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**COMMUTATION OF REINSURANCE CONTRACTS:  
A CASE STUDY IN GENERAL INSURANCE  
CORPORATION**

*A Dissertation Submitted in Partial Fulfillment of Requirement of  
the Degree of*

**MASTERS OF LAW**

Submitted by:  
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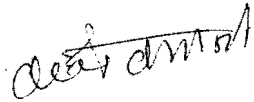
**2001**

## DECLARATION

I hereby declare that this dissertation, entitled “Commutation of Reinsurance Contracts: Case Study in General Insurance Corporation” has been carried out by me under the guidance of Dr. N L Mitra, Vice-Chancellor of National Law University, Jodhpur and the former Director of National Law School of India University, Bangalore.

This is an original piece of work except for such help taken from such authorities as has been duly acknowledged at the appropriate places by footnoting.

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## CHAPTER 1

### INTRODUCTION

The traditional reason for insurance companies to buy reinsurance has been to improve their financial security and more specifically to reduce their underwriting risks. Reinsurance security to an insurance company is only next in importance to the capital invested by the shareholders of the company. No insurance companies can run their business out of their own financial resources.<sup>1</sup>

The mounting losses, in recent years, due to large claims have caused numerous insolvencies and threaten the continued vitality of several old, well-established companies and both insurance and reinsurance markets. This has made the disputes between/ among companies inevitable. The companies (insurance as well as reinsurance) are confronted with issues and problems never encountered before in this centuries-old industry.<sup>2</sup> It is not only the magnitude of claims but also their novelty and complexity that has generated increasing disputes and controversy between the cedents and reinsurers.

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<sup>1</sup> Mr. Arizal Er., "Reinsurance Security", *Asian Insurance Review*, Dec. 2000 at 35.

<sup>2</sup> Jonathan F. Bank, Kenneth R. Pierce "Reinsurance: Overview and Discussion of Current Problems", Practising Law Institute.

The disputes among insurance and reinsurance companies are usually resolved through arbitration or reconciliation or compromise. Recourse to the court is not very common. There is one more method of negotiations between the reinsurer and the reinsured whereby reinsurer is discharged from an on-going contractual liability against payment of a downright agreed sum of money. This is called commutation. It is a technique by which the reinsurer and the reinsured through a discounted settlement close the treaties. Though the concept sounds rather straightforward, the process of reaching satisfactory commutations can often be a skilled, lengthy and time-consuming enterprise.

Commutation is the substitution of one form of payment or charge for another. In the reinsurance world the commutation is used to close down claims, policies or even whole relationships, changing them from ongoing contracts to crystallized sums of money, which will never alter.

Reinsurance is used not merely to control retained claims costs but also as a tool of financial management to manage their solvency margins, investment risks and tax liabilities. It is commonly observed that continuing solvency of the ceding company becomes increasingly dependent upon the soundness of its reinsurance programs and the security of reinsurers. However, generally speaking, the quality of reinsurance securities is to some extent determined by the level of profitability of the reinsurer.

In case the reinsurer shows bad security, the reinsured instead of continuing, has the option to stop its business with such reinsurer through commutation.

### **BACKDROP OF THE DESIRABILITY OF COMMUTATION IN INDIA**

Indian Insurance Companies have been participating in international Reinsurance Treaties of foreign insurers, including Lloyds Syndicates<sup>3</sup>, both, directly by cedents and indirectly by insurance brokers from London and elsewhere. This participation is in the form of inward reinsurance as well as outward reinsurance. Inward reinsurance means where the insurance companies in India are underwriting reinsurance business for foreign companies and thereby generating foreign exchange in the form of premium. Outward reinsurance takes place where domestic companies reinsure themselves with the foreign insurance as well as reinsurance companies. This results in the outflow of foreign exchange in the form of premium.

Since 1973 the General Insurance Corporation of India on behalf of its four subsidiaries was carrying out the reinsurance operations in respect of

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<sup>3</sup> In the time of William III and of Queen Anne, Lloyd's coffee houses in Tower Street and later at the corner of Abchurch lane in Lombard street, individuals were used to practice insurance who ultimately formed themselves into an association or society with a committee of management, which became famous under the name of Lloyds. For further detail refer: Sir Michael J. Mustill, *Arnold's Law of Marine insurance and Average* (London: Stevens & sons, 1981) at 78.



outward reinsurance i.e. arranging reinsurance for risks which could not be retained in the Indian market. From 1976 the Corporation started underwriting inward reinsurance business, on a pro-rata basis, for its own account and from 1992 the reinsurance acceptance of the Indian market was centralized at GIC to be carried out by a separate department known as SWIFT (Single Window International Facultative and Treaty).

Under the changed scenario by virtue of liberalization of insurance sector and consequent change in game rules from 2001, GIC has been re-notified as the only Indian Reinsurer to accept reinsurance business from all the domestic<sup>4</sup> and foreign insurance companies, life as well as non-life for its net account. Along with this the National Reinsurer is entrusted with the task of organizing domestic pools for reinsurance surplus in fire, marine hull and other classes, in consultation with all other insurers.<sup>5</sup> Earlier the National Reinsurer was under obligation to retrocede<sup>6</sup> at least 50% of the obligatory cessions received by it to the ceding insurers after protecting the portfolio by suitable excess of loss covers. IRDA has done away with compulsory retrocession (passing back of reinsurance premium to insurers on baskets

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<sup>4</sup> Under Section 101A of the Insurance Act, 1938, Insurance Regulatory and Development Authority may specify, with prior approval of the Central Government, the percent of the sum assured on each policy to be reinsured provided that no percentage so specified shall exceed thirty percent of the sum assured on such policy.

<sup>5</sup> Section 3 (7) of the IRDA (General Insurance – Reinsurance) Regulations, 2000.

<sup>6</sup> Section 3(11) of the IRDA (General Insurance – Reinsurance) Regulations, 2000.

different from the reinsured basket) from the National Reinsurer.<sup>7</sup> Though the Indian companies are given free hand to reinsure outside India, here also other Indian Insurers and National Reinsurer shall have pre-emptory right to participate in facultative and treaty surplus of the Indian company before such placement is done outside India.<sup>8</sup> The purpose of all these regulations is to maximize retention within the country; develop adequate capacity; secure the best possible protection for the reinsurance costs incurred; and simplify the administration of business.<sup>9</sup>

In its changed role as National Reinsurer, the GIC has made changes in its underwriting policy. Keeping this policy change in mind there is desirability of closing down the old treaties and entering into fresh deals. As these treaties are open since 1973, the GIC is getting a number of offers from reinsurers/reinsured to close the same. The outstanding losses are also being carried forward year after year without any changes. These old treaties can be closed down through commutation, which will benefit GIC also. It will help reduce the non-performing assets (NPA)<sup>10</sup> of the company<sup>11</sup>.

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<sup>7</sup> "News in Brief: IRDA does away with GIC compulsory retrocession", The Insurance Times, vol. XXI, No. 4, April 2001 at 11.

<sup>8</sup> Section 3(10) of the IRDA (General Insurance – Reinsurance) Regulations, 2000.

<sup>9</sup> Section 3(1) of the IRDA (General Insurance – Reinsurance) Regulations, 2000.

<sup>10</sup> Assets that are not producing any income.

<sup>11</sup> NPA will be reduced in case of long tail inward reinsurance treaties whereby these companies can commute and make their balance sheet off with long drawn liabilities.

The four state-owned subsidiaries of the GIC, involved in direct general business, are given functional and/or operational autonomy (the proposal to de-link them from GIC is also under consideration) to compete with the private player in the market. As a mark of their market strategy, these state-owned companies need to re-look at their old liabilities and if possible, discharge the same by commuting some or many treaties, which are not yielding profits and have become burden for them to carry over.

## CHAPTER 2

### STATEMENT OF PROBLEM AND METHODOLOGY

Commutation is the commercial alternative to the arbitration and reconciliation. It is used extensively and freely as and when it is profitable to commute, purely on commercial basis without any other consideration or external pressure. In India, under the protective regime of insurance and reinsurance, the response of GIC, the national reinsurer in India and its subsidiaries (engaged in direct general insurance business) to the commutation offers is more of rejections than of acceptances. The following table, to a great extent, exhibits the present picture of commutation in India. The table shows the data of only two companies, General Insurance Company representing its position and that of New India Assurance Company, which represent the position of other subsidiary companies also.

| <b>Name of Co.</b> | <b>Number of Offers</b> | <b>Acceptances</b> | <b>Rejections/ pending</b> |
|--------------------|-------------------------|--------------------|----------------------------|
| GIC                | 88                      | 49                 | 39                         |
| N I A Co. Ltd.     | 14                      | 0                  | All                        |

The detail of all these are given in the Annexure 1 and 2. Few inferences can be drawn from this table that are as under:

- It is observed that GIC, till date, has never made any offer to commute with any of its reinsurers/ retrocessionair. All the commutation entered into by

GIC were proposed by cedents. It means that GIC never made any efforts to reduce its liabilities and thus NPA, through commutation.

- Secondly, all the offers, which are accepted by GIC are made by the cedents that resulted in GIC making payment to them. GIC never accepted any offer from retrocessionair to commute and thereby never happened to receive payment from the retrocessionair/ reinsurer. In long tail claims involving less amount, where through commutation, GIC could gain liquidity and at the same can reduce the administrative cost of dragging these for long.
- Thirdly, the subsidiaries of the GIC neither made any commutation offer nor accepted one, offered by the companies from outside India. That means the companies never made any efforts to either reduce their liabilities and thereby NPA or reduce administrative cost in cases of long tail claims.

Taking into view the holistic picture, including the fact that the GIC and its subsidiaries, in their entire life span, have not made any commutation offer to any of the reinsurer or the retrocessionair, it is worth examining whether the companies found commutation never economically efficient or that the companies are in the habit of playing safe by avoiding the alternatives and generating non-performing assets, assets that decorate the Balance Sheet but serve no economic purpose.

As part of the study and field research in General Insurance Corporation where the researcher has spent two months and in New India Assurance Company Ltd., where the researcher made frequent visits, the researcher

made the observation that there exists the problem, in reference to the commutation, at two levels that are discussed below. Problem at the first level is peculiar to the GIC and its subsidiaries because of the reason of their governmental character leading to the Governmental involvement in their affairs.

## **RESEARCH PROBLEM**

The problem identified exists at two levels.

### **Problem of Decision-making on Commutation**

First level of problem arises at the administrative stage, while taking the decision to go for commutation. Being in governmental control, there is reluctance to take prompt decisions due to many reasons. Rather the situation is that most of the time, instead of rejecting the proposal, it is kept in abeyance and no decision is taken<sup>12</sup> and the proposal lapses on its own. And if at all the decision is taken, it has to pass through so many acid tests (of 'just, fair and reasonable' and subjection to Comptroller and Auditor General or vigilance commission) that it leads to harassment of the decision

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<sup>12</sup>. It is evidently clear from the data itself that, till date, no commutation decision has been taken on any of the proposals.

maker<sup>13</sup> and deter others also to take similar decisions in future. 'No-decision' situation has become more convenient and thus more preferred.

### **Problem specific to the General Insurance Corporation**

Since the General Insurance Corporation is an instrumentality of the state and is considered as a direct limb of the Government of India, there are some problems peculiar to it, which are as under:

- (i) In the case of commutation of inward reinsurance contract GIC approaching insurance companies to commute may involve the question of sovereign guarantee and hence liabilities undertaken may be difficult to readjust reducing the liability of the GIC;
- (ii) The commutation of outward reinsurance contract may involve reduction of revenue of the state in the long run. Besides, it will result in more liquidity with the company, which it may not need and which can be misused.
- (iii) Thirdly, government intervention, which is inevitable being a Government company, results in many other considerations besides monetary/ economic efficiency factor while considering the commutation. One example is the scrutiny by CAG resulting in the harassment of officer on wild allegation deters these companies to take any decision, which may be economically beneficial at that point of time.

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<sup>13</sup>. In one case known as NRG Victory case where by United India Insurance Company, took the decision to commute, the concerned officer has to struggle for almost 6 year to convince the authorities that the decision taken was a prudent one and the authorities are still do not seem convinced.

## **B. Procedure to be Adopted for Commutation**

The second level of problem pertains to process of commutation. It boils down to the procedure to be adopted by the company. To say specifically the problems like allocation of responsibility for such task and proportional power; uncertainty about government's position in each case; absence of definite allocative rules and regulatory mechanism; besides this, what are the inquiries that should be undertaken so as to make an effective, efficient and profitable commutation decision. Due to the protective regime of insurance industry in India, there was no occasion to develop any best practice code on commutation. The absence of any protocol in the GATS on commutation or any international treaty negotiation deepens the problem.

### **RESEARCH QUESTIONS**

After citing the problem, the researcher articulates the problem into specific questions, which are to be answered as the research proceeds.

- (a) What are the reasons, which necessitates the commutation?
  - (b) Why commutation is not taken as one of the strategies for efficient Financial Management?
  - (c) What are the factors, peculiar to Indian Companies being Governmental in nature, which acts as hurdle in taking decisions regarding commutation?
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## **PURPOSE OF RESEARCH**

Generally the purpose of any research is to find out the truth, which is hidden and which has not been discovered yet. The purpose of this research is to gain familiarity with a phenomenon/ technique called commutation and to gain new insight into it. It involves the portrayal of the characteristics of commutation process and the determination of the frequency with which the commutation takes place in India.

## **METHODOLOGY**

This piece of research is based upon the fieldwork done in the General Insurance Corporation, Mumbai. The researcher has spent two month there to get a fair idea about the understanding of the subject by the people working in GIC. Attempt has been made to get the holistic view through discussions with employees of all strata ranging from general manager to clerical level.

This research is mainly analytical, applied and qualitative. The paper has some content of description as well. It is analytical in the sense that the researcher has used facts or information already available and analysed these to make a critical evaluation of the material. The research is applied in the sense that it is directed towards finding a solution for an immediate problem faced by the industry, focusing on some specific companies. Again

the research is qualitative in nature meaning hereby that the phenomenon is concerned with some qualitative aspects. The research aims at finding the reasons for a particular behaviour on the part of employees in respect of commutation. It is not a study of behaviour of employee in abstract but the study of factors that lead them to 'act' or 'do not act' situation in their official capacity. The factors associated with the institution have impact on their mind that determines the use of discretionary power conferred upon them. The lack of incentive for the employees or lack of interest of the officials involved in the activity makes them indifferent. The qualitative approach to research is concerned with subjective assessment of attitudes, opinions and behaviour.

Both primary and secondary sources of data are used in the research. Primary data is collected from General Insurance Corporation, Mumbai and New India Assurance Company, Mumbai. The data relates to the number of commutation offers being made to the company by other companies, how much offers have been accepted and how much probable time the companies took to strike a deal. All this data gives the scenario prevailing in India with respect to the commutation.

The source of secondary data is the books, articles and commentary by the renowned people. The library of General Insurance Company, Mumbai, Insurance Institute of India, Mumbai, National Insurance Academy, Pune, the libraries of the National Law School of India University, Bangalore and the National Law University, Jodhpur.

## **CHAPTERISATION**

The paper is divided into seven chapters. The first chapter deals with the general introduction about the subject. It briefs about the concept of commutation how it is used in the reinsurance business to avoid the future disputes to arise. Along with that the chapter deals with the compelling situation in India that necessitates commutation and gives brief over view of the field study conducted in GIC by the researcher so as to understand the problem clearly.

The second chapter tries to evolve the problem related to commutation in general and specifically in Indian companies involved in the insurance and reinsurance business and have to deal with the commutation. Along with this the chapter describes the methodology as to how the study is undertaken to find out the probable solution to the problem in its larger and specific perspectives.

The third chapter describes the concepts of insurance, reinsurance and commutation in its larger perspective signifying the definition, historical evolution, its present situation & use. Understanding the evolution of reinsurance practices becomes necessary in order to know its objectives and to evaluate its present form. Besides, it deals with the circumstance under which the commutation is used as a strategy, form of commutation

The eight chapter, the last word, finally concludes the study and gives the suggestions. There are two sets of suggestions. First set of suggestions is given to improve the efficiency of the General Insurance Corporation of India that is necessary in the wake of peculiarity exclusivity of the business it is carrying out. The other set of suggestions is given with regard to the commutation process, dealing with laying down of some kind of rules at the administrative level, conferring authority to undertake commutation and the procedure to be followed that will go a long way in developing the best practices in this area. But here the researcher exhibits her limitation because the area of research is confined to the law and developing best practice is the job of the company and the employees who undertake the task of concluding the commutation. The researcher has only suggested some of the way in which commutation can be conducted that are peculiar to the GIC where the researcher has conducted field research.

## **CHAPTER 3**

### **CONCEPTS MADE EASY**

This chapter deals with the concept of insurance, reinsurance and commutation. It starts with the definition of insurance, reinsurance, reinsurance contract, its history and basic principles. The study of the evolution of reinsurance concept is necessary to know the factors responsible for the growth of reinsurance and the motives behind companies going for reinsurance.

The concept of reinsurance is dealt with in detail so as to clearly appreciate the concept of commutation. Commutation is a tool used to substitute the reinsurance contract. This chapter will further define the concept of commutation with the factors making it necessary and its benefits to both reinsured as well as the reinsurer. For instance, the purpose of reinsurance is to spread the risk but this objective gets frustrated when the reinsurer is a bad security. If reinsurer is not in a position to indemnify the reinsured then the very purpose of reinsurance goes bad and in such a situation, commutation can be used as a strategy to sever the ties with the bad reinsurer, in advance.

### **INSURANCE**

Insurance, in its legal sense, is a contractual arrangement whereby one party agrees to compensate another party for losses. Insurance transaction can be viewed as a branch of contract law which creates rights and corresponding obligations for those who are a party to it<sup>14</sup>. In its financial sense, insurance is a financial arrangement that redistributes the cost of unexpected losses<sup>15</sup>.

Insurance has a cushioning effect for people in the time of loss or catastrophe and thus for the whole economy. For instance, because of earthquake in Gujarat, people suffered unimaginable loss of life and property. In such cases, insurance companies indemnify people. According to latest statistics, four subsidiaries of General Insurance Corporation received total 30,717 claims<sup>16</sup> worth Rs. 325.27 crore from various parts of Gujarat. The maximum number of claims has been filed with New India Assurance Co. Ltd. with 13,739 worth Rs. 100.16 crore. People in distress receive substantial help through these companies even though at times, companies suffer considerable losses.

