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Realising value

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Case Studies in Runoff

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Issues Leading up to Runoff Decision

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

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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

Issues Post-Sale

- How to make money (and mitigate risks of losing money)
  - Commutation targets
  - Study large claim issues in detail (strategy for resolution)
  - Secure reinsurance recoverable (set up Bad Debt Provisions)
  - Identify any areas of reserves where there may be concerns
  - Identify Intra-Group relationships
- Actuarial Information Issues
  - Exposure information
  - Data Quality
  - Institutional knowledge of exposure
  - Updated case reserve information

Issues Post-Sale

- Purchase Accounting (Fair Value of Loss Reserves)
  - Discounting
  - Risk Margin
- Quarterly reporting under US GAAP
- Frequency of actuarial analyses
- Release of Capital
  - RBC
  - Solvency II (Internal Model or Standard Formula)
- Regulatory Compliance
  - Rules generally not suited to runoff companies – how to manage effectively
- Personnel
  - Morale / Motivation
  - General corporate culture integration

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

- Cons
  - Loss of opportunity to resolve issues profitably/favorably
  - Due Diligence exercise is time-consuming and costly
  - May not realize full book value of company on sale

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.

Runoff using In-house-management

- 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?

Areas of Actuarial involvement - Commutations

> Underlying Claim Coverage disputes
> Reinsurance contractual issues
> Support for balances owed
> Ability to pay / willingness to pay
> Degree of reserve uncertainty (risk premium)
> Time Value of money underlying reserve payout (discount)
> Capital considerations (capital release?)
> Allocation of IBNR (assuming reserving is not done contract-by-contract)
> Two-way commutation – both parties have reinsured each other (on different contracts, different years, different exposures)

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Areas of Actuarial involvement - Reserving

- Cannot make-up for any reserve shortfalls using profits from future premiums!
- Data issues
  - System migrations over the years can mean full loss development history lost
  - Benchmark Data?
- Knowledge of exposures
  - underwriters long-gone
- Changes in claims-handling / case reserving philosophy can be significant
  - Speed-up or slow-down in payments
  - Changes to case reserve adequacy
- Contractual Disputes
- Availability of benchmarks
  - Loss Ratios irrelevant for older years (premium doesn’t enter into reserving)
- Solvency II