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Implications of Principles Based Regulation on Run Off Portfolio Management

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Presentation Summary

- Run off is a substantial segment of the US and Global insurance markets.
  - Steadily gaining visibility and focus.
    - Regulators/rating agencies/shareholders.
- What is the strategic plan for managing the run off?
- More focus will be required to address the effect of principles based regulation.

The Run Off Marketplace

- Run offs may be solvent or insolvent.
- The reasons for entering run off vary.
  - A strategic decision to rationalize and reorganize operations.
  - The result of poor underwriting and/or claim administration.
  - Catastrophophic losses.
  - Adverse market developments.
  - Termination of client relationships.

The Run Off Marketplace

- Where are these liabilities?
  - Split between stand alone run off entities (46%)and those that manage run off alongside live business (54%).
  - Large segment of the market (43%) manages liabilities in excess of $1 B.
  - Liabilities are managed in either:
    - Separate/discontinued department.
    - Separate business entity.
    - Alongside live business.

Source – PwC US Discontinued Business Survey 2006

Regulatory Regimes and Regulatory Intervention

- Regulatory regimes and oversight vary by:
  - Jurisdiction.
  - Lines of business written by the companies domiciled in those jurisdictions, and
  - Varied stakeholder interests.
- Most companies are pleased with their regulatory relationships.
  - Why?
    - Absent RBC risk, little regulatory scrutiny of run off operations.

Source – PwC US Discontinued Business Survey 2006

Regulatory Regimes (US)

- National Association of Insurance Commissioners (NAIC) coordinates work of state insurance commissioners.
- Regulators are politically appointed within each state
  - Under control of state insurance commissions.
  - Powers derived by state insurance codes.
  - Set requirements for insurance companies to file Annual Statements and submit for state exams.
- Lack of uniformity among the various states:
  - Efforts through NAIC Model Act to standardize regulations.
  - Proposal for dual (federal/state) chartering system similar to that of banking industry.
  - Proposals for modernization of state system.

Regulatory Regimes (US)

Control Level Definitions (with respect to any insurer)

(RBC level set by NAIC Risk Based Capital instructions)

2.0	Company Action Level RBC	Insurer must prepare/submit RBC plan to Commissioner within 45 days
1.5	Regulatory Action Level RBC	Examine assets, liabilities and operations, including RBC plan review; issue corrective order if necessary
1.0	Authorized Control Level RBC	Action taken to place insurer under regulatory control (if deemed in best interests of policyholders/creditors)
0.7	Mandatory Control Level RBC	Action taken to place insurer under regulatory control (for P&C insurers)

Going Into Run Off
Effect on Company

- Immediate implications of run off:
  - Cessation of written premium.
  - Difficulty in collecting reinsurance asset.
  - Continued claims expenses.
  - Continued overhead to support run off.
  - Staff retention.
- Run offs may last many years.
  - Company must manage claim payments and expenses from existing assets and any investment income.
  - Interests of stakeholders change.
  - Need to re-focus business plan on run off operations.

Going Into Run Off

- Choice of Approach
  - Cash management.
  - Aggressive commutation.
  - Accelerated exit.
- Impact of principles based regulation on the desired approach.

Going Into Run Off

- Unless portfolio are actively managed, there is a deterioration in value due to:
  - Increased expense factors.
  - Reserve deterioration.
  - Loss of reinsurance asset.
  - Lack of coordination between investment income and claim payment activity.
  - Surplus decreases.

- Active management can result in:
  - Controlled expenses.
  - Positive reserve development.
  - Realization of the reinsurance asset.
  - Coordination between investment. income and claim payouts.
  - Positive surplus activity.

Effective Management of Run Off Liabilities Essentials of a Run Off Plan

- Financial statement/Reserve analysis.
- Financial / investment model including:
  - Capital funding statement.
  - Risk based capital analysis.
- Staff retention policy.
- Note: Most states do not require a run off plan.
- Regulatory compliance and communication plan.
- Risk assessment and scenario modelling.
- Claims / settlement policy and commutation protocol.
- Leadership and management team including governance board.

Effective Management of Run Off Liabilities
Run Off Plan Observations

- Key Risk Factors to a successful run off
  - Financial management of long tail liabilities.
  - Keeping and motivating staff.
  - Loss of the reinsurance asset.

Source – PwC US Discontinued Business Survey 2006

- Corresponding Plan Deficiencies
  - Most financial models go out 12 years or less.
  - Retention plans are not pervasive.
    - Most plans focus on retention rather than incentive.
  - Infrequent coordination/focus on inwards exposures and outward recoveries.

Effective Management of Run Off Liabilities Reinsurance Collections – Willingness to Pay

- Maximizing the value of reinsurance recoverable asset is essential to any run off entity.
  - Thorough review of the reinsurance program to ensure all available recoveries have been made and will continue to be made in timely fashion.
  - Continued analysis and review of the solvency of reinsurers to highlight weak security where collections efforts need to be focused in order to maximize dollars.

Effect of Principles Based Regulation

- Addressing the impact of principles based regulation requires a company to:
  - Clean up balance sheet
  - Simplify message to the market
  - Allow management to maintain focus on core products

Effect of Principles Based Regulation Opportunities/Consequences

- Settlement of major inwards exposures, particularly A&E, at significant savings.
- Stimulate cash flow through aggressive claims settlement, outward commutation and persistent collections activity.
- Alternative structures to facilitate ongoing capital return.
- Evaluation of disposal opportunities.
- Regulatory filing dispensations.
- Finality options for specific portfolios of business.

Effect of Principles Based Regulation Finality Options

Portfolio transfer	■ Can leave residual liabilities. ■ Still need to deal with run off if transferred within group.
Sale to run off market	■ Available market for purchasers of run off. ■ Owner contribution to purchase may well be prohibitive.
Reinsurance coverage	■ Gives balance sheet comfort and may comfort regulator but premium may be costly. ■ Sufficient protection from volatility of portfolio? ■ Will management/shareholder retain control? ■ Finality dependent on security of reinsurer.

Effect of Principles Based Regulation Finality Options

Plans of Administration	■ Provides a mechanism for achieving finality, and can be applied to specific portfolios of business. ■ Best suited to certain commercial lines. ■ Company may have opportunities to restructure their legal entities by looking at portfolios which could be amalgamated within a shell, and a plan designed to bring the run off to a close.

Effect of Principles Based Regulation Sale as a Solution

- Identifying the prospect?
  - Is sale the right option?
  - Does sale meet shareholder/regulator/rating agency criteria?
- Determining the value to be paid or transferred in relation to the business.
- Regulatory / operational / staffing issues relative to sale?
- Structuring / financing the transaction?
- Executing the business plan and what resources are needed
- Realize return on the investment.

Concluding Comments

- Principles based regulation enhances the focus on discontinued liabilities.
  - Increased regulatory/rating agency/shareholder scrutiny
  - Transparency
- The track record of long term run offs ending solvent and delivering value is not strong.
- Attention must be given throughout to the envisioned end game in order to achieve finality and release value.