## **REINSURANCE**

Reinsurance, in its most simple form, can be defined as insurance of insurance company. There is no general statutory definition of reinsurance in the majority

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<sup>14</sup> Mark S Dorfman, *Introduction to Insurance* (New Jersey: Prentice Hall, Inc., 1982) 6.

<sup>15</sup> Mark S Dorfman, *Introduction to Insurance* (New Jersey: Prentice Hall, Inc., 1982) 4.

<sup>16</sup> "News in Brief: GIC Subsidiaries get 30,717 Claims from Gujarat", *The Insurance Times*, Vol. XXI, No. 4, April 2001.

of jurisdictions. The following nations reported the existence of a general statutory definition:

### **Israel**

"An insurance contract is a contract between an insurer and an insured, which obliges insurer in consideration for a premium paid, to pay insurance benefits to the insured on the occurrence of an insured event".<sup>17</sup> Reinsurance is expressly excluded from the 1981 Act by article 72 but it may be assumed that this definition, appropriately modified, applies to reinsurance as well.

### **United States**

Insurance and reinsurance are regulated by the individual states of the USA and accordingly there is no federal definition of reinsurance. There are definitions in the legislation of various states. Under California Law a reinsurance contract is defined as "one by which an insurer procured a third person to insure him against loss or liability by reason of such original insurance".<sup>18</sup>

### **Judicial definitions**

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<sup>17</sup> Article 1of the Israeli Insurance Contract Law 1981.

<sup>18</sup> California Civil Code 620.

A feature of reinsurance law is the remarkably small number of cases to come before the courts in the vast majority of jurisdiction surveyed. This may be put down to the use of arbitration clauses and other dispute resolution mechanism and also to the fact that it is only comparatively recently that the parties to reinsurance agreements have resorted to litigation. In common law jurisdictions, traditionally, reinsurance had been something of a market for “gentlemen” in whom insurers regularly reinsure each other and were happy to settle amicably and it appears to have been the globalization of reinsurance, which has produced the increase in litigation. Judicial definitions of reinsurance have been attempted in the following jurisdictions.

#### **United Kingdom**

The definition of reinsurance has been considered in a number of English cases. The earliest, in *Delver v Barnes* in 1807<sup>19</sup> was “a new assurance effected by a policy on the same risk which was before insured in order to indemnify the underwriters from their previous subscriptions and both policies are to be in existence at the same time.”

This definition is far from perfect as it is well established in the London Market as recognized by the courts that a broker instructed to find insurance may well seek to put reinsurance into first place, so that any insurer who agrees to

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<sup>19</sup> (1807) 1 Taunt 48 at p. 51.



underwrite the direct risk is thereby able to accept a standing offer of reinsurance from willing reinsurers.<sup>20</sup>

Later cases have emphasized different aspects of the definition, e.g. by making it clear that a contract of reinsurance is a distinct obligation between reinsurer and reinsured which does not confer rights upon the direct policyholder<sup>21</sup>, as reinsurance is not any form of partnership or agency.<sup>22</sup> The assignment of reinsurance portfolio from one reinsurer to another is not a contract of reinsurance.<sup>23</sup>

### **United States**

Various cases in a number of jurisdictions have defined the term "reinsurance". A New York case *Skandia America Reinsurance Corporation v Schenck*<sup>24</sup> defined reinsurance as "the ceding by one insurance company to another of all or a portion of its risks for a stipulated portion of the premium". This definition appears to be fairly consistent with definition established by other courts in the context of reinsurance disputes e.g. *McDonough Construction Corporation v*

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<sup>20</sup> *General Accident Fire and Life Assurance v. Tanter* (1984) 1 Lloyd's Rep 58.

<sup>21</sup> *Glasgow Assurance Corporation v Welsb Insurance Corporation* 1914 S.C. 320.

<sup>22</sup> *English Insurance Co. v National Benefit Insurance Co.* (1929) A. C. 114.

<sup>23</sup> *GMA v Storebrand* (1995) L.R.L.R. 333.

<sup>24</sup> 441 F. Supp. 715 (S.D.N.Y. 1977).

*Pan Am Surety Co.*<sup>25</sup> “reinsurance is a contract that one insurer makes with another to protect the first insurer from a risk he has already assumed”.

## BASIC PRINCIPLES OF REINSURANCE

### A. Reinsurance Contracts

Reinsurance is a contract whereby one party, known as the reinsurer, undertakes to indemnify the other party either wholly or partially, for liabilities he may incur under a contract of insurance<sup>26</sup>. As Lord Mansfield observed:

“... a new contract, effected by a new policy, on the risk which was before insured in order to indemnify the underwriters from their previous subscriptions and both policies are in existence at the same time.”

American Court has construed a contract of reinsurance as being<sup>27</sup>:

“A contract whereby, one for a consideration agrees to indemnify another wholly or partially against loss or liability by a risk the latter has assumed under a separate and distinct contract as insurer of a third party.”

These two judgments highlight three features of reinsurance contracts:

<sup>25</sup> 190 S.O. 2d 617 (Florida Dist Ct. App. 1966).

<sup>26</sup> This view was expressed by Lord Mansfield in *Delver v Barnes*. (1807) 1 Taunt 48, 51.

<sup>27</sup> *Stickel v Excess Insurance Company of America*, Ohio Supreme Court, 22 Nov. 1939, 23 N.E. (2<sup>nd</sup>) 839, 136 Ohio St. 49.

- The reinsurers' undertaking to indemnify the primary insurer itself constitutes a contract of insurance;
- The reinsurance may provide a complete or only partial indemnity against the liabilities the primary insurer may incur under the head policy;
- The reinsurance is a separate contract between the reinsurer and its reinsured to which the original insured is not a party.

## B. The Nature of Reinsurance

Ceding companies and their reinsurers has a contractual relationship to which general principles of contract law apply. In addition, it is well established that parties to a reinsurance contract owe each other a mutual duty of *uberrimae fides* or "utmost good faith."<sup>28</sup> One of the most important applications of this duty is the reinsured's obligation to disclose to the reinsurer all material information relating to the risk that is to be reinsured. This obligation is so fundamental that a breach can result in rescission of the reinsurance contract.

Because ceding companies and their reinsurers often have congruent interests in spreading risk and minimizing losses, especially in proportional covers such as quota share contracts. The relationship of reinsurance can be analogized to that of a business "partnership." A federal court recently held the parties to a

<sup>28</sup> Sun Mut. Ins. Co. v. Ocean Ins. Co., 107 U.S. 485(1882); Unigard Sec. Ins. Co., Inc. v. North River Ins. Co., 4 F.3d 1049 (2d Cir. 1993).

reinsurance contract as 'partners in a marriage or in a business relationship, owing to each other the highest degree of fidelity.'<sup>29</sup>

## **B. Treaty vs. Facultative Coverage**

Although there are several variations on the basic theme, reinsurance contracts are either "facultative" agreements or "treaties." In a facultative contract, often called a certificate, the reinsurer promises to indemnify the cedent for all or a portion of the risks assumed under a single insurance policy. In a treaty, the reinsurer reinsures all or a portion of every policy which falls within a particular class of business, such as property or casualty, produced by the cedent. With facultative coverage, the reinsurer retains the "faculty" to accept or reject individual risks, while under a treaty, the cedent is bound to cede -- and the reinsurer is bound to accept -- the portion of each policy, which is subject to the treaty.

While facultative certificates are usually short, pre-printed forms, treaties are lengthier documents, often manuscript contracts, the terms of which are typically negotiated. There is no single standard reinsurance treaty or facultative wording. In practice, treaties are drafted by the broker or the reinsurer, and rarely by the ceding company.

Ceding companies typically purchase facultative certificates to reinsure risks,

<sup>29</sup> *Compagnie de Reassurance D'Ile de France v. New England Reins. Corp.*, 825 F. Supp. 370, 383-84 (D. Mass. 1993)

which are not otherwise covered under a treaty agreement. Such gaps can arise because of exclusion in a treaty or in special cases, such as where an insurer writes a policy with higher limits than its normal class of business.

### **C. Proportional vs. Excess of Loss Treaties**

Facultative certificates and treaties can either be: (1) "proportional" or "pro rata," whereby the reinsurer shares premiums and losses with its ceding company on a percentage basis; or (2) "excess of loss," in which the reinsurer indemnifies the ceding company against all or a portion of its losses in excess of a stated amount, up to a specified limit of liability.

The ceding company's "retention" is that part of the risk which it retains for its own account. In proportional contracts, the retention may be expressed as a percentage of the policy limits, while in excess of loss agreements it is stated as a money amount.

### **D. Clash Covers and Catastrophe Reinsurance**

"Clash covers," also known as "casualty catastrophe covers," generally come into play where a single loss occurrence involves more than one insured. A cedent may have procured a clash cover for years, which was never implicated in a loss, and may not be aware that clash coverage might exist for a long-tail claim. For example, environmental claims from different insureds arising out of the same waste site, or asbestos losses involving different insureds arising

from the same victims or buildings may implicate these covers. The cedent should make efforts to determine if such coverage exists.

Clash covers are not often easy to identify as such. A cedent can easily confuse its clash cover with a conventional casualty excess of loss treaty, giving an illusion of higher limits for non-clash losses.

Catastrophe reinsurance, or "cat cover," is a form of excess of loss reinsurance, which indemnifies the ceding company, subject to a specified limit, for cumulated property losses emanating from a catastrophic event. Recent disasters such as Hurricanes Hugo and Andrew, the Los Angeles earthquake and riots, and the Piper Alpha disaster in the North Sea, have created a huge demand for these reinsurance covers. This demand is being met in large part by specialty catastrophe reinsurers, particularly in Bermuda's burgeoning reinsurance market. With help from newly formed companies such as Tempest Re and Renaissance Re, to name just a few, Bermuda now boasts approximately one-third of the cat cover capacity available worldwide.

#### **E. The Duty of Utmost Good Faith**

Insurance is a contract upon speculation. The special facts lie more commonly in the knowledge of the insured only. The underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the

circumstance does not exist, and to induce him to estimate the risk as if it did not exist.

The keeping back of such a circumstance is a fraud, and therefore the policy is void [able]. Even if the suppression happens through mistake without fraudulent intention; yet still the underwriter is deceived, and the policy is void [able]; because the risk run is really different from the risk understood and intended to be run at the time of the agreement.

Four important characteristics of the duty of utmost good faith are as under<sup>30</sup>:

- First, the duty of good faith supplements, but does not obliterate, the contractual basis of the relationship.
- Second, the rationale for the duty is the insurer's (or the reinsurer's) dependence upon information supplied by the insured (or the reinsured).
- Third, the duty of utmost good faith, at its core, deals with matters of disclosure.
- Fourth, the duty applies to those issues, which affect the risk reinsured.

This seminal American case which extended the duty of good faith to reinsurance contracts framed the duty of utmost good faith in terms of disclosure:

In respect to the duty of disclosing all material facts, the case of reinsurance does not differ from that of an original insurance. The obligation in both cases is

one of *uberrimae fidei*. The exaction of information in some instances may be greater in a case of reinsurance than as between the parties to an original insurance.

In the former, the party seeking to shift the risk he has taken is bound to communicate his knowledge of the character of the original insured, where such information would be likely to influence the judgment of an underwriter; while in the latter the party ... is not bound nor could it be expected, that he should speak evil of himself.<sup>31</sup>

Under the British law also, the nature of the duty is one of disclosure. This duty of utmost good faith, which is implicated whenever the reinsured possesses information, which affects the risk reinsured, obligates it (both at the time of contracting and during other communications with the reinsurer) to provide the reinsurer with complete and candid disclosure. Failure to disclose matters, which are material to the risk, can constitute grounds for rescission<sup>32</sup>. Misrepresentation may lead to rescinding reinsurance treaties.

#### **F. "Follow the Fortunes" and "Loss Settlement" Clauses**

Generally, a "follow the fortunes" clause in a reinsurance agreement obligates

<sup>30</sup> John S. Butler & Robert M. Merkin, *Reinsurance Law* A.6. 1-06a (1988) (quoting Lord Mansfield in *Carter v. Boehm*, 3 Burr 1905, 1909 (1766)).

<sup>31</sup> *Sun Mut. Ins. Co. v. Ocean Ins. Co.*, 107 U.S. 485, 510 (1882)



the reinsurer to "follow" the insurance fortunes of its ceding company. This obligation is not unconditional, and will only be enforced if (1) the cedent handles and resolves the claim in good faith; and (2) the loss reasonably falls within the scope of coverage afforded by both the underlying insurance and the reinsurance agreement.

The historical basis for the "follow the fortunes" doctrine is that the cedent and reinsurer maintain an honorable relationship with each other, sharing in profits - - and losses. To this end, the parties would "stick together" despite short-term financial circumstances.

A variation on the "follow the fortunes" wording requires reinsurers to "follow the settlements" of their cedents. The "settlements" clause, which more specifically addresses the reinsurer's duty to indemnify the cedent for loss settlements than "follow the fortunes," typically provides: "All claims when covered by this reinsurance when settled by [the cedent] shall be binding on the Reinsurers, who shall be bound to pay their proportion of such settlements." There is some split in authority on the question whether "follow the fortunes" is implicit in every reinsurance relationship or it only exists if the reinsurance contract so provides. American courts generally regard the "follow the fortunes"

<sup>32</sup> Property Ins. Co. v National Protector Ins. Co. (1913) 18 Com. Cas. 119. *Compagnie de Reassurance D'île de France v New England Reins. Corp.*, 825 F. Supp. 370 (D. Mass. 1993).

concept as inherent in the reinsurance relationship and accord considerable deference to cedents in handling and settlement of claims<sup>33</sup>.

In *International Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's*, No. C2-92-829 (S.D. Ohio, September 27, 1994) ("ISLIC"), the court specifically held that the doctrine of "follow the fortunes" applies whether or not there is a pertinent clause in the reinsurance contract.

English authorities, however, tend to rely more strictly on the contract wording and may only apply "follow the fortunes" if the reinsurance contract contains appropriate language<sup>34</sup>. Even where "follow the fortunes" is considered implicit in the reinsurance relationship, cedents must bear in mind that the doctrine has limits.

While a commercially reasonable settlement or decision to provide coverage may not be "second guessed" or relitigated de novo, cedents must have acted in good faith and the claim must not, for example, clearly be excluded under the reinsured policy. Further, the reinsurer follows only the cedent's "insurance" fortunes, not the cedent's "business" fortunes, although the demarcation of when the one starts and the other finishes is blurry and not universally agreed upon.

<sup>33</sup> Mentor Ins. Co. (U.K.) Ltd. v. Norges Brannkasse, 996 F.2d 506 (2d Cir. 1993); Christiania Gen. Ins. Co. v. Great Am. Ins., 979 F.2d 268 (1992); Unigard Sec. Ins. Co., Inc. v. North River Ins. Co., 762 F. Supp. 566 (S.D.N.Y. 1991), *aff'd in part, rev'd in part*, 4 F.3d 1049 (2d Cir. 1993).

## **G. The Duty of Competent Claims Handling**

Under general principles of contract law, ceding insurers are subject to an implied duty of competent or businesslike claims handling. The general law of contracts imposes duties of skill and care in the performance of contract functions, including the duty to mitigate loss. The duty imposes obligations based on an objective standard of the "ordinary practice of the market" or the actions of "prudent reinsureds," meaning, *inter alia*, that the reinsured:

- (a) Keep full and proper records and accounts of all risks accepted or premiums received and receivable and all claims made or notified;
- (b) Investigate all claims and confirm that they fall within the terms of the contract and were properly payable before accepting them;
- (c) Properly investigate risks offered to them before acceptance and closings related thereto subsequently;
- (d) Keep full and proper accurate records showing at all times the amounts due and payable by and to the reinsured to and by the reinsurer under the contracts;
- (e) Ensure that all amounts owing to the reinsured were collected promptly when due and entered forthwith on their accounts, and all balances owing to the reinsurer were likewise paid promptly when due;

<sup>34</sup> Hill v. Mercantile & General Reinsurance Co., PLC (Court of Appeal, July 7, 1994); Scot (U.K.) Reins. Co., Ltd. v. Insurance Co. of Africa, 1 Lloyd's Rep. 312 (Court of Appeal 1985).

- (f) Obtain, file or otherwise keep in a proper manner, all accounting claims and other documents and records and make these reasonably available to the reinsurer.

## ORIGIN OF REINSURANCE

The origin of insurance and so reinsurance remains a mystery despite the efforts of considerable historical scholarship<sup>35</sup>. However one thing is clear the reinsurance is not as old as insurance.<sup>36</sup> Devices for the spreading of risks have been discovered dating back to the earliest days of commercial enterprise. For example, Chinese merchants would distribute their goods between several vessels for journeys along the hazardous rivers of China.

The development of present day form of insurance is generally credited to the merchants of the city-states of northern Italy. Soon their activities spread to the Low Countries and England. In 1310 the Duke of Flanders granted a charter for establishment of a Chamber of Assurance at Bruges to carry on the underwriting of marine risks.

The practice of marine insurance so flourished in London that eventually Parliament was compelled to regulate the business, passing in 1601 an 'Act touching policies of assurance used among merchants.'

<sup>35</sup> R L Cutler, *Reinsurance* (Avon: Bookcraft Publishing Co., 1979).

<sup>36</sup> J. O. Irukwu *Reinsurace in the Third World* (London: London Witherby & Co. Ltd., 1982) at 6

In the beginning the insurance was virtually restricted to merchants and shippers seeking protection against the loss of their goods and ships at sea from a limited number of individual merchant underwriters operating in Royal Exchange and the coffeehouses of London. At that time life insurance was in its early stage and in a very crude form whereas the issuance of fire and accident policies took another 79 and 239 years respectively.<sup>37</sup>

The exact date of first reinsurance being accepted by the underwriters for the risks is a matter of speculation. It was assumed that early underwriters limited their acceptances to the amounts they could afford to bear themselves, thereby avoiding any need for reinsurance. The practice of coinsurance<sup>38</sup> supports this hypothesis. Coinsurance is still practiced amongst insurers in most third world countries, but its practice has largely given way to the concept of reinsurance, which is most efficient system of risk sharing.<sup>39</sup>

Early records are somewhat confused by the use of the word "reinsurance" to cover both transactions between two insurers and cases where for some reason an insured effected a second insurance on the same property, possibly

<sup>37</sup> Reinsurance book taken from GIC.

