EY/AIRROC (re)insurance runoff survey: in search of finality

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Executive summary

The EY/AIRROC (re)insurance runoff survey, the first of its kind in the US, highlights the ongoing challenges faced by insurers and reinsurers, who are seeking finality through a range of strategic activities and some potential new approaches, including those enabled by Rhode Island's Insurance Business Transfer (IBT) regulation (Rhode Island Insurance Regulation 68). The main themes that emerged based on survey responses are the following:

Finality is at the top of the agenda for managers of runoff business.

The majority of respondents reported that runoff business is being managed through the use of strategic plans and structured approaches. Finality is at the core of these plans, with the majority of respondents identifying it as the top objective for runoff plans. However, they are clear-eyed that it will be difficult to achieve. The majority of survey respondents expect their runoff plans to take more than 10 years to reach finality. Some saw no way to achieve it in three to five years, one of the survey's answer options. In other words, finality, while a top priority, remains somewhat elusive and will be a long journey.

Restructuring is becoming more significant in the US runoff market.

Survey respondents also identified finality as the primary influence in runoff restructuring activities. Eliminating the risk of adverse development and promoting capital efficiencies were also cited as key influences. Companies appear willing to consider new tools and approaches to address runoff challenges, especially in light of Rhode Island's IBT regulation. In fact, many respondents expect that regulation to be the most significant development in the US runoff market over the next three to five years. Further, the maturation of the UK market will likely drive some acquisitions of US-based runoff portfolios.

This report:

- Provides an overview of the current state of runoff business in the US insurance and reinsurance industries
- Presents current approaches to structuring and managing runoff business portfolios
- Highlights key challenges faced by organizations seeking finality and/or more efficient and effective management
- Describes the restructuring and exit solutions that insurers and reinsurers have used or plan to use
- Looks ahead to future activities, emerging trends and likely developments

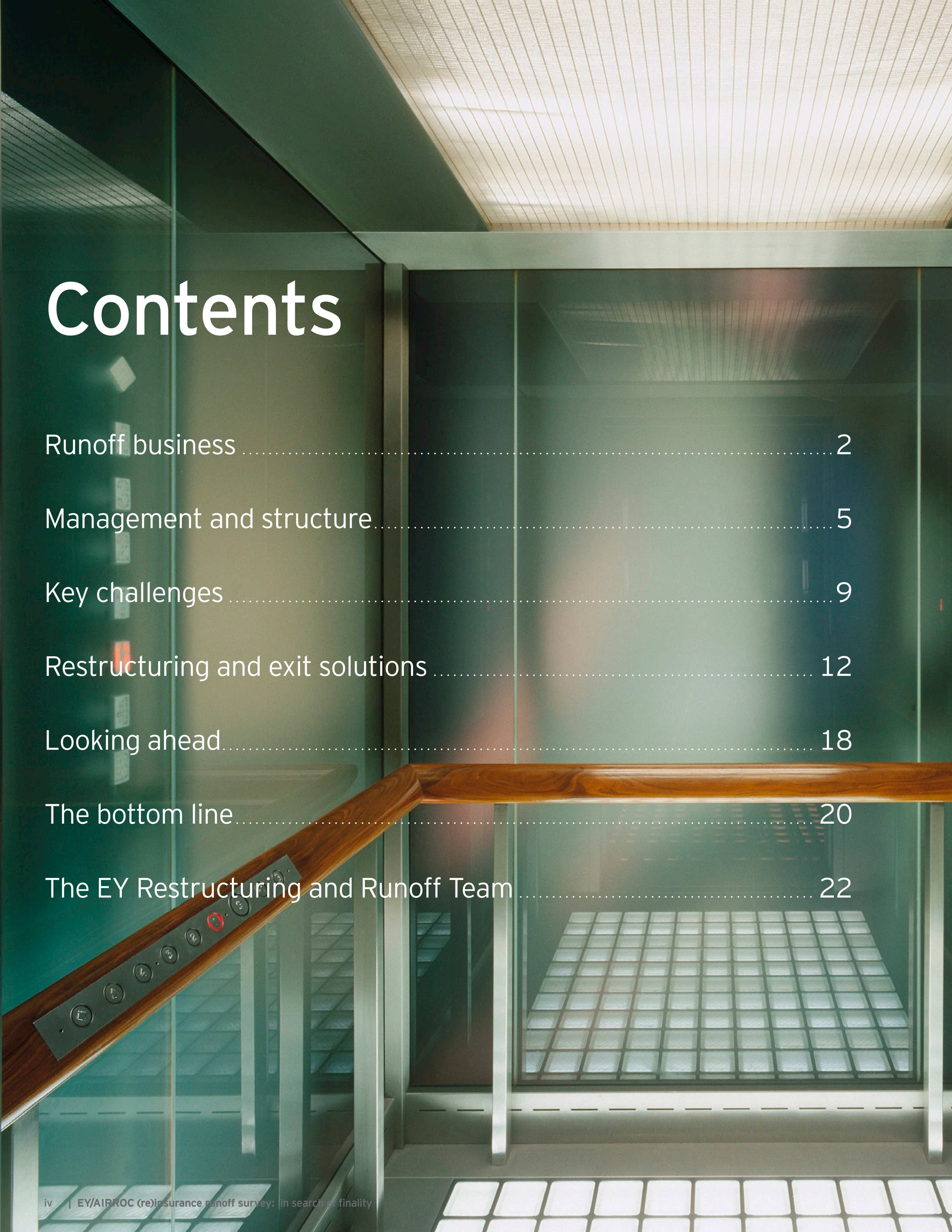
Commutation remains an important part of the runoff toolkit.

