

CLRS Seminar – Sept 10-11, 2015

R-5: Run Off Solutions for Legacy Liabilities





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This is how the reinsurance market used to operate in the 60's, 70's, and 80's



This is what the underwriters expected.



This is what really happened instead.





History – for those too young to remember

- > Poor Underwriting / Unprofitable Business
- > Soft Market conditions
- > Emergence of Latent Exposures
 - > Asbestos & Environmental
- > Rating Agency Issues
 - > Downgrade or expectation of downgrade
- > Poor Stock performance
 - > Persistent Low Valuation
 - > Sharp decrease in valuation
- > Change in strategy of parent company
- > Large Event(s)
 - > Hurricane Andrew
 - > 9/11
 - > 2004-2005 Hurricanes
- > Runoff Classes (class of 1985/6, class of 1992/3, class of 2001/2, class of 2005/6)

- > The rate of insolvencies from 1984-1994 was approximately THREE TIMES the rate from the 70's.
- > This was repeated in 2000-2003.
- > Reinsurance creditors are not protected by insolvency funds
- > Solutions had to be found to wind up reinsurance companies faster: Historically the run-off proceeded with zero payments to creditors (cedants) until the percentage payout could be reliably determined. But the “liquidator” (appropriately named) was paid in full for his (and his staff) expenses during the extended term of the liquidation.
- > Few crumbs were left for creditors.

There must be a better way

- > In the late 80's in Bermuda and the UK, court appointed liquidators (usually accountants) made a push to accelerate payments to creditors. Happy creditors equal more appointments to perform liquidations.
- > The legal means of achieving faster payments was a “Scheme of Arrangement”. This legal framework had been used in restructuring and re-organisations of non-insurers previously. Initially schemes in the context of an insolvent reinsurer were popular.
- > In the case of Cambridge Re in Bermuda no single creditor came forward to contest the use of a Scheme! The final dividend in the liquidation (i.e. closure) occurred in 1994, less than a decade after the run-off started.
- > A scheme requires compromise: “estimated payments” instead of rigidly determined indemnity from “liquidated debt”



Well Established Legal Process

- > Company's Act 2006 UK
- > Requires 2 Court Hearings:
 - > Class Composition
 - > Final Sanction (Approval)
- > Different Classes for IBNR claims and Liquidated Claims
- > Requires approval of 75% of creditors both by number and by size but is binding on 100% of creditors in the class (check these numbers!)
- > English Courts will accept jurisdiction if there is "sufficient connection"

- > Solvent companies desiring run-off finality and capital release sought to use Schemes
- > Commutations slowed down to create a voting block of cedants that wanted to settle
- > Non-UK operations sought to claim connection to the UK, e.g. UK branch of European Reinsurers or UK-broker produced business.
- > Various legal challenges introduced some complexity but it failed to slow the flow (e.g. different class for IBNR creditors)
- > Not used for “mandatory cover” like EL (WC)
- > Outwards reinsurance required separate negotiation (not necessarily binding) except for insolvent Schemes under Chapter 15 of US Bankruptcy Code
- > Now this option is severely restricted by the PRA (Prudential Regulation Authority).

I'm still here.....



- > In-house runoff
- > In-house runoff with 3rd party management
- > Reinsurance (100% QS or Stop-Loss)
- > Sale of Company or Subsidiary
- > Portfolio transfer (Part VII)
- > Merger
- > Schemes of Arrangement

- > Investor plea: I want my Capital back!



In-house-management runoff

- > Discontinue rating
 - > No value going forward when not writing business
 - > May be commercially advantageous to have no rating!
- > Reduce staffing
 - > Most/All underwriting staff (including pricing actuaries) released shortly after runoff announced
 - > Other functions experience staff reductions as less resource needed if not writing business
 - > Look to retain key staff through long-term “Stay-Pay” bonuses
- > Claims management
 - > Focus purely on contractual liabilities
 - > No concern about broker relationships – as not looking write next year’s business
 - > No concern about rating agency relationships – as rating is not important
 - > Not worried about going-forward relationships with cedants – looking to end/wrap-up relationships.
 - > Relationships with regulators continue to be important – approval of capital distributions
 - > Basic professionalism still important! For most employees, won’t be last job in (re)insurance industry.

> Pro's

- > Institutional knowledge maintained
- > Continuity of management
- > Cost-effective
 - > Not paying a third-party a profit margin. Any potential profit in settlement of reserves is retained
- > Maintain control over administration of runoff

> Cons

- > Motivation / Morale of remaining staff
 - > Potential perception that is bad for career. Financial incentive – profit potential.
- > Alignment of interests between management / shareholders
 - > Management may be interested in ongoing employment – may resist efforts to accelerate settlement of liabilities
- > Continuity of management
 - > Not uncommon that companies that go into runoff have been poorly managed. Would shareholders want continuity of such management?