<sup>38</sup> Under coinsurance arrangement several insurers get together and each insurer would take a direct share of the liability in respect of a risk, which was considered too large for any one insurer to bear one. The premium is shared between the insurers in accordance with their proportional liabilities, and in the event of a claim each insurer was liable to settle direct with the insured.

<sup>39</sup> J. O. Irukwu *Reinsurance in the Third World* (London: London Witherby & Co. Ltd., 1982) at 7.

because the original insurer has died or gone bankrupt. The latter was really fresh, direct insurance, in some cases being double insurance.

Despite such confusion in terminology it is clear from the records that reinsurance in its true sense had become generally practiced amongst marine underwriters by the end of the 17<sup>th</sup> century. James Allen Park in a treatise on 'A System of the Law of Marine Insurance' published in London in 1800 refers to an "ordonnance" of Louis XIV of France dated 1681 which declared that "it should be lawful to the insurer to make reinsurance with other men of those effects which they had themselves previously insured".

However until 18<sup>th</sup> century marine insurance markets of Europe continued to handle the larger risks mainly through the system of coinsurance. It was the increase in demand of insurance brought about by the Industrial Revolution and the emergence of joint-stock insurance companies that produced a large-scale demand for reinsurance in Europe.

In England its development was brought to a temporary halt by the intervention of Parliament. Concerned about the growth of certain (unspecified) abuses, the legislators inserted into an Act of 1746 to "regulate the insurance on ships belonging to the subjects of Great Britain and on merchandises or effects laden thereon" a section which provided:

"And be it further enacted by the Authority aforesaid. That it shall not be lawful to make reinsurance unless the assurer shall be insolvent,

becomes bankrupt or die, in either of which cases each assurer, his executors, administrators or assigners may make reinsurance to the amount of the sum before him assured provided it shall be expressed in the policy to be reinsurance.”

This made the marine reinsurance illegal until the Act was repealed in 1864. All the early reinsurances were arranged facultatively. It was not until the middle of the 19<sup>th</sup> century that the first marine reinsurance treaties were arranged which imposed obligations upon the direct insurer to cede part of his business and upon the reinsurer to accept what was offered.

The first record of fire reinsurance was an agreement by the Eagle Fire Insurance Company of New York in August 1813 to assume all of the outstanding risks of the Union Insurance Company (formerly the Jersey Bank). Seven years later in 1820 a German company is reputed to have entered into a reinsurance treaty, but the first case for which full details are available was a treaty between La Compagnie Nationale d'Assurances of Paris (then known as the Compagnie Royale) and the Compagnie des Proprietaires Reunis of Brussels. In 1824 La Nationale concluded a treaty with an English company, the Imperial Fire.

Sun Fire Office started to accept reinsurances from the Newcastle Fire Office as early as the 1820s. The Sun concluded its first overseas treaty with the Aachener Lund Munchener in 1838 and over the next 40 years accepted

business from all over the Continent, India and North and South America. In Britain fire insurance was known as guarantee business.

The origins of life reinsurance in Britain lie in the growth of demand for life assurance and the associated formation of new life insurance companies, which occurred during the first half of the 19th century. However the early days were beset by various difficulties and disputes attributable to a number of causes. For example, original insurers did not always disclose retentions or even retain any part of the risk for their own account and reassurances were not always cancelled following the discontinuance of the original policy. In addition problems arose because rates of premium and policy conditions varied between companies.

Such problems led seventeen Scottish life offices in 1849 to sign an agreement regulating reinsurance business in an endeavour to establish some acceptable standards of practice for the market covering such matters as premium rates, retentions and surrenders. A supplementary agreement was drawn up in 1873 covering retentions, extra premiums and commission rates, followed by a revised and extended agreement in 1887 dealing in more detail with surrender.

In 1900 forty-six British life offices signed an agreement on similar lines to the Scottish agreements. This agreement, known as the Reinsurance Agreement 1900, is still in force, regulating the practice of life reinsurance placed on a



facultative basis, though there is today very little business exchanged on a reciprocal basis.

It was until 1918 that a specialist reinsurance company, the Mercantile & General, transacted life reinsurance business in Britain. Life reinsurance treaties, like-wise, did not appear until after the First World War, the main impetus coming from the introduction by the M&G of risk premium rates for United Kingdom business in 1927.

The development of the life reinsurance markets took place somewhat earlier on the Continent, some treaties were accepted by specialist reinsurance companies from the 1850s onwards though from 1865 to 1880 only the Swiss Reinsurance Company transacted such business.

## **THE PURPOSE OF REINSURANCE**

Insurance is a mechanism for spreading losses over larger number of persons exposed to loss. Unlike most social-security schemes, all private insurances work on a funding principle. Insurers pool the premiums they collect from policyholders form a fund to pay the claims of the unfortunate few.

Generally the insurance is calculated and paid at the inception of the insurance, but losses generally then to occur fairly evenly throughout the period of insurance. Moreover when losses do occur they may not be notified

immediately and further time may elapse, extending perhaps to several years in the case of some third party liability claims, before they are settled.

The possibility of occurrence of one loss-producing event may affect several exposure units. Consequently, it is not easy estimate the premium correctly based upon the loss experience during one underwriting year as it may fluctuate considerably from its expected experience averaged over a longer period. But at the same time, competition and other factors impose a constraint on the size of both the reserves and the premium loadings that a company can afford to carry. Consequently some additional form of protection is required against the losses, which at worst may imperil a company's insolvency or at least cause it a financial embarrassment. This protection can be provided by reinsurance.

### **ROLE OF REINSURANCE**

There are many reasons why insurance companies may incur losses and may ultimately fail. Some are common to other industries, such as inefficiency, inadequacy, intensive competition, over-trading etc. Other reasons peculiar to the insurance are:

- (a) Under-estimation of the expected claim costs, based upon the past claim experience, may be because of sampling errors associated with small samples or a failure to project trends in experience or because some

There are some other benefits also of buying reinsurance. Firstly, it makes possible a further spreading of losses. Secondly, reinsurance provides insurers with additional underwriting capacity in that they can both accept larger risks than otherwise would be possible and sometimes accommodate existing policyholders or intermediaries by writing types of business which normally they would prefer to avoid. Thirdly, the reinsurance is being used by insurers as a tool of financial management in order to manage their solvency margins, investment risks and tax liabilities.

## **COMMUTATION**

Due to the global upheavals in this industry, commutations have gained and continue to gain, popularity in the past 20 years. Commutation has a strategic importance. This is one of the strategic issues, which are to be settled by the Government and the insurance regulator so that the roadblocks on the fast progress of Indian Insurance are removed in the interest of the consumers as well as the insurance industry.

A commutation is a form of compromise between a direct insurance company and its reinsurer(s). It is a means of releasing the reinsurer from these obligations to indemnify in exchange for that reinsurer paying to its cedant (the insurance company), an agreed sum that is designed to cover all present and future claim amounts.

A reinsurance contract exists between these parties and, typically, provides protection to the insurance company for a multitude of claims of a specified type or class. Commutation does not lend itself to the settlement of direct insurance claims.

The termination of reinsurance contract by effluxion of time or by cancellation does not necessarily bring to an end all transactions between the reinsured and the reinsurer. On the contrary, the process of accounting between them is likely to continue for some time after termination of the contract, as the effect of losses attaching to the reinsured risks is often not felt until months or even many years, after the termination of reinsurance contract.

Commutation by contrast, is a means of efficient and clean cut of all liabilities between reinsurer and reinsured in respect of a reinsurance contract. It implies not only the termination of reinsurance contract but also of the necessity for any further accounting between the parties thereto. Commutation is also possible long after the termination of a reinsurance contract by the means such as effluxion of time or cancellation.

Commutation is sometimes considered as a compromise. Commutation and compromise are practiced under different set of circumstances, which makes the two different from each other though they have many points of similarity. The chief difference between the two is that the compromise is entered into in order to resolve disputes between the parties and not merely in order to affect a clean cut of their mutual obligations. And that is the main reason that the

reinsured usually accepts an amount substantially less than the total of paid and outstanding claims and IBNRs because (for example) some of the claims, which the reinsured has presented to the reinsurer, are in dispute.

It often makes commercial sense for the parties to agree that rather than incur legal costs in having their disputes resolved by litigation or arbitration, they will effect a compromise by the reinsurer paying and the reinsured accepting a proportion only of the reinsured's total claims. Commutation is generally practiced to bring finality in a long tail account and in case of run-off companies.

Commutation is the commercial alternative to arbitration and litigation and can resolve a dispute where there would otherwise be a re-occurrence of the dispute in the future. It is a tool for valuable claims management as well.

## **LEGAL REGIME GOVERNING COMMUTATION**

Commutation is novation of contract covered by the Law of contract of all major systems of the world especially, of common and civil law. In India, sec. 62<sup>40</sup> of the Indian Contract Act 1862 provides for novation of contract, which means the substitution of another contract extinguishing the liabilities under old contract<sup>41</sup>. The substitution of contract must be of substance<sup>42</sup>. It is the intention

<sup>40</sup> **Sec. 62 Effect of novation, rescission and alteration of contract** – if the parties to a contract agree to substitute a new contract for it, or to rescind or alter it, the original contract need not be performed.

of the parties and not merely the form, which is a determining factor<sup>43</sup> as to whether there is substitution of liabilities or not.

Commutation is one way of discharging the contract of reinsurance for which provision is made in Indian Contract Act. Contract can be discharged in four ways, which are given as under:

### **Discharge of Contract**

- By Performance
- By Impossibility of Contract
- By Agreement
- By Breach

Commutation is the discharge of contract by agreement wherein the parties to the contract agree to substitute a new contract for the existing one. In such circumstances, the original contract need not be performed. This is called novation of contract covered under Section 62 of the Indian Contract Act 1862. As was held in *Scarf v Jardine*<sup>44</sup> " ...where some new contract is substituted for the one existing either between the same parties or between the different parties, the consideration mutually being the discharge of the old contract..."

Novation is of two kinds:

<sup>41</sup> AIR 1956 Madh B 25 (27) (DB), AIR 1954 Nag 142 (147, 148) (DB).

<sup>42</sup> AIR 1927 Cal 538 (542) (DB), AIR 1957 Andh Pra 784 (789).

<sup>43</sup> AIR 1957 Andh Pra 784 (789).

- Change of parties
- Substitution of a new contract in place of older one.

Commutation is a substitution of a new contract in place of another. For the substitution of a contract, the old one must exist at the time of substitution. Secondly, there must not be a breach of contract. If there is a breach, then it amounts to discharge of contract in itself and hence the substitution is not possible.

Through commutation, the parties to a reinsurance agreement agree to settle their future claims liabilities on the payment of lump sum, which forms the consideration for contract between the parties. The money is calculated by the actuaries and the premium, if any due to the reinsurer by the reinsured is settled with the probable claim money. The balance is paid to the reinsured as per the terms of agreement.

Reinsurance contract is either entered into as facultative contract or on the basis of treaty agreement, usually, for one year. Commutation of contract is not the alteration of contract. In alteration, the liabilities are adjusted in a renewed way on renewed terms and conditions but in commutation, there is clean cut of liabilities... deciding only the amount and mode of payment. Commutation is rather used as an alternative to the alteration of contract. Instead of altering the terms and conditions of the contract, it is substituted by a new one and the old

<sup>44</sup> (1882) 7 App Cas 345, 351.

liabilities are cut then and there and if need, new contract is entered into to give effect to new terms and conditions.

## **CONTRACT OF COMMUTATION**

The contract of commutation includes the following clauses<sup>45</sup>:

1. **Payment Clause:** First and foremost clause is regarding the quantum of amount, which is agreed by the parties to be paid and the mode of payment in the direction of full and final settlement of all claims due to reinsured from the reinsurer. There should be clear intention of the parties to such settlement.
2. **Full and Final Settlement:** The settlement of all liabilities under reinsurance agreement shall be full and final only when the payment is received by the reinsured duly and fully as per stipulated by the parties and cleared by the financial institution.
3. **Limited to the Particular Treaties:** The full and final settlement will be limited to particular treaties entered into by the parties in a particular underwriting year specified in the contract or schedule or annexure as the case may be.
4. **Assignment of Rights, Titles and Interests to the Reinsured:** Under commutation contract all the rights, titles and interests of the reinsurer under the reinsurance agreement to any common account excess of loss protection, which is beneficial to it, will be assigned to the reinsured, by

<sup>45</sup> The model Commutation Agreement is attached at the end as an Annexure No. 1



which the reinsurer will be released from any liability whatsoever arising under the agreements.

5. **Mutual Discharge from the Liabilities:** Under the commutation agreement, the reinsurer and the reinsured, their affiliates, successors and assigns and their respective directors, officers, employees and agents shall be released and forever discharged from all liabilities which had, have or shall have arisen towards the reinsured or the reinsurer as the case may be, by reason of or in respect of any act, matter, cause or thing whatsoever with respect to the agreements<sup>46</sup>.
6. **Jurisdiction of the Court:** The parties agree in the commutation agreement to submit themselves to the jurisdiction of the court of a particular country for the settlement of all or any disputes arising out of this commutation or the breach thereof or the reinsurer's liabilities to the reinsured on the agreements.
7. **Return to Original Position:** In the event of the court of competent jurisdiction requiring the return by reinsured of any portion of the payment made to it by the reinsured in pursuant to the commutation agreement, shall render the release given by the parties to each other and the commutation of the agreements null and void and consequently make the parties to go back to the original status as though the commutation had not existed.
8. **Amendment of the Agreement:** The commutation constitutes the entire agreement between the parties and can be modified or amended only by an instrument in writing signed by the parties hereunder.

9. **Authority of the Parties:** It is declared by the parties that they are corporation, company or body of good standing and has the full authority to execute the commutation agreement.
10. **Confidentiality:** The parties to the agreement to maintain the confidentiality of the commutation terms and conditions. But at the same time these can be disclosed when necessary and required by the Parties' auditors, governing regulatory bodies or third parties in court proceedings and arbitration in connection with mandatory discovery requirements. But under other circumstances, the parties can disclose this commutation and its terms and conditions with the prior written consent of the other party for such disclosure.

## **REASONS FOR PROPOSING COMMUTATIONS**

Commutation may be required for many reasons for protecting the best interests of the concerned parties. There are many reasons for resorting to commutation such as:

1. The financial instability of the reinsurer has been the traditional reason for ceding companies to pursue loss commutations. The threat of corporate bankruptcy especially in the insurance business because of the possibility of huge liability that may suddenly arise due to volatility of the circumstances. In such a situation it is good to commute the long tail treaties. Absence of commutation may result in heavy capital erosion and

<sup>46</sup> The sample release agreement is given after the paper in the form of Annexure No. 2.

burden of excessive liability, which results quite often in the company going for bankruptcy petition.

2. Change in the underwriting policy is also a major reason to go for commutation. In the changed scenario in Indian insurance sector presents a good example of this. This change in underwriting policy is due to the change in public policy. Though there is no compulsion it is desirable to commute old treaties in the changed scenario.
3. Similar to the earlier reason, the company may decide to discontinue writing of a particular class of business as a part of its changed underwriting policy.
4. Quality of underwriting leading to large underwriting losses.
5. Softening of the insurance/reinsurance market. Liberalization of insurance sector in India allows private insurers to play in the market which may lead to the coagulation and de-coagulation by merger, take-over and other form of reorganization and thus the readjustment of liabilities. The factors underpinning major mergers and acquisitions are various such as achieving sufficient size to maximize economies of scale and to be competitive in international markets, to spread human resources and production costs over a bigger customer base, to broader risk exposure over different geographic regions and to spread and sustain information technology expenditure are all key factors<sup>47</sup>.

<sup>47</sup> Julie Anne Tarr, "Some Critical Legal Issues Affecting Insurance Transactions Globally", *Journal of Business Law*, 52, Nov., 2001.

6. Commutation is also used to runoff a line of business so as to avoid statutory reporting penalties for reinsuring with non-admitted or "non-qualified" reinsurers.

Priorities differ from company to company but, in general, commutations are now thought of as being of positive value to risk carriers and can benefit both the cedant and reinsurer. At the same time, Commutation is not always advisable. Commutation is usually used to bring finality in a long tail account. In this situation if the reinsured gets his IBNR (Incurred But Not Reported) estimated wrong or if an unforeseen catastrophe occurs, which requires the reinsured to respond under a contract which, but for the commutation, would have been protected by the reinsurance, the reinsured will be left without cover. On the other hand, if the amount recoverable is small and if the reinsurer is a slow or erratic payer, it may well benefit the reinsured to accept lump sum in commutation of all future liabilities on the part of that reinsurer. From the reinsurers' perspective, commutation is obviously attractive in respect of long tail business, the outcome of which is uncertain, provided the reinsured's estimate is within limits. Besides this there are many more reasons, discussed later in the paper, which makes it profitable and thus desirable for the companies to carry out commutation.

## **BENEFITS OF COMMUTATION**

Commutation has a strategic importance. For both the parties i.e. for cedent and the reinsurer, commutation has different benefits. Here are some:

A. From the cedant's perspective, the main benefits may be summarised as follows:

- Avoidance of a bad debt in case of reinsurer experiencing financial difficulties, it may be unwilling or unable to pay claims as and when they arise. To avoid that debt, commutation of liabilities can be resorted to. This is because the money can be recovered when they have assets to pay-off their liabilities. If commutations with such weak reinsurers/reinsured is delayed, there is a possibility that their liabilities may increase as compared to their assets leading to run-off/liquidation. In such cases, we will be unable to recover the full amount due to us.
- In case reinsurer goes runoff, (a situation where company cease underwriting new business), it is wiser to go for commutation to readjust the liabilities in time when these companies are still in a position to meet part of their liabilities. There is every likelihood that the situation may deteriorate over time leading to a situation where their commutation proposal would become meaningless because it may be difficult to effect recoveries.