The acceleration of runoff through commutation is the most common strategy for dealing with legacy business among insurers seeking early finality. Most respondents report that their companies have considered an exit option, with commutation being the most commonly considered exit option (83%), followed closely by loss portfolio transfer (76%). However, these options do not provide complete finality for runoff business portfolios; commutation typically covers only some contracts or policies, while loss portfolio transfers offer some economic finality, but not legal finality. Thus, companies appear ready to consider alternative approaches, even if they continue to embrace their best current options.

Asbestos claims continue to plague the industry.

The survey results make clear that adverse loss experience is the most important challenge facing runoff businesses, and an overwhelming majority of respondents cite asbestos claims as the most frequent challenge to effective runoff.

Given these developments, EY believes the future will bring many significant changes and considerable activity to runoff business, with insurers moving quickly and boldly in pursuit of new restructuring tools, such as the Rhode Island IBT, that can deliver finality and release excess capital from runoff portfolios.



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About the EY/AIRROC (re)insurance runoff survey

In early 2016, EY collaborated with the Association of Insurance and Reinsurance Runoff Companies (AIRROC) to conduct a comprehensive survey of industry experts to understand their perspective and hear their predictions on the future of insurance and reinsurance runoff business in the US. Specifically, the survey sought to identify the strategic objectives and management approaches for companies with runoff business, as well as the options they are considering to address the many challenges associated with that business.

The survey primarily targeted members of AIRROC, the only US-based non-profit association focusing on the legacy sector of the insurance and reinsurance industries. Survey respondents included 44% of AIRROC's primary member contacts. The respondents were primarily C-suite or senior management in claims, reinsurance or finance departments with US domiciled insurers and reinsurers with runoff business, as well as runoff acquirers and foreign carriers with US-domiciled policies in runoff. The companies included both large international organizations and midsized carriers.

Runoff business
An overview

How does your organization define runoff business?