Company Sale Option – DD Process

- > Similarity to reinsurance in that involves trading of uncertain/risky insurance liabilities for a fixed price
- > Process usually run by investment bankers rather than (re)insurance brokers
- > Relatively few participants in the auction (similar to large runoff reinsurance deals)
- > Information asymmetry (similar to retrospective reinsurance)
 - > As in retrospective reinsurance, transferor of liabilities has better information about the exposure than transferee of liabilities.
 - > As in retrospective reinsurance, this is addressed through a risk margin (or – in the case of a sale – a discount to book value)
 - > Size of premium/discount a function of amount of uncertainty, risk appetite of buyer and seller, as well as supply and demand in market for trading insurance liabilities.
- > Timeline
 - > Generally longer than reinsurance transaction as DD more significant/comprehensive
 - > Months – Years
 - > Closing takes longer
 - > Will require regulatory approval(s)



Company Sale Option – DD Process

- > Confidential Data Room established
 - > Comprehensive information on the company made available
 - > Requires involvement of many different disciplines to assess information including:
 - > Legal (disputes company is involved with)
 - > IT (assessment of systems)
 - > Actuarial (Best estimate reserves; degree of upside/downside risk; payout pattern)
 - > Accounting (any issues existing with Balance Sheet – overstated assets; understated liabilities; off-balance sheet items; contingent liabilities)
 - > Claims (views on large individual claims; views on case reserve adequacy)
 - > Actuarial reserve reports generally available
 - > Recent Independent actuary reports
 - > In-house actuarial reports
- > Discussions with management



Company Sale – Pro's and Cons

> Pro's

- > Complete Finality
- > Shareholders get their money back immediately
- > No ongoing risk of reserve deterioration
- > No ongoing management responsibilities
- > ALL issues (not just those associated with settling claims) associated with the company are transferred to a third-party
- > Relatively fast and predictable approval process, especially versus portfolio transfers

> Cons

- > Due Diligence exercise is time-consuming and costly
- > May not realize full book value of company on sale

- > Only useful if the entire company or sub is in run-off
- > Need to portfolio out on-going live business; Or any other business that the seller does not want to separate
- > True corporate mergers did not exist under company law in the UK until December 2007
- > Mergers may still be considered as a Portfolio Transfer with required regulatory approval in the UK
- > Previously the same result was achieved by effecting a Part VII transfer (100% portfolio transfer) followed by a liquidation of the empty shell.
- > Different laws in different EU countries resulting from EU Directives
- > Mergers more likely to be recognised in the US

- > Part 7 is not referring to an actuarial exam
- > Part VII of the Financial Services and Markets Act 2000
- > Relies upon application of EEA insurance and reinsurance directives
- > Very expansive application: any policies where the applicable law is the law of some part of the UK
- > Overseas branches that wrote UK sourced business can re-domesticate the business back to the UK to be eligible for a Part VII transfer
- > Portfolio transfers offer surgical precision of definition of portfolio to be transferred
- > Must be supported by a detailed risk assessment by an Independent Expert (normally an actuary)
- > Significant Pre-Solvency II activity (1/1/2016)

- > For a transfer of general insurance business the independent expert should normally be competent at **assessing technical provisions and the uncertainties of the liabilities they represent** (such as an actuary). Exceptionally, where issues other than the ability of the transferee to meet the liabilities to be transferred are much more significant in assessing the likely effects of the scheme, this criterion might not be applied. In such a case the independent expert would be expected to take advice from an appropriately qualified practitioner about the adequacy of the financial resources of the transferee. (Financial Conduct Authority, Supervision Manual, Chapter 18.2.17)

- > Solvency II familiarity

- > Demonstrable Independence

- > Similar size of capital not required; merely adequate capital levels

- > Duty to Court

- > Who appointed the IE
- > Approved by Regulator
- > Professional Qualifications
- > Independence
- > Scope
- > Purpose
- > Summary of Terms
- > List of data and documents used, anything not provided?
- > Reliance of Information and/or Judgement of others; Who are they?
- > Effect on Policyholders: Transferring, left behind, new host
- > Transferring RI contracts
- > Matters not considered
- > Opinion

Part VII Transfers - Projected Timetable

From nomination of the Independent Expert (“IE”), a transfer could take approximately 12 months, broadly following the indicative timetable set out below.

- > Week 1-13: PRA approval of IE and preparation of the IE report; draft legal documentation; submission of draft documentation to PRA
- > Week 19: Receive PRA feedback on draft documentation
- > Weeks 23-25: PRA approves form of IE report and transaction documents; PRA/FCA circulates draft first report for comment
- > **Week 26: Court directions hearing**
- > Week 27-29: PRA notifies EEA regulators of proposed transfer (beginning their three month consultation period); publication of statutory notices; policyholder communications sent
- > Week 39: Draft supplemental IE report submitted to PRA/FCA; end of 3 month EEA consultation period
- > Week 40-41: PRA provides certificate of solvency for transferee; witness statement regarding due service of policyholder communications and witness statement regarding compliance with statutory requirements filed at Court;
- > Week 43-44: PRA/FCA circulates draft second report for comment
- > **Week 45: Court sanction hearing**

- > All countries must have a procedure for portfolio transfers – dictated by the Insurance and Reinsurance Directives of the EU
- > Great diversity of requirements (and results)
- > None as onerous as the UK

Examples

- > Ireland also requires a Court sanctioned approval process; it may be possible for retrocessions to be transferred
- > Sweden requires actuarial reports for both the transferor and the transferee
- > Belgium has a relatively simple process by comparison.

- > “Insurance Transfers in Europe”, June 2012, Clyde & Co. LLP, www.clydeco.com
- > “Strategies for discontinued insurance business”, May 2008, doc 15293, Norton Rose Fulbright, www.nortonrosefulbright.com
- > “The Prudential Regulation Authority’s (PRA’s) approach to schemes of arrangement proposed by PRA-authorized insurers under Part 26 of the Companies Act 2006”, April 2014, www.bankofengland.co.uk/pra
- > The internet