The fact is that the Companies in run-off do not propose commutation of outstanding losses at the generally accepted percentage of 90%/95%. The offer is normally made at a lower percentage e.g. 50-60% of outstanding losses and 80-90% in case of outstanding balances. Although the amount

proposed is less than what is generally claimed, it is advantageous to accept the offer (although at a lesser percentage), as there are good chances of these companies going into liquidation. Once these companies go into liquidation, recovery takes a number of years and full amount due is also not receivable. There is also investment loss. As already mentioned, GIC has received a number of commutation proposals from runoff companies where GIC has both acceptances and placements. It is in respect of these companies that GIC has to accept (after negotiation) on time their proposal as this would help in cash flow and become source of income through investment. So it is beneficial to commute with such companies.

In the present scenario, though with the change in GIC's role as the Indian Reinsurer, a part of the current outward would become run-off but its solvency has not affected. It is because the GIC going runoff is not due to its insolvency but due to change in public policy. Therefore, there is desirability for a close look into commutation proposals on our outward placements, of course, with adjustments in respect of corresponding accounts of the SWIFT portfolio.

- Increased cash flow if the cedant itself is experiencing financial problems or is indeed in liquidation or a Scheme of Arrangement. Cash flow may be an overriding consideration.

B. From the reinsurers perspective, the main benefits may be summarised as follows:

- In case of long-tail claims it is beneficial for the reinsurers to commute and payoff the liabilities in time. The reinsurance treaties, especially in classes like engineering and hull, are long tail in nature and it could take several years for full settlement of the claims. Moreover during the long delays in the court awards and settlements, inflation also tend to increase the monetary value of property of liabilities, that makes it difficult for the reinsurer handle them. It is well-accepted proposition that costs postponed are certainly costs increased<sup>48</sup>.
- Crystallization and mitigation of underwriting losses under the reinsurance contract, where the results have exceeded industry standards.
- A reduction in the administration costs by a removal of all paperwork, and hence saving of human resources where the treaties causing regular workloads for no great reward. Commutation would recover the money in good time for the cedants, perhaps even allowing them to avoid some problems of weak security by recovering early, and reducing the administrative burden in the reinsurers' offices. Clearing out mundane work would also give the staff more time to concentrate on the more significant issues facing their companies.

<sup>48</sup> Julius Neave, *Speaking of Reinsurance* (Middlesex: Kluwer Publishing, 1980) at

## CHAPTER 4

### FRAME-WORK OF STUDY

As is clear in the second chapter, the problem exists at two levels. **For the first level of problem**, which is related to the administrative law, the study is directed towards evolving an arrangement or a system wherein the officers/employees of the government company can take a prudent decision, which is economically efficient, or say which is profitable to the company without any consideration or pressure from outside or inside.

Evolving a system of efficient decision-making by the officer depends upon two factors. First factor pertains to conferring the discretionary powers on the officials of the company and creating an environment free from day to day interference required to exercise that power. Second factor pertains to the clubbing of interest of the officer and that of the corporation so that he can take decisions, which serve the best interest of the company and consequently of his own.

The study start with the premise that executive has been conferred discretionary power, which is essential to run the administration. It is all the more needed to run the business, which cannot be operated within strict confines. Taking the existence of discretionary power of the officers, the study will look into paraphernalia of procedural and substantive requirements, which



ultimately makes the discretionary power an empty bag. It is available on papers only.

The inaction on the part of officer is not due to his disinterest but the fear of harassment. In the current social and political milieu, it is easy to blame/punish an individual officer for taking wrong decisions, but its conditions, which create a fertile ground for inaction, are generally overlooked.

This study is directed towards creating an environment where the discretionary power is extended to the meaningful limits and where the officer concerned is given the complete freedom to exercise the discretionary power coupled with accountability in the best interest of the business.

This is very essential given the peculiarity and exclusivity of the business, General Insurance Corporation is carrying out. There can be reasons for the Government to interfere in the direct business to give effect to many social or say political objective but in case of reinsurance, no socio-political agenda can be fulfilled. Reinsurance is carried out purely on the commercial/ economic lines. So system should be directed towards giving great deal of discretion coupled with accountability.

With respect to the second aspect, which relates to the clubbing of interest of the corporation and that of the employees so as to increase their interest in the enterprise and thus increasing the productivity. This involves different kinds of incentive system. One possible system that can be developed is to make the employees the owners of the enterprise and responsible for the growth of the

same. They should be given the opportunity to participate in the decision making process.

Another option can be to develop contract system whereby the top management and other key officials are engaged to achieve specific objectives and thereby given the full freedom to carryout the business to achieve that. It may take the form of performance contract or managerial contracts.

Before discussing the suitability of the option in regard to GIC, let us first see what is the discretionary power, why it is essential to the run the administration and more specifically the business. The executive carries out its activities through departments, statutory corporations and government companies. Depending upon the type of organization, the scope of discretionary power varies.

This will be followed by a brief introduction of what employee ownership is all about with all its benefits and costs. And the system of contractual hub can be developed to increase the efficiency of the officers.

### **Discretionary Powers**

The functions dischargeable by the administration may either be ministerial or discretionary. A ministerial function is one where the relevant law prescribes the duty to be performed by the concerned authority in certain and specific terms leaving nothing to the discretion or judgment of the authority.

According to Keir and Lawson, "many of the acts performed by the public authorities or public officers are done in strict obedience to the rules of statute or common law which impose on them a simple and definite duty in respect of which they have no choice".<sup>49</sup>

Discretionary power lies where the power is given to make a choice between/ among alternative course of actions<sup>50</sup>. It is realized that a Government having only ministerial duties with no discretionary functions will be extremely rigid and unworkable, so to some extent, officials must be allowed a choice as to when, how and whether they will act.

Discretion has become an all-pervading phenomenon of modern age.<sup>51</sup> There are some good reasons to confer discretion on administrative authorities<sup>52</sup>, to deal with the problems by cast-to-case level, which are as under:

- The present day problems which the administration is called upon to deal with are of complex and varying nature and it is difficult to comprehend them all within the scope of general rules;

<sup>49</sup>. Keir and Lawson, *Cases in Constitutional Law* 402 (1967).

<sup>50</sup>. Davis *Discretionary Justice* 4 (1969).

<sup>51</sup>. M P Jain & S N Jain, *Principles of Administrative law* (Nagpur: Wadhwa and Company, 1999) 327.

<sup>52</sup>. *id.*

- Most of the problems are new, practically of the first impression. Lack of any previous experience to deal with them does not warrant the adoption of general rules;
- It is not always possible to foresee each and every problem but when a problem arises it must in any case be solved by the administration in spite of the absence of specific rules applicable to the situation;
- Circumstances differ from case to case so that applying one rule mechanically to all cases may itself result in injustice.

However there are several disadvantages<sup>53</sup> in the administration of case-to-case approach as compared with the adoption of a general rule applicable to all similar cases. Such as:

- A general rule usually avoids retroactivity and operates in future so that one has prior notice of the rules and thus may regulate his conduct accordingly. In case-to-case approach, the individual may be caught by surprise and may not be able to adjust his affairs in the absence of his ability to foresee future administrative action.
- Case to case approach involves the danger of discrimination amongst various individuals.

<sup>53</sup> M P Jain & S N Jain *Principles of Administrative law* (Nagpur: Wadhwa and Company, 1999). At 328.

- The process is time consuming and involves decision in a multiplicity of cases.
- There is danger of abuse of discretion by administrative officials.

## PUBLIC UNDERTAKINGS

Not all the trade, commerce or business activity is left to private enterprise. The Government is present, to a large extent, into business and industrial activities, which has been on increase, in India, since independence<sup>54</sup>. Certain constitutional provisions and economic policies support state's involvement. Art. 298<sup>55</sup> extend the executive power of the State to carrying on any trade or business. Art. 19(6) allow the state to carry on any trade of industry by itself or through a corporation owned or controlled by it to the complete or partial exclusion of citizens<sup>56</sup>. The Directive Principles of State Policy in the constitution lay down in clear and unequivocal terms that the State shall so direct its policy that:

<sup>54</sup>. VKRV Rao, "The Role of Public Enterprises in the Indian Economy", 10 IJPA, 412, (1964).

<sup>55</sup>. 298. Power to carry on trade, etc. – the executive power of the Union and of each State shall extend to the carrying on of any trade or business and to the acquisition, holding and disposal of property and the making of contracts for any purpose:  
Provided that –  
the said executive power of the Union shall, in so far as such trade or business or such purpose is not one with respect to which Parliament may make laws, be subject in each State to legislation by the State; and  
the said executive power of each State shall, in so far as such trade or business or such purpose is not one with respect to which the State legislature may make laws, be subject to legislation by Parliament.

<sup>56</sup> Jain *Indian Constitutional Law*, Ch. 12.

- (a) The ownership and control of material resources of the community are distributed to sub serve the common good; and
- (b) The operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

### **Department v Public Enterprises**

State carries on its activities through either departments or autonomous bodies including statutory corporations and government companies<sup>57</sup>. The economic and commercial activities are run effectively through autonomous bodies because of certain inherent disadvantages in running through departments, which is not conducive for the efficient management of the commercial enterprises. Some of the reasons are as under:

- A. The staff of departmental enterprises consists of civil servants whose terms of recruitment and conditions of service are the same as those of the government servants. It is usually not possible to promote anyone on merit or take prompt disciplinary action.
- B. Procedure to obtain sanctions for expenditure are tardy because the cash receipts are put into Government

<sup>57</sup>. The Companies Act 1956 defines u/s 617 "Government company" as any company in which not less than fifty-one percent of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central

account and can not be taken out without special sanction.

- C. Governmental enterprises are subject to the same procedures regarding accounting, auditing and budget control and purchase and sale as are applicable to other government departments.

### **Statutory Corporation v Government Companies**

The system of autonomous bodies has grown because of the felt-need to ensure freedom and flexibility of approach to an undertaking so that it may act with initiative and necessary expedition. However the crucial question arises as to the choice between the two forms of organization – statutory corporation v. governmental company - to run a commercial enterprise.

Immediately after the independence, the statutory corporations form was in vogue<sup>58</sup>. But with the change in government policy, it came to prefer the company-type organization to the statutory corporations<sup>59</sup>. It was because of the workload, the parliament found it difficult to pass the large volume of legislation necessary for establishing a large number of statutory corporations. Whereas the company can be formed by the executive without parliamentary

Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government company as thus defined.

<sup>58</sup>. The Industrial Policy Resolution of 1948 envisaged that the management of the public enterprises will, as a rule, be through public corporations.

<sup>59</sup>. The Bureau of Public Enterprises, Annual Report for the Year 1970-71 showed that out of 97 public undertakings listed for review, only six were statutory corporations and all the rest were government companies.

sanction by drawing up Articles of Association and getting it registered under the Companies Act 1956.

The companies is the preferred form of organization where an enterprise is to be launched in association with a private entrepreneur – national or foreign; or where it has to be started with a view to eventually transferring it to private hands; or where the government has to acquire shares of an existing enterprise in an emergency to meet financial or employment crises of a nationally important private undertaking.<sup>60</sup>

Whereas the statutory corporation is more appropriate when it is necessary to meet certain peculiar needs of an undertaking e.g. when it is a public utility or is in the nature of monopoly or requires special provisions or when some existing private enterprise is being nationalized.<sup>61</sup>

The companies are preferred over statutory corporations because companies enjoy the flexibility over statutory corporations as the amendments can be made easily in the articles of association of a company as the experience is gained over a period of time. This is precisely the reason for the abuse of power by the executive in such companies.

<sup>60</sup> M P Jain & S N Jain *Principles of Administrative law* (Nagpur: Wadhwa and Company, 1999) 974.

<sup>61</sup> *Id.*



The government companies are run for all practical purposes as government departments and has thus become adjunct to ministries. The concept of autonomy is diluted as the ministries, which "writes and can revise its Articles of Association", largely control the companies by keeping them outside parliamentary scrutiny and control. In case of statutory corporations, adjustments can be made only by amending the statute, which is not easy because of the pressure of work on the legislature.

There is one more reason that necessitate more interference by the Government in public enterprises in general and in companies in specific because of its suitability for the same. It is that, unlike private companies, the Government companies are "*instrumentality of the State*"<sup>62</sup> which makes them state under Article 12 of the Constitution. From this point of view, the government exercises more control over these companies diluting its, supposedly, independent character because of its answerability for those companies. Its control reaches to the extent of intervention without any substantial cause in day-to-day decisions of the management.

The flexibility, which government enjoys vis-à-vis a government company makes this organizational forms more attractive to the government than a statutory body. This has been criticized frequently.

<sup>62</sup> Ramana v I.A.A.I., 1979 S.C. 1628. In this case it was held that any body or authority, whether constituted by statute or not may come within the definition of 'State' under Article 12, if it acts as an 'agent or instrumentality' of the Government. This instrumentality does not mean the relationship between a principle and agent under the law of contract but the factum of such body exercising governmental powers or functions so that its acts may be treated, under constitutional law, to be 'State action'.

## CRITIQUE ON GOVERNMENTAL INTERFERENCE

The formulations that the public sector should be "like Caesar's wife, it should be above suspicion" has led to such institutional arrangements as double audit and the jurisdiction of the Vigilance Commission, which had demoralizing effect on the management. Duplication of audit, one by statutory auditors and again by CAG, apart from being time consuming, causes unnecessary harassment.

What is worse, however, is the vigilance procedure, not only for suspected offences against the law but also for violation of administrative procedure. The procedures are sometime so long-drawn that they continue to haunt their victim years after the event has occurred and sometimes after the officer concerned had retired.

Fear of audits and vigilance by CVC has nullified the enhancement of financial powers by 50% to 60 for senior insurance officials across various cadres at the four state-owned general insurance companies, "for the settlement of claims, refunds and disposal of salvages". The fear of CVC has deterred many officials from using their enhanced power as the "quick" passing of claims may come under suspicion.<sup>63</sup>

<sup>63</sup> "News in Brief: CVC Clouds over Insurance Claims", Insurance Post, Vol. XXI, No. 4, April 2001.

With this specter of harassment and even possible prosecution it is no surprise that there is a reluctance on the part of public sector executives to take better managerial decision, in business, this can be a serious handicap, for bold decision some of which may even turn out to be wrong, are the essence of entrepreneurship.<sup>64</sup>

The Sachar Committee has said recently that through the company structure, the ideal of separating commercial activity of the government from bureaucratic intervention has not been achieved in practice because "the administrative ministries or departments which promote these companies make them function as appendages" and the government company becomes "an extended arm of the government department" so much so that it becomes difficult to distinguish between a government company and a departmental undertaking. The committee has underlined the view that "efficient conduct of industrial and business enterprises requires that operational decision should be prompt and that there should be far greater delegation of authority than at present and flexibility of operations to enable the management of public enterprises to produce results."<sup>65</sup>

They should be put in such an environment where sword of Damocles of harassment by the audit or the political interference no longer has any scope. For this purpose, the scope of reducing the extra audit of insurance and reinsurance companies will be considered. Jha Commission in its report

<sup>64</sup>. Trauma of Public Sector, Ed. Dr. S. M. Patil, Maj. Gen. SCN Jatar etc. (New Delhi: DC Publications, 1992) at 1.25.

<sup>65</sup>. Sachar Committee, *A Study Report on Companies & MRTP Acts*, 130 (KD Kale ed.)

suggested for removing the double audit system for public enterprises so as to bring them at par with those of private enterprises. The audit by CAG may stifle the innovative management and aggressive entrepreneurship. The very purpose of creating public enterprises in the form of companies and statutory corporation is to give them more autonomy and make them operate on commercial lines, which is not present in government departments. One view is that instead of maintaining CAG audit for public enterprises, the ability of public enterprises to raise resources on their own (since these companies or corporations cease to make demands on the budget) can be the better criterion to judge their performance.

### **REASONS FOR FAILURE OF PUBLIC ENTITIES**

Notwithstanding the form of organization facilitating governmental interference the public entities have shown the inefficiencies across industries. The insurance sector is no exception to that. The main reason for the poor performance of the public enterprises can be traced as under<sup>66</sup>:

- (a) Unclear Goal
- (b) Lack of Managerial Autonomy
- (c) Financial Difficulties
- (d) Wages and employment (overstaffing)

### **IMPROVING THE EFFECTIVENESS OF THE PUBLIC ENTERPRISES**

The fact that public enterprises perform poorly does not mean that the public sector is incapable of getting it right. The effectiveness of public enterprises can be improved by applying three core instruments to reinforce commercial operation in the public sector. These are as mentioned:

- (a) Corporatization, which establishes the quasi-independence of public entities from noncommercial pressures and constraints.
- (b) Explicit Contracts between governments and managers or private entities involved increasing the autonomy and accountability by specific performance objectives that embody government-defined goals.
- (c) Pricing strategy designed to ensure cost recovery, which creates a desirable form of financial independence for public entities.

Though one of the possible ways to make the public enterprises more effective and efficient is the corporatization, which insulate the same from many government constraints and pressures. The corporatization stipulates the subjection of entity to standard commercial and tax law, accounting criteria, competition rules and labour law and is less susceptible to government interference. Corporatization requires the transfer of employees from civil services status to contracts governed by ordinary labour law. Commercial accounting procedures through cost accounting identifies non-remunerative activities and reveals sources of inefficiencies, making cost and benefit more transparent in public enterprises.

Secondly, corporatization provides an organizational structure but by itself it merely transforms the problem of official governance into more tractable,

<sup>66</sup> "World Development Report: Infrastructure", (Oxford: New York University Press, 1994)

although still difficult, task of corporate governance. Organizational changes alone neither provide clear goals nor create incentives for managers to meet these goals. It is generally argued that public enterprises are run on commercial principles but this has not helped managers to be more effective because their arguments is that the autonomy they get is too limited to be effective and that it is too easily revoked. At the same time, workers argue that they have little incentive to be effective because good and poor performers are treated equally. Even users argue that corporatization has not given them access to improved or expanded services.

This problem of corporate governance can be solved by two ways:

First is to introduce the market principles such as:

- (a) Adequate competition;
- (b) Level the regulatory playing field; or
- (c) To maximize the profits or to achieve set rates of return.

Secondly, if these market solutions cannot be used to address corporate governance problem then there is one more approach that can be adopted is to create a contractual hub in the company implying that the managerial and top key officials can be employed on contract basis, compensation depending upon their efficiency and fulfillment of the objective for which they are employed.

These contracts can be of three kinds:

- (a) Performance agreements;

(b) Management agreement;

(c) Service agreement.