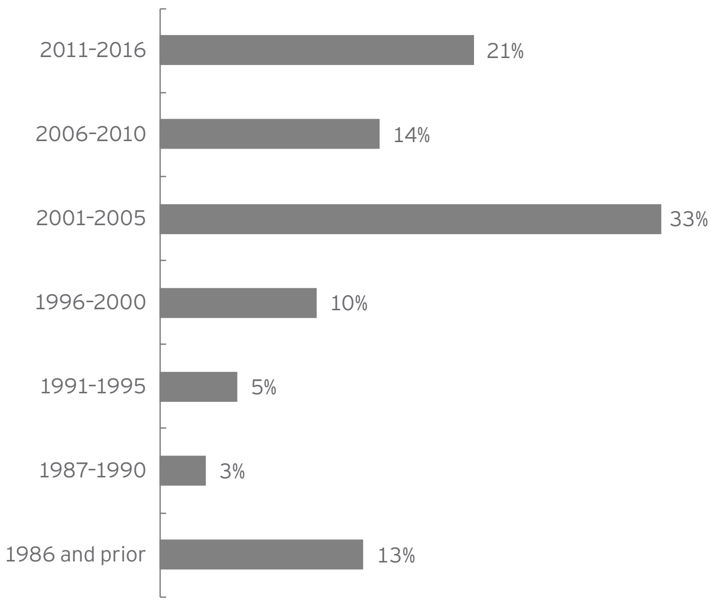
While there is not a single, standard definition that fits all companies, runoff business is typically considered to be any line of business that is no longer written. Common answers included:

- *"Any discontinued line of business."*
- *"Business that is being wound down and no longer underwritten."*
- *"Business that is non-core to the group."*
- *"Carriers or business units closed to new business."*

What is the most recent underwriting year that your organization classifies as runoff business?

(See figure 1.)

Figure 1

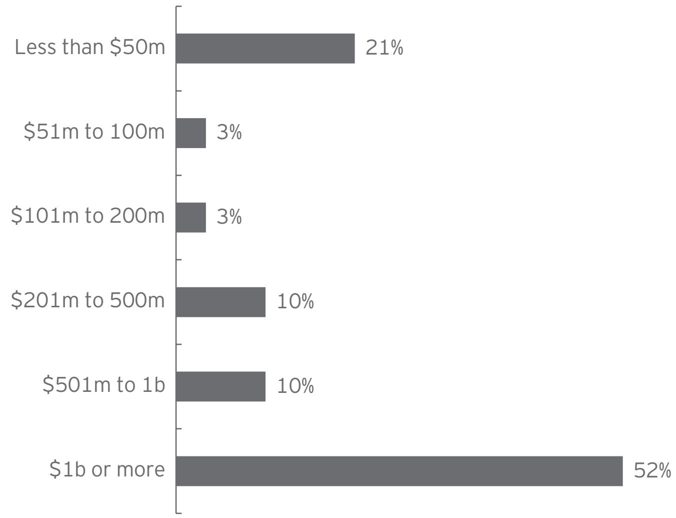


Numbers may not add due to rounding.

Interestingly, more recent business is now being classified as runoff, according to respondents. When asked to name the most recent underwriting year for runoff business, more than two-thirds of respondents reported a year in the span of 2001 to 2016. Nearly one-third of organizations classified 2001 to 2005 as the most recent underwriting year for runoff business, and 21% of respondents identified 2011 to 2016. Earlier classification of business in runoff appears to be a growing trend, as confirmed by evidence of more organizations establishing dedicated runoff units (See figure 8).

What are your or your client organization's total gross runoff reserves (reserves equal case plus incurred but not reported, IBNR)? *(See figure 2.)*

Figure 2



Numbers may not add due to rounding.

Please provide the percentage of total runoff reserves that the following types of claim exposures represent for your or your client's runoff portfolios (reserves = case plus IBNR). *(See figure 3.)*

Figure 3

Types of claims exposures	Mean
Asbestos	41.6%
Workers' Comp	22.8%
Professional lines	12.6%
Accident/health	6.6%
Environmental	4.0%
Product	2.6%
Other latent	1.9%
Construction defect	1.5%
Other	6.3%

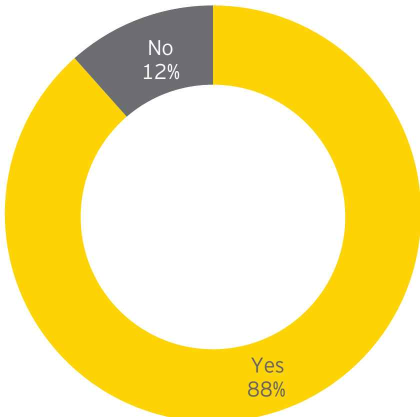
Numbers may not add due to rounding.

