenses are current valued taking into financial and non-financial factors to accelerate payment and close the case.</p> <p style="padding-left: 40px;">Balance Sheet            (1) Assets: <u>Decrease</u> by the consideration payment made by the seller to buyer                              <u>Increase</u> for the buyer of the commutation            (2) Unpaid claims: decrease for seller and increase for buyer</p>	
<b>Part b: 0.75 point(s)</b>	
<p><b>Sample 1:</b>            Novation: Both parties agree to a new contract and void past obligations.</p> <p>In this case both entities will clear their liability and asset entries associated with the prior agreement and set up new ones. Differences would be booked in income statement.</p> <p><b>Sample 2:</b>            Novation: Replace old contract with a new valid contract between the same or different parties. Balance sheet impact depends on terms of the contract.</p>	
<b>EXAMINER'S REPORT</b>	
<p>Candidates were expected to know the definition of commutation and novation and describe the impact on the balance sheet of each.</p> <p>Candidates did well on the first part of this question and did not do well on the second part. About a third of the candidates received no marks on part b. Many of the candidates that received some marks on part b received the marks for the definition of novation but could not describe the impact on the balance sheet of a novation.</p>	

## SAMPLE ANSWERS AND EXAMINER'S REPORT

### Part a

Candidates did well on part a. Most candidates knew the definition of commutation. Some candidates did not provide a detailed enough description of commutation and lost marks and commonly omitted "to accelerate payments and close the case" from the definition.

Most candidates were able to identify the impact on the balance sheet of a commutation, but some candidates identified the impact on loss development triangles, which was not part of the question.

### Part b

Candidates did not do well on part b. Most candidates knew the definition of novation. Some candidates did not provide a detailed enough description of novation and lost marks, often by omitting "between the same or different parties" from the definition.

Most candidates were not able to identify the impact on the balance sheet of a novation. Many candidates answered incorrectly or simply did not answer this part of the question.