## **EMPLOYEES' OWNERSHIP**

There is another way to increase the efficiency of the employees is to club their interest with that of the company. All the employees, whether permanent or temporary can be conferred the ownership, varying in nature as the case may be. Let me first give account of what is employee ownership, its forms and how it can be effected.

The concept of employee ownership is evolved in response to the decline of unionism and the resulting search for other means of assuring efficiency and equity in labour contracting. Where as in East, the concept has been stimulated by the rapid collapse of state socialism and the subsequent search for market oriented ownership structure that stop short of a direct leap into full finance capitalism. The employee ownership has both benefits and its cost, like any other form of ownership. The main benefits of employee ownership include the incentive to the employees to work more for the interest of the company. It also helps in reducing the harmful behaviour of the employee such as strikes and lockouts or leaving the company and joining other for some appreciation etc.

### **Types of Employee Participation:**

Basically ownership involves two rights,

(i) the right to control the firm (which may take an attenuated form of a right to vote in electing the firm's directors and on major corporate transactions); and  
(ii) the right to receive the firm's residual earnings. The employees may participate in either or both of these rights to a lesser or a greater degree.

**1. Direct Employee Ownership:** DEO involves the right to votes and apportionment of earnings among employees according to the amount of work they contribute to the firm. It is convenient in such an arrangement to form cooperative corporation or partnership though Stock Corporation can also be employed with shareholdings manipulated to maintain proportionality to the amount of work contributed rather than the amount of capital.

DEO is quite common in the professional service sectors. Such as law firms, accounting and management consulting etc. In such firms, the ownership is not shared among all of the firm's employees but rather is confined to professionals and even then is awarded only to those who have survived a period of apprenticeship. This is not true only in professional services firms but nearly all firms show this trend that the ownership is confined to only a subset of the firm's employees.

Outside professions, there are several other service sectors in which direct employee ownership is relatively common. One of these is transportation – including bus services, taxicab services and trucking – where firms are often owned collectively by their drives.



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Outside professions, there are several other service sectors in which direct employee ownership is relatively common. One of these is transportation – including bus services, taxicab services and trucking – where firms are often owned collectively by their drivers.

**2. Employee Stock Ownership:** In this system, the firms are structured as a conventional investor-owned business corporation, in which votes and earnings are allocated according to amounts invested and then sell some or all of the stock to the firm's employees.

**3. Earnings Rights only:** Employees are given the sole claim on a firm's earnings but no control. The ICOM cooperative in UK is formed on this pattern.

**4. Control Rights only:** There is reverse pattern, in which employees are given a share in control while having no claim on the firm's residual earnings. Germany has specially this kind of arrangement in almost all of its large firms where employee representatives are given half the seats on a firm's board of director.

For the second level of problem, there is a need to develop a standardized rules and regulations or norms for the conduct of commutation. Presently, the commutation is carried out, if at all, through brokers. Generally brokers, while getting the business for the company, get the share of commission based on the amount involved. But in case of commutation their share is not based upon any amount offered or accepted by the company, rather they get the fees for the whole dealing. So their interest is limited to receive fees irrespective of the commutation getting mature in favour of the company. Because of lack of their interest in the deal, another alternative needs to be evolved. Instead of taking services of outside broker, the possibility of opening a cell within the company itself comprising of its employees should be sought out. It will have two benefit,

one the surplus staff will be used and secondly extra money, which is paid to the broker can also be saved.

## CHAPTER 5

### NON-LIFE INSURANCE INDUSTRY IN INDIA

Before appreciating the position of reinsurance in India and GIC being national reinsurer, it is relevant to browse through the position of insurance industry in India. It is relevant in order to appreciate the emergence of National Reinsurer in India and what advantages or disadvantages it can have for Indian economy.

The insurance industry in India, till recently, was monopolized by the State. This sector was nationalized with the passage of Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972. Under this scheme all the 107 the then existing entities were merged into four state owned non-life insurance companies with GIC as its holding company. The objective of nationalization is to develop general insurance business in the best interest of the community. This had the effect of running the business on priority basis fixed by the State rather than purely on commercial lines.

The GIC and its subsidiaries have fulfilled many of the expectations of Nationalization, such as the reach of insurance to the remote places (office virtually in each district), substantial investment in socio-economic sector and catering to rural India (development of rural non traditional covers).

In Feb. 2001, the insurance sector was opened for the private players. On the recommendations of Committee on Reforms in Insurance Sector (CRIS), the insurance sector witnessed changes, which are as under:

- Establishment of IRDA to regulate and develop the insurance in India;
- Functional autonomy to the Subsidiaries of GIC;
- GIC to act as "National Reinsurer"
- New private entrants in insurance business;

Insurance Regulatory and Development Authority (IRDA) is established to regulate the private players and supervise insurance business. Insurance is a service industry that runs on trust. So the presence of Regulator would ensure that the market does not create anarchy and panic, as was the case during pre-nationalization days.

The Government has designated the General Insurance Corporation of India as the national reinsurer<sup>67</sup>. The IRDA has adopted the compulsory cession to a national reinsurer followed by a voluntary agreement amongst the insurers for retrocession arrangement<sup>68</sup>. Before going into the profile of GIC for the case study, let us see what are the advantages of establishing a national reinsurance institute, which is state owned and controlled.

<sup>67</sup> Annual Report, 2000-01, Government of India, Ministry of Finance, New Delhi.

<sup>68</sup> Under sec. 101A "every insurer shall reinsure with Indian reinsurer such percentage of the sum assured on each policy as may be specified by the authority with the previous approval of the Central Government under subsection (2)."

The subsidiaries of General Insurance Company are given functional autonomy. Though there are proposals for de-linking these companies from GIC and making them separate and independent, however, till date, no action has been taken in this direction.

The state monopoly was also diluted in favour of private players with the Insurance Regulatory and Development Authority<sup>69</sup> issuing certificate of registration to the thirteen new insurance companies<sup>70</sup> besides state-owned four companies operating in non-life insurance business. Out of these thirteen companies, eight are carrying out life insurance<sup>71</sup> and five<sup>72</sup> general insurance business. With a view to cease the exclusive privilege of LIC and GIC in life and non-life business, the amendments were carried out in Life Insurance Corporation Act, 1956; General Insurance Business (Nationalization) Act, 1972; and Insurance Act 1938.

<sup>69</sup> Insurance Regulatory and Development Authority was established on 19<sup>th</sup> April, 1999 by the Insurance Regulatory and Development Authority (IRDA) Act, 1999 passed by both the Houses of Parliament, to protect the interest of holders of insurance policies and to regulate, promote and ensure orderly growth of the insurance Industry.

<sup>70</sup> Annual Report for 2000-01, Government of India, Ministry of Finance, New Delhi.

<sup>71</sup> (i) HDFC Standard Life Insurance Co. Ltd; (ii) ICICI Prudential Life Insurance Co. Ltd. (iii) Max New York Life Insurance Co. Ltd. (iv) Om Kotak Mahendra Life Insurance Co. Ltd. (v) Birla Sun Life Insurance Co. Ltd. (vi) Tata-AIG Life Insurance Co. Ltd. (vii) ING Vysya Life Insurance Co. Ltd. (viii) SBI Life Insurance Co. Ltd.

<sup>72</sup> (i) Royal Sundram Alliance Insurance Co. Ltd. (ii) Reliance General Insurance Co. Ltd. (iii) IFFCO-TOKYO General Insurance Co. Ltd. (iv) Tata-AIG General Insurance Co. Ltd. (v) Bajaj Allianz General Insurance Co. Ltd.

## CHAPTER 6

### REINSURANCE IN INDIA

This chapter deals, largely with the reinsurance in India with GIC being notified as National Reinsurer. Before going into the profile of GIC and other related aspects relating to reinsurance, this chapter will deal with the history of specialized reinsurance companies.

In earlier times, the reinsurance was exchanged between insurance companies but with the passage of time the companies encountered many problems in this system that attribute to the origin of specialized reinsurance companies. The evolution of specialized reinsurance companies is necessary to be looked into to comprehend the factors that led to their evolution and justifications for having them. Then *raison d'être* for the emergence of state-owned reinsurer shall be examined. This will be followed by the statement of benefits or advantages that a specialized state-owned reinsurance company can give to an economy. Then the chapter shall end with the with the profile and the purpose of National Reinsurer in India.

#### HISTORY OF SPECIALIZED REINSURANCE COMPANIES

Reinsurances were first exchanged between direct insurers, sometimes competing in the same markets. Although reinsurance was an improvement on coinsurance, the reinsurer could still obtain valuable information about the

ceding company's business whether the reinsurance was placed facultatively or by treaty and possibly could use it to compete unfairly for direct insurances. The only main constraint on an unscrupulous reinsurer was the knowledge that in so far as its reinsurance business was conducted on a reciprocal basis its ceding offices had the same amount of information about the reinsurers' own direct business.

Probably this is one of the factors that led to the establishment of companies specialized in reinsurance business. However the first reinsurance company was established in 1842 by a German direct insurance company for the sole purpose of handling surplus lines from its parent company, so bypassing competitors.

An unsuccessful attempt was made in the same year to form the world's first independent reinsurance company, the Kolnische Rucksversicherungs Gesellschaft, but it was not until 1852 that the company was able to commence business.

The early developments of what have come to be known as professional reinsurance companies took place on the Continent of Europe, where the world's two leading reinsurance companies, the Munich Reinsurance Company and the Swiss Reinsurance Company were formed in 1880 and 1863 respectively. The first successful British company was Mercantile & General founded originally as a direct insurer in 1907.



Likewise in America professional reinsurance companies were slow to evolve. The first record is of a company, the Reinsurance Company of America, which was wound up on 1890. Another 19 years passed before the next company was formed in 1909.

## **STATE-OWNED REINSURANCE INSTITUTION**

The political and economic upheavals of the 20<sup>th</sup> century have markedly changed many domestic and reinsurance markets. Throughout the Communist bloc and in many other Socialist states insurance was nationalized with the establishment of separate state reinsurance corporations to transact business on international reinsurance markets, usually on a reciprocal basis with the corporations accepting foreign reinsurances in exchange for its own cessions.

Although the start of the 1990s has been marked by a reversal of such policies in several countries in Eastern Europe and other parts of the world, with state corporations being privatized and new private companies being allowed to be established, state insurance and reinsurance corporations still remain in many countries.

Although the state insurance corporation may be able to harness the full capacity of its domestic market, for various reasons it still will be necessary to purchase some reinsurance from abroad. To minimize the foreign exchange costs of such external reinsurances State Corporation may seek the reciprocal exchange of business from reinsurers. But over the last 25 years two other

devices have been adopted. Developing countries in various parts of the world, sometimes as part of more general economic groupings have organized regional underwriting pools for the exchange of surplus lines. Also a number of regional reinsurance corporations (such as the African Reinsurance Corporation) have been formed to maximize the amount of premium income retained within a region.

In developing countries, the reinsurer is, generally, state-owned and monopolizes the market unlike the developed countries where the reinsurance sector is privately owned and at the same time many players are allowed in the market. The reasons to establish the state-owned exclusive reinsurer in the developing countries vary from country to country<sup>73</sup>. One probable reason could be that in many developing countries insurance business was for a long time practiced by foreign insurers or by subsidiaries of foreign insurance and reinsurance companies, from which a normal flow of reinsurance business to a local reinsurer could not be expected, since such business was normally handled by the head offices abroad. That is probably the reason for establishing these reinsurance institutes, not purely for commercial/profit oriented or improving the balance of payment position but to maximize the capacity for the cover of large and complex risks within these countries only. But this has an inherent danger. In an attempt to preserve foreign currency

<sup>73</sup>. "Reinsurance Problems in Developing Countries", A Study conducted by UNCTAD Secretariat (New York: United Nations, 1975) at 35.

reserve, governments sometimes, out of ignorance, expose the economy to the indigestible loss<sup>74</sup>.

The creation of exclusive state-owned reinsurer, for developing countries, has following benefits<sup>75</sup>:

- It achieves the **higher national retention** and hence **reduces the foreign exchange outflow** due to reinsurance premium.
- Enhancement of **additional national retention or over-all risk bearing capacity** by the redistribution of surpluses, which exceed the capacity of the reinsurance institutions, up to a certain level, among the national ceding companies.
- Due to participation in all business underwritten in the country, the national reinsurer assumes the character of the **data collecting center**, which has the impact in sound development of the insurance market because it can provide local companies with information about risks, tariffs and claims, a broad knowledge of market conditions and many other matters which the direct companies when left to operate on their own cannot possibly acquire.

<sup>74</sup> Julius Neave, *Speaking of Reinsurance* (Middlesex: Kluwer Publishing, 1980) at 160.

<sup>75</sup> "Reinsurance Problems in Developing Countries", A Study conducted by UNCTAD Secretariat (New York: United Nations, 1975) at 35.

- The centralization of business ceded through one reinsurance institution brings more **technical skill and greater bargaining power** to bear in negotiating with foreign reinsurers than could individual local companies. It also fetches the sounder reciprocity with a subsequent reduction in the net out-flow of foreign exchange.
- The existence of reinsurance institution may render **regional co-operation** in the field of insurance easier and more promising than it would be if the market were exclusively in the hands of direct-writing companies. For instance, the creation of regional reinsurance pools is facilitated if central, national institutions, which deal with whole cross-section of each domestic insurance, represent the companies of the countries concerned.
- Last but not the least, the reinsurance institution plays a great role in the **capital formation** for the development projects.

## **NATIONAL REINSURER IN INDIA: A PROFILE OF GIC**

The General Insurance Corporation has been notified as National Reinsurer. The General Insurance Corporation is a private company<sup>76</sup> registered under the Companies Act, 1956<sup>77</sup> with the object to regulate, supervise and control the business of General Insurance in India in best interest of the community and in

<sup>76</sup> Clause 3 of the Articles of Association of the GIC says "The Corporation is a private company..."

this direction, to aid assist and advise its subsidiaries in the matter of setting up of standards of conduct and sound practices and in many other aspects.

The notification designating the GIC as the national reinsurer has changed the role of the GIC from one of supervisor and controller of the insurance business to the one that is doing reinsurance business in the domestic as well as in the international market. The objective behind this change in role is to have maximum retention of risk in India and thus saving foreign exchange and making India a 'reinsurance hub in the Asian region.

General Insurance Corporation, as the name implies has been corporatized in its structuring but not in form. Not all incidents of corporatization, till date, have been incorporated in the GIC. To bring true corporatization in GIC, introduction of corporate governance is necessary to bring about autonomy coupled with accountability.

As far as commutation is concerned, there is no direct mention, in the objective of the company. Commutation can be imported within Clause III (B) (1)<sup>78</sup> of the Memorandum of Association of GIC that prescribes one of the incidental or ancillary objective to be attained by the Company. The power and the authority

<sup>77</sup> GIC was incorporated in pursuance of Section 9(1) of the General Insurance Business (Nationalization) Act, 1972.

<sup>78</sup> It says to pay, satisfy or compromise any claims made against the company in respect of any contracts of insurance granted by, dealt in or entered into by the company, which claims the Company may deem it expedient to pay, satisfy or compromise notwithstanding that the validity thereof at law may be disputable and to revive any contracts that may have become void or lapsed on such terms and conditions and in such cases as may be deemed expedient or in lieu of reviving any such contract or make any other concession in favour of the persons or nay of the persons entitled to such contract.

of the directors to commute can be read in clause 23 (X)<sup>79</sup> of the Articles of Association of the GIC.

<sup>79</sup> To enter into all such negotiations and contracts and rescind and vary all such contracts and execute and do all such acts, deeds and things in the name and on behalf of the corporation as they may consider expedient for or in relation to any of the matters aforesaid, or otherwise for the purpose of the corporation.

## CHAPTER 7

### CASE STUDY IN GIC AND NEW INDIA ASSURANCE COMPANY

#### PRACTICE ON COMMUTATION: ANALYSIS OF DATA

In India, till recently, only state-owned GIC subsidiary companies were involved in direct non-life reinsurance business and consequently commutation. As far as commutation is concerned, there is no direct mention, in the objective of the company. Commutation can be imported within Clause III (B) (1)<sup>80</sup> of the Memorandum of Association of GIC that prescribes one of the incidental or ancillary objective to be attained by the Company. The power and the authority of the directors to commute can be read in clause 23 (X)<sup>81</sup> of the Articles of Association of the GIC.

<sup>80</sup> It says to pay, satisfy or compromise any claims made against the company in respect of any contracts of insurance granted by, dealt in or entered into by the company, which claims the Company may deem it expedient to pay, satisfy or compromise notwithstanding that the validity thereof at law may be disputable and to revive any contracts that may have become void or lapsed on such terms and conditions and in such cases as may be deemed expedient or in lieu of reviving any such contract or make any other concession in favour of the persons or nay of the persons entitled to such contract.

<sup>81</sup> To enter into all such negotiations and contracts and rescind and vary all such contracts and execute and do all such acts, deeds and things in the name and on behalf of the corporation as they may consider expedient for or in relation to any of the matters aforesaid, or otherwise for the purpose of the corporation.

Till the collection of data, GIC got total 88 offers for commutation out of which around 49<sup>82</sup> offers were materialized and 39<sup>83</sup> offers were either rejected or still in abeyance.

The fact is that commutation negotiations are hardly closed; they are usually kept in abeyance or open for further talks. The data pertains to commutation offers made to the GIC between 1996 to Feb. 2001. Out of 49 commutations that materialized, the researcher could lay her hand on only 13 cases<sup>84</sup> during the stay in GIC.

The trends what the researcher observed are as follows:

- The major reason cited for commutation by the offerer is that the claims are almost stabilized or involves less money, to reduce administrative or management expenses in keeping those treaties open through commutation.
- Another reason, *inter alia*, for commutation are change in underwriting policy or to cut long tail liabilities or when the company goes into run-off.
- The average time taken by the company to commute is around 6 months to one year. In some cases, it took around two years to reach final settlement.

<sup>82</sup> Annexure 2.

<sup>83</sup> Annexure 3.

<sup>84</sup> Annexure 4. Case study of 13 commutations of treaties in GIC.