The majority of organizations have total gross runoff reserves over $1 billion, which seems to confirm the significant size of some US runoff portfolios. The second most common amount (21%) for runoff reserves is less than $50 million. Survey responses indicate that the majority of runoff portfolios are reserved for asbestos claim exposures, with the mean percentage of total reserves for asbestos claims at 41.6%. Workers' compensation was a distant second at 22.8%. It is clear that respondents expect asbestos liabilities to continue to be a capital strain going forward.

Management and structure
Proactive strategies and dedicated teams

Do you or your client's organization have a strategic runoff plan? *(See figure 4.)*

Figure 4

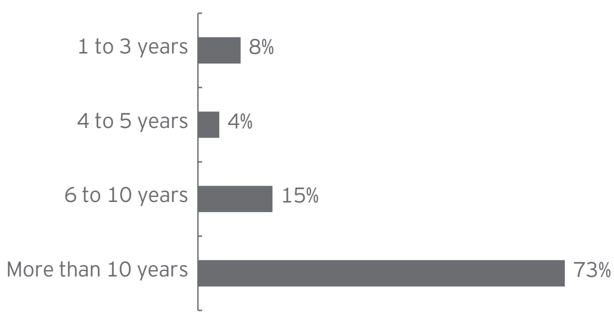


Numbers may not add due to rounding.

A full 88% of respondents reported having a strategic plan in place for their runoff business. Clearly, management sees the importance of managing runoff business and recognizes the opportunities to deal with it proactively.

What is the anticipated duration of your or your client organization's runoff to finality? *(See figure 5.)*

Figure 5



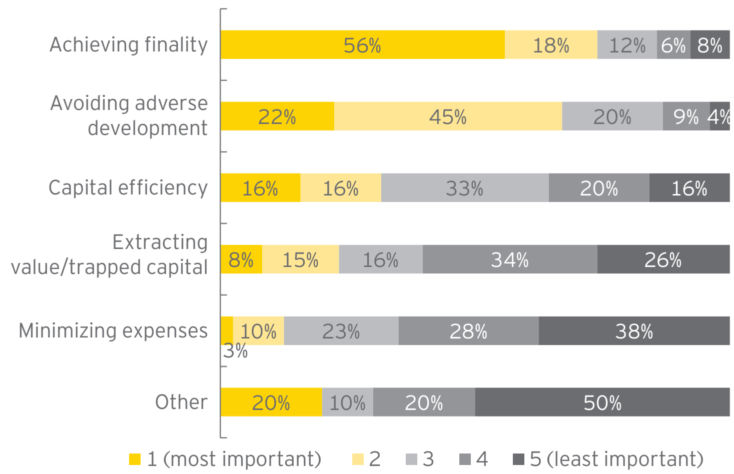
Numbers may not add due to rounding.

A full 73% of survey respondents believe their runoff will take longer than 10 years to reach finality. The finding highlights the risk of a passive, long-term approach to runoff and supports the rationale for finality as the key objective to a strategic runoff plan.

What are the key objectives of your or your client organization's strategic runoff plan? Please rank the top 5 objectives, with 1 being the most important.

(See figure 6.)

Figure 6

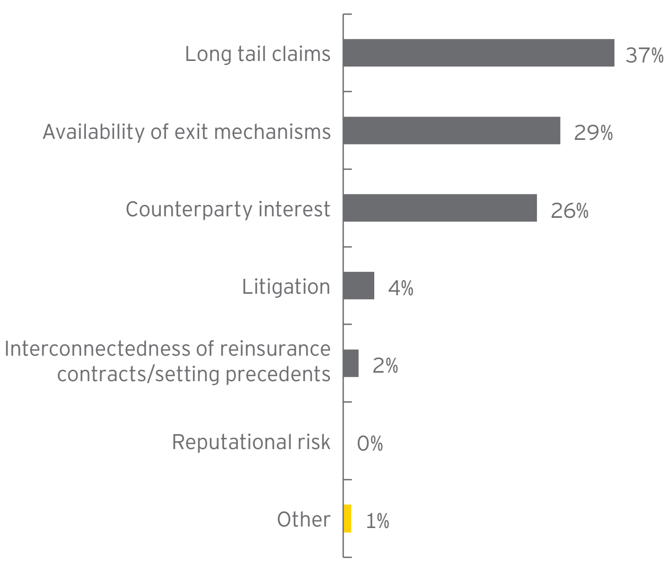


Other factors specified
Commutations
Maximizing creditor distributions
The judicial and court system
Lack of exit mechanisms

Numbers may not add due to rounding.

In your opinion, what is the single most important concern influencing the ability to gain finality for runoff liabilities in the US? *(See figure 7.)*

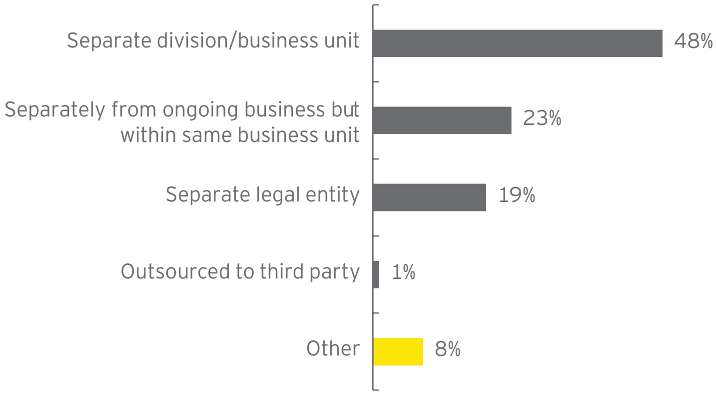
Figure 7



A majority of respondents identified achieving finality as the most important objective for runoff plans. They identified long-tail claims, availability of exit mechanisms and counterparty interest as the most important concerns influencing the ability to gain finality for runoff liabilities. The results validate senior management's frequently expressed frustration with the lack of progress in managing runoff claims and their limited options to address legacy liabilities. Many owners of long-term runoff portfolios (e.g., those containing asbestos exposures) believe they have no viable exit option for restructuring.

How is your or your client's organization's runoff business managed? *(See figure 8.)*

Figure 8



Other factors specified
Stand-alone runoff company
Within existing operation

Numbers may not add due to rounding.

Do you have staff exclusively dedicated to handling runoff?

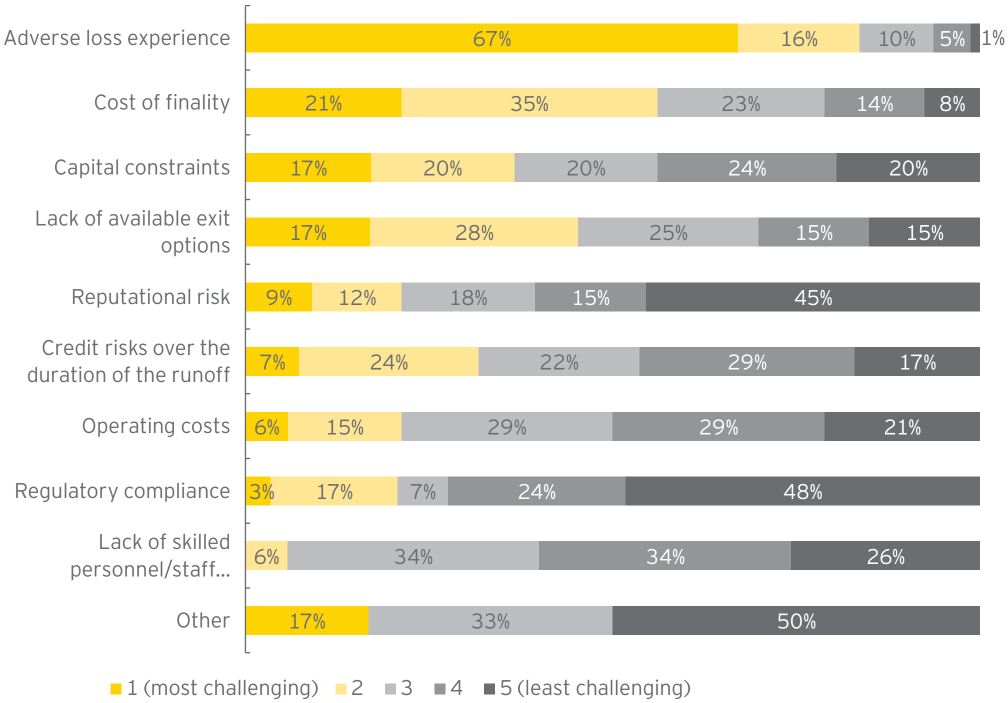
Nearly half of survey respondents manage runoff business through a separate division or business unit, with 23% managing runoff separately from the ongoing business, but within the same business unit. Another 19% of respondents manage runoff in a separate legal entity. A large majority of respondents (89%) have staff exclusively dedicated to handling runoff. It seems that an overwhelming majority of insurers now acknowledge that runoff is best handled separately from active business by exclusively dedicated staff.