- Complete reliance on only official enquiries (such as asking for balance sheet) and formal commutation offers made by the company. No other informal and analytical inquiries are made by the company (GIC). Such informal inquiries become necessary in case of company going run-off such as finding the reason for going run-off. Whether it is because of investment loss or miscalculation of premium to attract the business or mishandling of claims etc.
- Heavy reliance on brokers is observed. The commutation takes place usually through brokers. All the inquiries, if at all, made are done by the brokers only.
- GIC hardly made any offer, except one or two, to commute with either cedent or retrocessionair.

The New India Assurance Company Ltd. got around 13 offers<sup>85</sup> from different companies from different countries within a period lasting from 1998 to 2001. The observations made by the researcher from the date are similar to that of GIC. Few important observations made with regard to NIA are as under:

- First and foremost point is that till date NIA Co. has never accepted any commutation offer.
- No instance where NIA made commutation offer. This is the situation in other subsidiaries as well.

<sup>85</sup> Annexure 4. Commutation offers made to New India Assurance Company Ltd.

The trend with regard to the reason cited for commutation is varying in nature in case of NIA Co. Reasons include change in underwriting policy, running off entity or running of a particular business or gone into liquidation or to reduce administrative cost as the little money is involved in the claims.

#### **Case of Reinsurance Australian Corporation Limited:**

Reinsurance Australian Corporation is a private limited company, which deals in reinsurance business. The General Insurance Corporation has been retroceding its business with the company since 1980s. At present, the treaties are open as long as since 1990s for which the commutation has been offered.

On 9th March 2000, it sent a letter to GIC through broker<sup>86</sup> stating its intention to commute its treaties with General Insurance Corporation. The reason cited for the commutation is that the company is in a run-off mode. Due to the effect of Windstorm Lother and Martin that hit the Europe, the company is exposed to large risks, which resulted in reduction of capital base of the company that has substantially deteriorated the risk profile. In order to reduce its risk exposure, ReAC has stopped underwriting from 17th Feb. 2000, new business and self-managing its runoff.

The company proposed to commute treaties at 60% of the outstanding losses and 62.5% of the outstanding balances instead of the general worldwide

<sup>86</sup> J. B. Boda & Co. Pvt. Ltd. is a Mumbai based brokers' firm, which deal in reinsurance broking.

practice of 100% of outstanding losses and 90% of the outstanding balances. This is because the company has suffered A\$ 500 mn since Jan. 1, 1998 that is continuing till first half year 2000. The initial offer was calculated at INR 51,910,723.

Not getting any positive response from GIC by November 2000 the company revised its offer to pay INR 65,000,000. But GIC remained unmoved from its stand of commuting at the rate of 90% of the outstanding losses and 100% outstanding balances.

At last the company, not getting any response from GIC to commute without any substantial reason, withdrew its offer to commute on 12th May, 2001 nearly after one and a half year of negotiations/ waiting.

Few observations in this case, made by the researcher are as follows. Firstly, the negotiations between the parties were very formal and minimal. The company hardly made any enquiry to know the real status and the real reason for the deteriorating position of the company and completely relied upon the official releases and other official disclosures made by the company.

The enquiries made about the ReAC contains the financial statement issued by the company for 2000, one article published in the newspaper stating that fact of deteriorating position of the company and its decision to stop underwriting new business because of its inability to fulfil the solvency margin prescribed by the Australian Prudential Regulatory Authority. The GIC never made any efforts

to check the viability of the Company as to how much are the chances that the company will survive this adverse situation. It is very crucial to know such things to go ahead in for commutation. The decision to commute finally, whatever it may be, should be based upon reasons. Prudent 'no' to the commutation is preferred than imprudent 'yes'.

In case the company is on the verge of bankruptcy, the company will be in less favourable position to negotiate for commutation. And further once the company goes in for liquidation on the ground of insolvency, for which there are chances, the claims of GIC will be no more than as the unsecured creditor. This may result in the reduction of the money to be received by the GIC.

companies/corporations may handle the situation better though bearing some loss.

There can be some place for some governmental role in certain areas of direct insurance. For instance, the law requires motorists to have third party liability cover but that facility is inexpertly or insufficiently offered by private insurers, it should be offered by the state. If the private sector is unable to provide or unwilling to provide certain cover required by a statute, there is not alternative to governmental intervention. But this situation does not arise in reinsurance.

The objective of state involvement in reinsurance is financial, because reinsurance does not directly affect the individual. Government interest in reinsurance offers no political advantages and is almost certainly derived from financial rather than social motives<sup>87</sup>. Considering this aspect in mind, the negotiation for commutation and for that matter, the commutation itself should be carried out purely on commercial lines. Since commutation involves huge money and GIC is dealing with public money so accountability is unquestioned.

In India, though the designation of General Insurance Corporation as national reinsurer can be rationalized, there is need to improve its efficiency in general as well as specifically in the context of commutation. Where

<sup>87</sup> Julius Neave, *Speaking of Reinsurance* (Middlesex: Kluwer Publishing, 1980) at 160.

## **CHAPTER 8**

### **LAST WORD WITH SUGGESTIONS**

#### **REFLECTIONS**

This is a case study of General Insurance Corporation of India, which is designated as the National Reinsurer. The study finds that in the present scenario of volatility in the market, the State's involvement as a regulator of direct business and in reinsurance business is justified to retain maximum risk within India. But it should not extend beyond the prudent level where it may be disadvantageous for the economy and against the basic philosophy of the insurance.

State involvement is essential to create balance in the market among private players. Private players remain in the field as long as it is beneficial for them to be there. But in situations such as the case of slump as the one faced by the world economy today, where the private players find it difficult to survive, the Government involvement as market manager gives the cushioning effect to the economy.

In the wake of terrorist attacks when the claims are bound to mount, the burden over reinsurers all over the world is inevitable. In such conditions, where the private reinsurer may find it difficult to cope, the Government

commutation, on the one hand, is a way to avoid future disputes, on the other hand, is a means of credit management, which can be used for the benefit of the company as well as the economy as a whole. But the main hurdle, as has been substantiated earlier, is creating an environment congenial to work independently, without fear or favor.

General Insurance Corporation is the only player in the reinsurance domestic market so it has the responsibility to develop a healthy market so as to attract reinsurance business from foreign companies. It is not by default but by a deliberate choice that GIC is made the only player in the market, so it becomes all the more important to ensure its efficiency.

This is possible if GIC is taken out of the clutches of the Government. The government interference in the day-to-day management should be made minimum and the employees' interests should be clubbed with those of the company. To achieve this objective, introduction of corporate governance is must.

However corporate governance, in its broadest definition can be offered as the process of aligning the interests of the managers of a corporate entity with those of all its stakeholders – employees, creditors and especially, shareholders. Unfortunately there is no straightforward answer to the question if there exists a recognized set of common standard but specific

standards can be developed and adopted keeping in view the needs of the enterprise and in accordance with the corporate culture specific to the national boundaries and/ or business sectors.

Some of the suggestions, general and specific, in the context of GIC are given below. This will help in creating congenial environment, which will facilitate the quick and independent decision-making generally as well as in the context of commutation.

## **SUGGESTIONS**

Considering the peculiarity of the reinsurance business and the fact that it is handled by one state-owned company, there is need to evolve a set of rules and conventions by which the government can help in the better functioning of the GIC.

Here are some suggestions given to improve the efficiency of the General Insurance Corporation of India. Efficiency here means the relationship between the ends and the means. Let me take the liberty to say that the inefficiency occurs when the desired ends can be obtained with less means or more ends can be achieved with less means than are presently employed. So efficiency is measured not by the relationship between the physical quantities of ends or means, but by the relationship between the value of the ends and the value of the means.



## 1. GENERAL SUGGESTIONS

- a) It is unrealistic to think that the public enterprises could be made completely autonomous and independent from government's supervision. Actually it is not that the Government's supervision or guidance, *per se* is bad but that it should be based on well-established rules and conventions so as to make that guidance relevant for the efficient functioning or for achieving the objectives of the enterprise. On these lines, a higher degree of autonomy for the General Insurance Corporation is mooted considering the peculiarity and exclusivity of the business it is dealing in with. But this autonomy does not mean complete freedom. It should be subject to the regulatory oversight by the regulatory authority than by the Ministry. Government is to set clear policies and goals while leaving detailed planning and implementation to the company only. This delegation of responsibility and conscious absence of political intervention is one factor that will attract high-quality managers and help them to take hard and quick decisions in the times of emergency or otherwise without fear or favour.
- b) Reinsurance is one business, which can essentially function successfully on the broadest international basis. After the prudent level of retention of risk in the local market, it is essential to go international level. That makes it inevitable to deal in foreign currency in abundance effecting foreign exchange. This makes it essential to keep a close eye on reinsurance business so the audit by CAG becomes very crucial.

The disability of double audit in the case of public enterprise (which places them in a disadvantageous position vis-à-vis the private sector) should be removed and they should be allowed to complete their accounts, get them audited and submit them to the Annual General Meeting, in accordance with the same procedures and subject to the same formalities as the private sector. But at the same time the audit by CAG, instead of duplicating the kind of audit, which the chartered accountants do, should be made to play a wider, higher and more positive role of periodical overall appraisal. That appraisal should cover not merely the actions or omissions of the management but also governmental decisions, directives, delays etc., which have had a bearing on the performance of the enterprise in question.

The scope of CAG audit as envisaged as both regulatory and proprietary audit going beyond financial audit resulting in efficiency cum performance audit, should include the scrutiny of memorandum and article of association, to see whether they provide for adequate directive control in the hands of the government; whether they contain the over-riding provision for the issue of directives by the government in regard to the working of the company, which the Board would be bound to give effect to; whether they advisedly contain certain provisions regarding appointment of certain management officials in the company or with the approval of the government etc.

The appraisal should not merely concentrate on negative (or absence of negative) aspects of the enterprises. They should highlight the negative as

well as the positive aspects of the working of enterprises. There should be critical analysis so as to clearly bring out the deficiencies attributable to poor management or deficiencies arising out of bad investment decisions or insufficient support by government or day-to-day interference by the government in the working of the enterprise.

- c) Attempts should be made to negotiate the performance agreements between the Government and the managers. In order to reach effective performance agreements the Government should develop information and evaluation system identify the sources of incentive failures. Then it should reward managers and employees in exchange for fulfilling agreed performance targets. This can be in the form of bonus in case the company makes profits up to a certain level because of its efficient working etc. Another kind of incentive can relate to the duration/extension of the agreement itself.
  
- d) To make the losses arising from managerial weaknesses, responsible and unbiased managers through management contracting can be employed so as to achieve the target. This approach can be more effective than relying upon the performance agreements. But this can work only if the manager are given autonomy in decision-making in general and specifically with regard to the key functions affecting productivity and service quality such as staffing, procurement or publicly provided working capital. Only then can he be held accountable for over all performance. Another factor related to it is the compensation to the manager based upon the performance.

## **2. Suggestions pertaining to commutation**

- a) There is need to develop the best practice for commutation at international as well as national level uniformly practiced by all the companies involved in the reinsurance business. Different strategies are needed to be developed for inward and outward reinsurance business. Similarly different set of practices is to be adopted for commuting the reinsurance treaties for which the offers have been made by the cedent (direct insurer) company and where the offer is made by the retrocessionair.
- b) There is need to specify the circumstances, where commutation offers should be made by the companies so as to avoid the accumulation of non-performing assets or is otherwise beneficial for the company.
- c) The commutation of inward and outward reinsurance treaties needs different strategy. In case of inward reinsurance contracts, where the cedent is to be paid money by the Indian company, stringent analytical enquiries should be made about the offer and the offerer company keeping in view the best interest of the company. In case of outward commutation offer received by the company,
- d) There should be an appropriate committee to carry out commutation. The proposal goes like that:
  - A permanent committee of three active directors should be constituted for the appraisal of commutation offers made and received by the GIC. The

power of the Board to constitute such a committee is given in clause 23 (xix) of the Articles of Association of the Company. The committee will be responsible to the Board of Directors and will ensure the prompt approval of the proposals by the Board of Directors.

- Second level of committee may consist of three members out of which, two Managers from Reinsurance Dept i.e. one from Inward and one from Outward and one Manager from the Accounts Dept to be set up to process the offers. on the recommendations of this committee, the final decision will be taken by the first level of committee.

e) There must be a set of bylaws or rules for allocation of responsibility and ratification of commutation offers. Clause (23) (ix) of the Articles of Association of GIC, confer the power on board of directors to make, vary and repeal bye-laws for the regulation of the business of the Corporation or its Board or its officers and servants. Besides that Government has the rule making vide section 30 of the General Insurance Business (Nationalization) Act, 1972 and section 24(2) (g) read with section 14 of the Insurance Regulatory and Development Authority Act, 1999. The government should make the set of rules as for the conduct of the commutation. The commutation agreements should be entered into following the rules laid down appropriately. The performance of such agreements shall be made only after ratification of the renegotiation contract on case-to-case basis. Alternatively, the IRDA may make a regulation to this effect under the authority vested in IRDA by the Act of 1999 vide section 26(2) (e) read with section 14 (20) (e) of the IRDA Act. Of course, the best course of action is

having a set of rules for the purpose. There is a one more alternative. The GIC may develop a 'best practice code', which may include the procedure of renegotiation for commutation. This is only a soft law. At international level, where there is involvement of 'sovereign power exercise' by states, there must either be specific protocol developed under GATS or a model code to be developed under UNCITRAL. General Insurance Corporation must strive in this direction.

f) The broad strategy that can be adopted by the committee regarding commutation is as under. All the commutation offers will be placed before the managerial committee as soon as possible. The committee will start examining the reasons cited by the offerer to commute and see the viability of the reasons and commutation. The commutation based upon different reasons needs different treatment by the committee with respect to the enquiries to be made before negotiating further. For instance, if the offer is going run-off, then the enquiries should focus on the reason for going run-off. Whether it is because of change in underwriting policy or due to merger or acquisition of the companies or due to heavy claims faced by the company in a particular business in the past and thereby it decided to stop underwriting business etc. All these aspects are necessary to know because these have the bearing on the strategy to be adopted for commutation.

g) The commutation to be dealt in on case-to-case basis. With respect to all the offers, as soon as these are received, the committee should fixed the tentative time-limit within which to complete all the enquiries about the

offerer and place before the committee. After finishing the groundwork, the committee should again fix the rate at which it thinks it proper to commute based upon the particulars of the case. Company ought not to be uniform in all the cases, with respect to the percentage at which it will commute. Time factor is of utmost important as the market trends, inflation and foreign exchange rate (because reinsurance is dealt in foreign currency) has the bearing upon the payments involved. Otherwise also, the norm should be developed with respect to the time limit within which a particular class of commutation should be disposed off.

h) The committee should record the reason at every step of negotiation for the purpose of transparency. Even if the commutation is not accepted within a specified time limit, cite the reasons in all circumstances whether the commutation is accepted or rejected.

i) The committee should keep close eye on the other companies on regular basis so that whenever there is any breach or chance of breach of expressed or implied warranties on the part of the other company, commutation can be initiated in the best interest of the business of the company.

j) To specify the circumstance in which the GIC should initiate the commutation negotiation by the cedent with the retrocessionair or vice-versa, as the case may be. For instance, some amount can be fixed below which if claims are going for a particular period, then to save the

administrative cost, commutation ought be initiated. To approach failing security on outward programmes. Another instance can be where the company goes run-off due to mishandling of claims, and then the commutation should be initiated. Since insurer under duty of competent claim handling, the GIC should keep close eye on the other companies' profile regarding their working so that commutation can be entered at appropriate time. Where commutation proposals are to be initiated from our end, the Committee will examine and make recommendations for portfolio withdrawal to the reinsured/reinsurers.

k) While the commutation offers are to be looked at on a case-to-case basis, those involving IBNR element need to be looked at very closely. Where the commutation proposal is in respect of any outstanding claim or any outstanding balances not involving IBNR, these can be processed immediately.

l) The allegation that the commutation of outward reinsurance contract results in reduction of revenue may not be always correct. The commutation of outward contracts results in contraction of regular periodical installments into one lump sum, increase the liquidity with certainty. It is not reduction of revenue (as illustrated by the formula) since the present value received is less the sum calculated on the basis of purchase value of many annuities over so many periods, that is,  $A=P(1+I)^n$ , where 'A' means annuity



installments; 'P' means present value' 'I' means interest per hundred and 'n'  
means number of years.

## ANNEXURE 1

### COMMUTATION AND RELEASE AGREEMENT



### COMMUTATION AND RELEASE AGREEMENT

This Agreement dated as of the thirty-first day of May, 1997;

COMMUTATION AND RELEASE AGREEMENT ("COMMUTATION") entered into between **GENERAL INSURANCE CORPORATION OF INDIA, BOMBAY** (hereinafter referred to as "REINSURER") AND **AMERICAN INTERNATIONAL GROUP INC.**, its member and associated companies, including but not limited to **AIG EUROPE S.A.**; **AIG EUROPE (UK) LTD.**; **AIG EUROPE (Ireland) LTD.** including their branches, subsidiaries and affiliate companies. (hereinafter collectively referred to as "REINSURED").

WHEREAS the REINSURER entered into numerous reinsurance agreements with the REINSURED, whereby the REINSURER in consideration of payment of premium, was committed to reinsure certain risks insured by the REINSURED;

WHEREAS the REINSURER and REINSURED, desire fully and finally to settle and commute all obligations and liabilities known and unknown of the REINSURER and REINSURED under those certain underwriting years of those certain reinsurance agreements specifically listed in Exhibit A to this commutation agreement (the "AGREEMENTS");

WHEREAS the REINSURER has offered to pay and the REINSURED has agreed to accept in full satisfaction of the REINSURER's present and future liability under the AGREEMENTS the sum of XEU 12.804,88 to be paid to the REINSURED in the manner set forth herein;



NOW THEREFORE, IT IS AGREED BY AND BETWEEN THE REINSURER AND REINSURED THAT:

1. The REINSURER shall pay to the REINSURED the sum of XEU 12.804,88 immediately upon execution of this COMMUTATION by the REINSURER. Said funds are to be paid to the REINSURED in European Currency Unit, or in such manner as the parties may agree provided that any manner of payment other than European Currency Unit must be specifically authorized in writing by the REINSURED. Said funds are to be paid by check or wire transfer to the account of S.A.I.L. with Credit Lyonnais Belgium, 17 Avenue Marnix, 1000 Brussels - Belgium, unless the REINSURED in writing specifically instructs the REINSURER otherwise.
2. The REINSURER shall accept the sum set forth in paragraph 1 herein in full and final settlement of any and all amounts claimed to be due to the REINSURED from the REINSURER and arising under or in respect of the AGREEMENTS.
3. This Commutation is expressly limited to the REINSURER's particular percentages of participation in the particular underwriting years of the particular reinsurance agreements listed in Exhibit A. It is not the intention of the parties to this COMMUTATION to commute the terms, conditions and provisions of any other reinsurance agreement or any other underwriting year of any reinsurance agreement.
4. The REINSURER hereby assigns to the REINSURED all its rights, title and interests if any, to its share or shares of any common account excess of loss protection which would inure to its benefit in connection with the AGREEMENTS. Nothing in this paragraph shall render the REINSURER liable for any claim arising under the AGREEMENTS.
5. If and when the payments referred to in paragraph 1 herein shall have been fully and duly made by the REINSURER, received by the REINSURED and presented to and honored by the financial institution upon which the REINSURER's payment is drawn, then the REINSURER, its affiliates, successors and assigns and their respective directors, officers, employees and agents shall be released and forever discharged from all liability that the REINSURER, its affiliates, successors and assigns and their respective directors, officers, employees and agents had, have or shall have to the REINSURED by reason of or in respect of any act, matter, cause or thing whatsoever with respect to the AGREEMENTS.



The parties terms but w governing re connection this COMM written con COMMUTA precaution

to maintain the confidentiality of this COMMUTATION and its necessary or required may disclose same to the parties' auditors, By ry bodies or third parties in court proceedings and arbitrations in mandatory discovery requirements. Either party may also disclose TION and its terms under other circumstances if it obtains the prior of the other party for such disclosure. Either party disclosing this in a manner permitted by this article will take all reasonable S. protect its confidentiality.

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IN WITNE AND REI

HEREOF the parties herein have executed this COMMUTATION AGREEMENT in duplicate, as of the day and year first written above.

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TLE : ector

A.I.L.

behalf AMERICAN INTERNATIONAL GROUP, INC. and its member and sociati companies.



Effective on the same date on which the REINSURED shall release the REINSURER as provided for in paragraph 5 herein, the REINSURER shall likewise release and discharge the REINSURED, their affiliates, successors and assigns and their respective directors, officers, employees and agents from all liability that the REINSURED, their affiliates, successors and assigns and their respective directors, officers, employees and agents had, have or shall have to the REINSURER by reason of or in respect of any act, matter, cause or thing whatsoever with respect to the AGREEMENTS.

- In the event that the REINSURER fails to make the cash payment described in paragraph 1 herein or if said payment is dishonored by the financial institution upon which it is drawn, the parties hereto agree that the REINSURER shall at the request of the REINSURED submit to the jurisdiction of any court of competent jurisdiction within FRANCE and shall comply with all the requirements necessary to give such court jurisdiction with respect to any litigation commenced by the REINSURED which arises out of this COMMUTATION or the breach thereof or the REINSURER's liability to the REINSURED on the AGREEMENTS.
3. In the event that a court of competent jurisdiction requires return by the REINSURED of any portion of the payment made in paragraph 1 hereof, the releases given by the parties herein pursuant to paragraphs 5 and 6 and the commutation of the AGREEMENTS shall be null and void and in addition thereto, both parties shall be returned to their original status as though this COMMUTATION had not existed.
9. The rights, duties and obligations set forth herein shall inure to the benefit of and be binding upon any and all predecessors, successors, liquidators, receivers or assigns of the parties hereto.
10. This commutation shall constitute the entire agreement between the parties as it relates to the subject matter herein. This commutation may not be modified or amended, except by an instrument in writing signed by the parties hereunder.
11. The parties hereto expressly warrant and represent that they are corporations in good standing in their respective places of domicile, that the execution of this commutation is fully authorized by each of them and that the person or persons executing this COMMUTATION have the necessary and appropriate authority to do so.

## ANNEXURE 2

### LIST OF COMMUTATION AGREEMENTS ENTERED INTO BY GIC

| No. |  | Date on which Note was prepared | Date on which Note was sent to BAS | Total amount payable by us/(due to us) (O/s bals) | Treaty Number   |
|-----|--|---------------------------------|------------------------------------|---|---|
| 1.  | The South East Insurance Co. Ltd., Thailand  | 02.08.96                        | 27.08.96                           | T. Bht. 329.20                                    | HF 5023, FF 383   |
| 2.  | United Reinsurance Co. of Ireland (Aviation) | 26.08.96                        | 27.08.96                           | US \$ 22,000.00                                   |   |
| 3.  | Larsa/Agricola/Plar, Panama                  | 07.08.96                        | 12.09.96                           | US \$ 15,045.91                                   | FFX 3591, FFX 3519, FFX 3520                              |
| 4.  | General Accident Fire & Life Corp.           | 16.08.96                        | 13.09.96                           | US \$ 124.24                                      | FFX 3540<br>FFX 3541                                      |
| 5.  | National Reinsurance Co. of Sudan Ltd.       | 28.08.96                        | 13.09.96                           | Pds. 44.56  | CF 6159   |
| 6.  | Transatlantica, Italy                        | 22.07.96                        | 13.09.96                           | (Il 1,659,863)<br>Pds. 276.13<br>US \$ 1,897.18   | FF 7152,<br>MF 8259,<br>CF 6160,                          |
| 7.  | Belge D'Assurances Transport 1897, Belgium   | 01.10.96                        | 03.10.96                           | US \$ 5.25  | CF 6021   |
| 8   | Cie Transcontinentale De Reassurances        | 23.10.96                        | 30.10.96                           | NIL   | CFX 585   |
| 9.  | Rashtriya Beema Sansthan, Nepal              | 20.01.97                        | 24.01.97                           | N. Rs. 2,160.00                                   | FF 7218<br>(1984,85,86,87, 88 closed)                     |
| 10  | Haffina Re, Singapore                        | 05.02.97                        | 24.02.97                           | S \$ 3,148  | FF 7451/152(92)   |
| 11  | Nigeria Re, Nigeria                          | 11.03.97                        | 17.03.97                           | N 10,104.39                                       | FF 7153, MF 8260, MF 8313, FFX 3643, FF 7236, MF 8261/62, |
| 12  | NRG Victory, UK                              | 19.03.97                        | 20.03.97                           | Pds. 10.64 (no pyt)                               | FFX 3504  |
| 13  | Aviation Office of America, USA              | 10.04.97                        | 17.04.97                           | US \$ 82,950                                      | AVF 951, AVF 1033, AVF 1039                               |
| 14  | Taisei Fire & Marine,                        | 06.06.97                        | 17.06.97                           | Y 1,167,733                                       | FFX 239.  |

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|    |   |  |          |   |   |
|----|---|--|----------|---|---|
| 17 | Overseas Assu. Corp.,<br>Singapore          | 17.07.97   |          | NIL                                     | CF 6247 (1984,<br>1985 & 1986)                          |
| 18 | Egyptian American Ins. Co.,<br>Egypt        | 14.07.97   | 22.07.97 | US \$ 1209.20                           | FF 328, FF 329, FF<br>330, CF 6047, MF<br>8127, MF 8128 |
| 19 | Ingosstrakh Ins. Co, USSR                   | 24.07.97   | 08.08.97 | US \$ 3236.34                           | CF 6268   |
| 20 | Yasuda Fire & Marine, Japan                 | 10.09.97   | 15.09.97 | Yen 6,761.70                            | HF 5098   |
| 21 | Nippon Fire & Marine, Japan                 | 28.08.97   | 15.09.97 | US \$ 395.02                            | FFX 3880  |
| 22 | Overseas Assu.Sgp                           | 02.09.97   | 15.09.97 | No o/s loss                             | CF 6247   |
| 23 | National General Ins. Co.                   | 18.08.97   | 16.09.97 | Dhs 10,767.87                           | FFP 213/92, CFP<br>36/92, MFP 57/92                     |
| 24 | Yasuda Fire & Marine, Japan                 | 08.09.97   |          | Reco of Yen<br>5148                     | HF 629  |
| 25 | National Ins.Co.of Egypt                    | 22.09.97   | 25.09.97 | EGP 2296.80 &<br>QRL 204.01             | FF 7323   |
| 26 | Sedgwick Marine (Bland Payne),<br>UK        | 10.11.97   | 11.11.97 | USD 4653.67                             | HF 612  |
| 27 | Rhine Re, Switzerland                       | 11.11.97   | 18.11.97 | SwFr 122,505.45                         | FFX 3962, FFP 355                                       |
| 28 | Singapore Aviation & General<br>Ins. co.    | 9.12.97  | 15.12.97 | S \$ 159.69                             | MF 8195,<br>CF 6106                                     |
| 29 | Nordstern Allgemeine<br>Vers., W.Germany    | 12.12.97   | 15.12.97 | Dmk1744.64                              | HF 5076,<br>CF 6137                                     |
| 30 | AIG Europe (SWIFT)                          | Since it was a claim portfolio withdrawal note was not<br>prepared. BAS made the accounts settlement. FFP619/92-93 |          |   |   |
| 31 | L'Union Des Assu De Paris                   | 27.01.98   | 05.02.98 | £ 6,253.20                              | CF 458  |
| 32 | Korean Re                                   | 29.01.98   | 09.02.98 | US \$ 471.19                            | FFP 1/91-92   |
| 33 | EA Generali, Austria                        | 05.02.98   | 11.02.98 | ATS 58,332                              | FFX 483/92  |
| 34 | Great Lakes Re, Belgium                     |  |          |   |   |
| 35 | Al Ahlia Ins Co, Bahrain.                   | 06.02.98   | 11.02.98 | BHD 515.46                              | FFP 63,CFP 8,<br>HFP 35,MFP18                           |
| 36 | MGFA, France                                | 09.02.98   | 11.02.98 | US\$ 240.30<br>FrFcs 151.20<br>£ 134.10 | CF 6153   |
| 37 | Progressive Ins, Malayasia                  | 12.05.98   | 17.07.98 | MR 3927.00                              | FF 7307,CF 6236,MF<br>8356/8357/8358                    |
| 38 | Soc.Commerciale De Reassu<br>(SCOR), France | 14.05.98   | 20.07.98 | USD2582.42                              | FF 7535   |
| 39 | Legal & General Ins, UK                     | 13.08.98   | 01.09.98 | £ 70.43                                 | FFP 1070 (94,95,96)                                     |
| 40 | Royal Re, UK                                | 21.08.98   | 01.09.98 | £ 687.04                                | FFX 3502,<br>FFP 287 (1992)                             |
| 41 | Aegon Ins Group                             | 14.01.99   | 18.01.99 | £23,459.10                              | MF 8044/ MF8045/EPF<br>1692/93/94(Swift)                |

|    |                            |          |          |                      |   |
|----|----------------------------|----------|----------|----------------------|---|
| 42 | Cannon Assurance, Kenya    | 28.01.99 | 01.02.99 | Kshs<br>144,420.71   | FF 7379/80,CF<br>6260/61, MF8413, MF<br>8445, MFX 9140/41/42  |
| 43 | R.J. Kiln, UK              | 16.11.98 | 01.02.99 | USD12,217.<br>21     | FFX<br>394/397/3789/3796/391<br>7/3918/3999/4046/4047   |
| 44 | Munich Re                  | 15.7.99  | 16.7.99  | USD 6252<br>DM 852   | FF 147,FFX<br>212/3806/3922/3934/38<br>75/3904/423/MFX<br>953/HF5067                                |
| 45 | Kenya Re                   | 17.09.99 | 27.10.99 | Kshs<br>1,666,871.43 | CF6270,FF7511,FFP38<br>4(92-94), FFP193(92-<br>94), FFP94(92-94),<br>FFP62(92-94),<br>FFP63(92-94), |
| 46 | Bimeh Markazi Iran         | 05.08.99 | 01.09.99 | IR 409,139           | FF 7349/7350/7351/<br>CF 6253/MF 8389/<br>8390/CF6179/MF911/F<br>FX 3649/3650 (Thru<br>WFD/S.wrigh) |
| 47 | Progressive Insu, Malaysia | 17.11.99 | 29.11.99 | MR 1374.61           | FFP 200/92, HFP<br>70/92,MFP 46/92  |
| 48 | Al Sagr Ins., Dubai        | 17.11.99 | 29.11.99 | Dhs 1908.60          | CFP197/213,EFP129,<br>FFP949,FFP1033,<br>MFP240/241,MFX352<br>(all are for 1994 u/w yr              |
| 49 | Mapfre Re, Spain           | 15.12.99 | 22.12.99 | Pts 556,518          | FFX 1080/1081, FFX<br>44/45/46, (SWIFT)   |



# Run-off & SWIFT

| NAME OF THE COMPANY            | COMMUTATION OFFER     | TREATY NO.           | NAME OF THE TREATY      | OFFER RECEIVED |
|--------------------------------|-----------------------|----------------------|-------------------------|----------------|
| AL AHLIA INSURANCE CO.(JORDAN) | CARGO Q/S & 1SURPLUS  | CF 6243              | CARGO QUATA SHARE       | 13.10.1999     |
| WILLIS                         |                       | CF 6344              | CARGO SURPLUS           | 13.10.1999     |
|                                |                       |                      | 1ST REMINDER DATE       | 17.04.2000     |
|                                |                       |                      | 2ND REMINDER DATE       | 03.07.1998     |
|                                |                       |                      | 3RD REMINDER DATE       | 18.11.1998     |
| AFRICAN & MIDDLE EAST          | CUT OFF FOR UW/Y 1983 | PROP. RETRO. TY      | FF 7493 90 & 91         | 29.05.1998     |
| LES MUTUELLES DU MANS ASSUR.   |                       |                      |                         | 29.05.1998     |
|                                | CUT OFF UW/Y 1983     | MARINE/AVN RETRO.    | Pac FF 296              | 29.05.1998     |
|                                |                       |                      | 1ST REMINDER DATE       | 17.02.1997     |
| AEGON (DIRECT)                 | FACULTATIVE FIRE XOL  |                      | QUOTA SHARE             | 06.07.2000     |
| AL JAZIRAH INS. CO. LTD.       | BOUQUET COMMUT.       | FF 393/94 - 84 & 85  | FIRE QS/1ST SURPLUS     | 29.10.2000     |
| THROUGH M.B.BODA               | UW/YEAR 1983 TO 1986  | CF 6073/74 - 84 & 85 | CARGO QS/1ST SURPLUS    |                |
|                                |                       | HF 5027/28 - 84 & 85 | HULL QS/1ST SURPLUS     |                |
|                                |                       | MF 8167/88 - 84 & 85 | MISC QS/1ST SURPLUS     |                |
|                                |                       | MF 8304/05 - 84 & 85 | MISC CAR/EAR QS/1ST SUR |                |
| THROUGH R.N.SETH               |                       | FF 393/94 - 83       | FIRE QS/1ST SURPLUS     | 29.10.2000     |
|                                |                       | CF 6073/74 - 83      | CARGO QS/1ST SURPLUS    |                |
|                                |                       | HF 5027/28 - 83      | HULL QS/1ST SURPLUS     |                |
|                                |                       | MF 8167/88 - 83      | MISC QS/1ST SURPLUS     |                |
|                                |                       | MF 8305 - 83         | MISC CAR/EAR QS/1ST SUR |                |
| THROUGH STEWART                |                       | FF 393/94 - 86       | FIRE QS/1ST SURPLUS     | 29.10.2000     |
|                                |                       | CF 6073/74 - 86      | CARGO QS/1ST SURPLUS    |                |
|                                |                       | HF 5027/28 - 86      | HULL QS/1ST SURPLUS     |                |
|                                |                       | MF 8167/88 - 86      | MISC QS/1ST SURPLUS     |                |
|                                |                       | MF 8304/05 - 86      | MISC CAR/EAR QS/1ST SUR |                |
| THROUGH J. B. BODA             |                       | HF 5027 - 1983       | HULL CARGO SURPLUS      | 29.10.2000     |
|                                |                       |                      | 1ST REMINDER            | 31.10.2000     |
|                                |                       |                      | 2ND REMINDER            | 07.12.2000     |
|                                |                       |                      | 3RD REMINDER            | 03.01.2001     |
|                                |                       |                      | 4TH REMINDER            | 20.01.2001     |
|                                |                       |                      | 5TH REMINDER            | 13.03.2001     |
| 5 AIG EUROPE (U.K) LTD.        | CUT-OFF               | 1983                 | MARINE HULL TREATY      | 28.02.2001     |
| 6 AVAILABLE SRACE              | COMMUTATION           | 1996 & 1997          |                         | 07.08.2000     |
|                                |                       |                      | REMINDER 1ST            | 22.12.2000     |
|                                |                       |                      | REMINDER 2ND            | 28.02.2001     |
|                                |                       |                      | Reminder 3rd            | 29.06.2001     |
| 7 CHINA MARINERS ASSUR. CORPN  | COMMUTATION           | MARINE CARGO OPEN    | CARGO OPEN COVER        | 03.10.2000     |
| DIRECT                         |                       | (1994 A/C)           |                         |                |

Amount RECEIVED

JOD 204 (90%)

JOD 150 (90%)

257 7182

SR 6,610 (90%)

NIL

NIL

US\$ 52,054.52 (100% less 5%edis)

US\$ 961.37 (90%)

LIS COMMUTATION PROPOSALS NOT ACCEPTED BY GIC

ANNEXURE 3

|    |  |                       |   |   |  |
|----|--|-----------------------|---|---|--|
| 8  | CAPITAL INSURANCE<br>J.B.BODA  | COMMLTATION           | HF 5142 - 1984<br>CF 6233 - 1984<br>HF 697 - 1983                       | HULL Q/S<br>MARINE Q/S<br>HULL A/S  |  |
| 9  | CICA RE<br>J.B. BODA   | COMMUTATION           | FF 7486 CF 6292<br>MF 8464/65/68<br>FFX 4032/33                         |   | 18.07.2000<br>12.12.2000   |
| 10 | FALKSAM INTERNATIONAL  | COMMUTATION           | ENERGY QS   | INTERNAL LPROP I SUR.   | 12.04.2000   |
| 11 | GREAT LAKES REINSURANCE CO.  | COMMUTATION & RELEASE |   | INTERN. PROPERTY 1ST SUR<br>1ST REMINDER<br>2ND REMINDER  | 15.05.2000 45<br>03.07.2000 46<br>24.10.2000                       |
| 12 | HUNGARIAN POLISH & ROMANIAN<br>AMERICAN INSURANCE COMPANIES  | COMMUTATION PROPOSAL  |   | 1ST REMINDER  | 03.05.1998<br>01.11.1998   |
| 13 | HANNOVER RE  | COMMUTATION           | FFP 7496  | FACULTATIVE SURPLUS 'A'   | 21.08.2000   |
| 14 | INDIA INTER. INS. SINGAPORE  | COMMUTATION           | FFP 7498 101 EPP 71<br>FFP 510101 FFR 257                               | FAC. SURPLUS 'A'<br>92-95   | 21.08.2000   |
| 15 | KENYA ORIENT INS.CO.LTD. KENYA   | COMMUTATION           | 1989 TO 94  | VARIOUS OWARD TY.   | 18.04.2001   |
| 16 | NOGA INS. CO.LTD. MERGED INTO<br>HADAR INSURANCE<br>LA NATIONALE ISRAEL INS.LTD.<br>PORTFOLIO PURCHASED BY HADER<br>M. B. BODA | COMMUTATION           |   | FIRE & AP Q/S U/Y 1995/98   | 15.01.2001<br>15.01.2001   |
| 17 | NIGERIA RE<br>J.B. BODA  | COMMUTATION           | CF 429<br>FF 84   | T.W.P. MARINE QUOTA SHAR<br>NON MARINE QUOTA SHARE<br>1ST REMINDER                              | 14.11.2000<br>12.04.2001   |
| 18 | OVERSEAS ASS. CORPN. SINGAPORE<br>J.B.BODA / WILLIS FABER  | CUT OFF PROPOSAL      | CFP 6247 - 1984/85/87<br>1984 TO 1986                                   | II SURPLUS MARINE CARGO   |  |
| 19 | PRUDENTIAL ASSURANCE CO.LTD<br>THROUGH TO SEDGWICH PAYNE<br>THROUGH WILLIS FABER<br>THROUGH K.M.D./DAWES<br>THROUGH KMD/NORMAN | COMMUTATION           | FF 7027/7091<br>FFX 4077/78<br>HF 5074<br>HF 5111/5130<br>AVF 1022/1141 | FIRE PRIOR SURPLUS<br>PROPERTY CAT XL<br>MARINE QUTA SHARE<br>HULL Q/S RETRO<br>AVN QUOTA SHARE | 07.11.2000<br>07.11.2000<br>07.11.2000<br>07.11.2000<br>07.11.2000 |
| 20 | PARTNER RE   | COMMUTATION           | 1984  | PROP SURPLUS  | 09.04.2001   |
| 21 | ROYAL & SUNALLIANCE  | COMMUTATION           |   |   | 17.10.1997   |

458 4331.46 M48 0.71  
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458 4877.62  
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of their comm  
cancellation prop. offer

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|----|-----------------------------------|-------------|-----------------------|------------------------------|------------|
|    | THROUGH K.M.DASTUR                | Commutation | CFP 6034 - 1983TO86   | DRILLING RIG FAC/OBL         | 17.10.1997 |
|    | THROUGH BHAICHAND AMOLUK          |             | HFP 5004 - 1983TO86   | HULL FAC/BL                  | 17.10.1997 |
|    | DIRECT                            |             | MF 8133/8186 83TO86   | MISC IST SURP. ENGG          | 17.10.1997 |
|    | WILLIS FABER                      |             | MF 8130 - 83TO85      | MISC II SUR. ENGG            | 17.10.1997 |
|    | THROUGH GREAG FESSTER             |             | FFX 342/43-84 TO 87   | CAT XL SURP/II LAYER         | 17.10.1997 |
|    |                                   |             | FFX 3896/17-1988TO91  | FIRE XL III & FIRE 5TH LAYER | 17.10.1997 |
|    |                                   |             | FFX 3963/84 -89TO 91  | FIRE FLOOD DAMAGE XL I LAYER |            |
|    |                                   |             |                       | 1ST REMINDER                 | 28.11.1997 |
|    |                                   |             |                       | 2N REMINDER                  | 25.03.1999 |
|    |                                   |             |                       | 3RD REMINDER                 | 28.07.1999 |
| 22 | SKANDIA                           | COMMUTATION |                       | FAC SURPLUS 'A' TREATY       | 22.09.1997 |
|    | THROUGH ODYSSEY RE                |             |                       | 1ST REMINDER                 | 20.05.1999 |
|    | HANNOVER Re.                      |             |                       | 2ND REMINDER                 | 27.07.2000 |
| 23 | SAFR                              | COMMUTATION |                       | FACULTATIVE RETROCESSIO      | 12.05.1999 |
| 24 | SCOR                              | COMMUTATION |                       | RETROCESSION TREATY          | 05.11.1998 |
|    |                                   |             |                       |                              | 01.12.1998 |
| 25 | SUMITOMO JAPAN                    | COMMUTATION |                       | MARKET SURPLUS CARGO         | 11.08.2000 |
|    | THROUGH SEDGWICK                  | COMMUTATION |                       | MARKET SURPLUS CARGO         | 11.08.2000 |
|    | THROUGH SEDGWICK                  | COMMUTATION |                       | MARKET SURPLUS HULL          | 11.08.2000 |
|    | THROUGH J.B. BODA                 | COMMUTATION |                       | MARKET SURPLUS CARGO         | 11.08.2000 |
|    | THROUGH J.B. BODA                 | COMMUTATION |                       | MARKET SURPLUS HULL          | 11.08.2000 |
|    | DIRECT                            |             |                       | MARKET SUR MISC & ENGG       | 11.08.2000 |
| 26 | SEAGULL INSURANCE LTD MAURITIUS   | COMMUTAION  | MFX 490/1999          | MOTOR WC XL 1ST LAYER        | 20.07.2000 |
|    |                                   |             | MFX 492/1999          | MOTOR WC XL 3RD LAYER        | 20.07.2000 |
|    |                                   |             | CFP 199/98            | MARINE CARGO QUOTA SHA       | 20.07.2000 |
|    |                                   |             | CFP 199/99            | MARINE CARGO QUOTA SHA       | 20.07.2000 |
|    |                                   |             |                       | REMINDER 1ST                 | 15.09.2000 |
|    |                                   |             |                       | REMINDER 2ND                 | 20.07.2000 |
|    |                                   |             |                       | REMINDER 3RD                 | 18.08.2000 |
| 27 | SCOTTISH LION INSURANCE COMPANY   | COMMUTATION |                       |                              | 27.04.2000 |
|    | THROUGH WILLIS                    |             | CF 6228 - 1984        | QUOTA SHARE CARGO            | 27.04.2000 |
|    | THROUGH P.S. MOSE                 |             | FF 7422/23 - 87 TO 90 | FIRE QUOTA SHARE             | 27.04.2000 |
|    | THROUGH WILLS                     |             | FAC2/05/0832 - 83     | FAC LIAB.                    | 27.04.2000 |
|    | THROUGH KMD/ALEXANDER HOWDEN      |             | FFX 4102 - 1991       | INWARD A/C XL IV             | 27.04.2000 |
|    | THROUGH KMD/ALEXANDER HOWDEN      |             | FFX 4103 - 1991       | INWARD A/C XL V              | 27.04.2000 |
|    | THROUGH P.S. MOSSE                |             | AVN 0964 - 1983       | AVN OBLG Q/S                 | 27.04.2000 |
|    | THROUGH C.T. BOWRING              |             | FFX 4102/03 - 91      | INWARD A/C XL IV / V         | 27.04.2000 |
|    |                                   |             |                       | 1ST REMINDER                 | 29.06.2000 |
| 28 | SATELLITE                         | COMMUTATION | 1996/97               | BELGIAN SPACE TREATY         | 22.11.2000 |
| 29 | TAIWAN FIRE & MARINE INS. CO.LTD. | COMMUTATION | 1994 - 1996           | MARINE HULL 1ST SURPLUS      | 01.02.2001 |
|    | ALEXANDER HOWDEN                  |             |                       | 1ST REMINDER                 | 27.02.2001 |
|    |                                   |             |                       | 2ND REMINDER                 | 15.03.2001 |

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FRF 1455616-80  
FRF 17149-21

NIL (No 0/3)

15619.50 - HFP/282

|    |   |             |                |   |                          |
|----|---|-------------|----------------|---|--------------------------|
| 30 | A TAYLOR ESQUIRE & OTHERS<br>ALEXANDER HOWDEN | COMMUTATION | 1992           | SIGMA SURPLUS TREATY<br>1ST REMINDER    | 23.07.1997<br>09.12.1997 |
| 31 | VICTORY REINSURANCE CO.LTD.(NRG)              | COMMUTATION | 1984/85        | XL COVER<br>1ST REMINDER                | 13.01.2000<br>08.02.2000 |
| 32 | UNIONE ITALIANA DI RIASSICURAZIONI            | COMMUTATION | 1992           | FACULTATIVE REINSURANCE<br>1ST REMINDER | 03.01.2000<br>22.02.2000 |
| 33 | WARBA INSUR.CO.                               | COMMUTATION | 1997/98 & 1999 | NON-MARINE                              | 17.01.2001               |
| 34 | ASSIC. GEN. DUBAI                             | COMMUTATION | 1985 YO 91     | MEO Q/S                                 | 30.04.2001               |
| 35 | TAIWAN F & M                                  | COMMUTATION | 1994-98        | SECOND SUR HULL TY                      | 11.04.2001               |

USD 8,479,86 USD 24,036.  
 Com 211.48  
 4% Interest on Above Inv  
 NLG 5,666,309 (100%)

USD 183,795.00  
 HFP/283 USD 218.42

36 AXA Ins. PLC. Commutation 1993 HFP/194/93 11-06-2001  
 Hull Treaty 24-05-2001

USD 134.60

37 Berjaya Gen. Ins. Bhd. Commutation 1986 to 91 proportional treaty 30-1-2001

RM. Fix 1,117.40  
 Cargo 11,911.37  
 Engg. 1,292,956.87  
 MISC. 11,120.60  
 Bonds 36,454.83  
 353,650.85

38 Commer Assc. S.P.A. Commutation 1984 N/M Fac/oblig. 22-2-1999

ITL 9,498,675.00 (100%)  
 Ourselves 229,393.00

39 St. Helen's Trust Ltd. Commutation 1983 to 85 Hull Fac oblig.

USD 527.06  
 USD 103,808.69  
 Com 53-07

## ANNEXURE 4

### STUDY OF CASES FROM GIC

| <b>Sr.<br/>No</b> | <b>Name of the<br/>company</b>    | <b>Reason for<br/>offering<br/>commutation</b>   | <b>Through<br/>whom</b> | <b>Time<br/>taken to<br/>commute</b> |
|-------------------|-----------------------------------|--|-------------------------|--------------------------------------|
| 1                 | Nordstern<br>Aligenmeine<br>Veris | To save the<br>administrative costs  | Through<br>brokers      | Almost<br>half year                  |
| 2.                | Cannon<br>Assurance<br>Kenya Ltd  | GIC offered to close<br>the files with<br>company, in<br>response to that the<br>company offered to<br>commute at 90% of<br>the outstanding<br>losses since<br>outstanding claims<br>under various<br>treaties are still<br>open; GIC offered to<br>commute at 80%,<br>which was not | Through<br>brokers      | Took 10<br>months                    |

acceptable to the  
 other side... so  
 commutation at  
 90%.

- |    |  |   |                    |                             |
|----|--|---|--------------------|-----------------------------|
| 3. | Nippon Fire<br>and Marine<br>Ins. Co.<br>Japan | Commutation was<br>offered to reduce<br>the administrative<br>costs because the<br>claims have almost<br>stabilized and in this<br>case whole of the<br>market agreed to<br>commute.... At 85%<br>of the outstanding<br>losses. | Through<br>brokers | Took<br>almost 19<br>months |
| 4. | Yasuda Fire<br>and Marine<br>Ins. Co.<br>Japan | To reduce the<br>administrative costs<br>since the amount<br>involved is very<br>less;  | Through<br>brokers | Took two<br>months          |
| 5. | National                                       | Amount involved   | Through            | Almost                      |

|     |                                |  |                 |                    |
|-----|--------------------------------|--|-----------------|--------------------|
|     | General Insurance Co. of Dubai | was less, so commutation was offered by GIC  | brokers         | two months         |
| 6.  | MGFA Finance                   | To limit management expenses   | Through brokers | Took one year      |
| 7.  | Legal and General Ins. UK      | Change in underwriting policy due to merger of the company   | Through brokers | Took three months  |
| 8.  | AIG Europe                     | To reduce administrative burden of producing and handling figures due to the diminishing size of the figures being processed together. |                 | Almost nine months |
| 9.  | Aegon Insurance Group          | To save future administrative expenses   | Through brokers | Seven months       |
| 10. | Mapfre Re., Spain              | To cut long tail liabilities   | Through brokers | Three months       |
| 11. | Progressive                    | No reason cited as   | Through         | Eight              |

|     |                                   |  |                    |                      |
|-----|-----------------------------------|--|--------------------|----------------------|
|     | Inc.                              | such, but little<br>money was involved | brokers            | months               |
| 12. | E. A.<br>Generali Re.,<br>Austria | No reason cited                        | Through<br>brokers | Almost six<br>months |
| 13. | Al Ahlia                          | Little money was<br>involved           | Through<br>brokers | Two<br>months        |



## ANNEXURE 5

### CASE STUDY OF NEW INDIA ASSURANCE COMPANY

| Sr.<br>No. | Name of the<br>Company                           | Reason for<br>Commutatio<br>n   | Year of<br>Treaty  | Offer<br>made                          | Action<br>taken        |
|------------|--|---|--|--|------------------------|
| 1.         | Generally<br>Assicura<br>Zioni General<br>S.P.A. | Change in<br>underwriting<br>policy so to<br>reduce the<br>administrativ<br>e cost and to<br>deal with<br>cedent<br>efficiently | 1990   | 2 <sup>nd</sup><br>Septemb<br>er, 2001 | No action<br>till date |
| 2.         | Reinsurance<br>Australia<br>Corp.                | (Self<br>managed<br>run-off)<br>Running Off<br>Company<br>Because It<br>Could Not<br>Meet The                                   | Around<br>40<br>contracts<br>entered<br>into<br>during<br>1994 to<br>1997. | 29 <sup>th</sup> Sep.<br>2000.         | No action              |

Marginal  
Solvency  
Fixed By The  
Australia  
Prudential  
Regulatory  
Authority

- |    |  |   |  |           |
|----|--|---|--|-----------|
| 3. | Bryanston<br>Insurance<br>Company Ltd. | No solid<br>offer. Only<br>the intention<br>to commute<br>was<br>expressed<br>which was<br>not<br>responded<br>back by the<br>NIA Co. | 24 <sup>th</sup><br>Novembe<br>r, 2000 | No action |
| 4. | Mentor<br>Insurance Co.<br>(UK) Ltd.   | Company is<br>in liquidation<br>u/s 105 of<br>The<br>Insolvency<br>Act 1986.  |  |           |

|    |   |   |   |                                 |                                      |
|----|---|---|---|---------------------------------|--------------------------------------|
| 5. | Bothnia<br>Internation<br>Insurance Co<br>Ltd. Finland      | Intention of<br>commute<br>was<br>expressed...<br>not<br>entertained<br>by NIA                    | Treaties<br>entered<br>into<br>between<br>1985-<br>1989 | 6 <sup>th</sup> Feb.,<br>1996.  | No action                            |
| 6. | China<br>Reinsurance<br>Co.                                 | Open offer to<br>NIA to bid for<br>commutation.   | Treaties<br>entered<br>into<br>between<br>1980-91       | 18 <sup>th</sup> May,<br>2000.  | Not<br>entertained<br>by the<br>com. |
| 7. | North Atlantic<br>Insurance Co.<br>Ltd. (NAIC),<br>England. | Scheme of<br>arrangement<br>is in place, so<br>seek<br>reinsurance<br>recovery for<br>liquidation | Treaties<br>between<br>1982-83                          | 7 <sup>th</sup> April,<br>1997. | Not<br>entertained                   |
| 8. | SAFR,<br>Partner Re<br>Group                                | Small amount<br>of money is<br>involved so to<br>avoid<br>administrativ                           | Treaties<br>from<br>1991-92                             | 20 <sup>th</sup> June,<br>1998  |                                      |

|     |  |  |                                 |                               |            |
|-----|--|--|---------------------------------|-------------------------------|------------|
|     |  | e cost.  |                                 |                               |            |
| 9   | Swiss Re                                 | Run-off of the non-life portfolio after the acquisition by Swiss Re of Mercantile & General Reinsurance Co. (M&G Re) in 1996. So proposal for a general offer. | Old treaties between 1973 to 86 | 17 <sup>th</sup> March, 2000. | No actions |
| 10. | Folksam International Insurance Co. Ltd. | Due to the involvement of small amount of money and stable development.  | 1984-88                         | 4 <sup>th</sup> July, 1997.   | No action  |
| 11. | Compagnie Europeene                      | Insufficiency of funds to  | 1988-89                         | 10 <sup>th</sup> June, 1997   | No action  |

|     |   |   |         |                             |                     |
|-----|---|---|---------|-----------------------------|---------------------|
|     | De Reassurance SA France (CER Paris)      | settle all outstanding liabilities due by 1995  |         |                             |                     |
| 12. | NRG Victory                               | Run-off company since 1993. So to contain our financial exposures and to control administrative expenses. | 1990-93 | 17 <sup>th</sup> June 1998. | Refused commutation |
| 13. | Equatorial Reinsurance (S) Ltd. Singapore | Suggestion came from broker to NIA for commutation of outstanding premium since the company ceased        | 1993-94 | 22 <sup>nd</sup> July 1998  | No action           |

|     |             |                 |         |                       |           |
|-----|-------------|-----------------|---------|-----------------------|-----------|
|     |             | underwriting.   |         |                       |           |
| 14. | Central     | Run-off since   | 1981-82 | 5 <sup>th</sup> Sep., | No action |
|     | Reinsurance | 1993 and in     |         | 2001                  |           |
|     | Corp Ltd.   | its final stage |         |                       |           |
|     | Johansberg  | of closure      |         |                       |           |

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