Key challenges

Asbestos claims continue to plague the industry

Please select the five most important challenges facing US insurers and reinsurers with runoff business, with 1 being the most challenging. *(See figure 9.)*

Figure 9

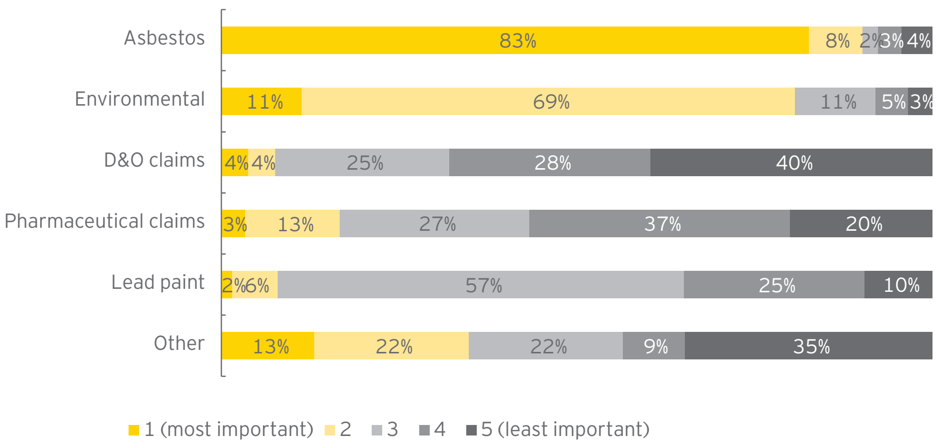


Numbers may not add due to rounding.

Survey respondents cited adverse loss experience as the most important challenge facing runoff business. In light of the fact that most respondents expect the duration of their runoff to exceed ten years (see figure 5), the uncertainty of adverse development experience seems to be a valid concern. Again, this supports the rationale for finality as the key objective to a strategic runoff plan. Many of the survey responses indicate that management is frustrated by lack of exit options available for dealing with legacy liabilities and is looking for effective ways to deal with it.

What claim exposures in your or your client's portfolio will present a challenge to the effective runoff of the business? Please rank the top 5, with 1 being the most challenging. *(See figure 10.)*

Figure 10



Other factors specified
Climate change
Concession
CTE (head injury)
Drones
Driverless cars
Individual disability income (IDI)
Law enforcement liability
New latent claim type
Sexual molestation
Talcum powders
Toxic chemicals
Workers' compensation

Numbers may not add due to rounding.

An overwhelming majority of respondents cited asbestos claims as the most frequent challenge to effective runoff.

To gain an appreciation of the risks being confronted by the P&C industry, one simply has to consider recent asbestos and environmental (A&E) loss development experience. In its most recent study, A.M. Best estimates the industry's ultimate net liabilities as $85B for asbestos and $42B for environmental. Compared to industry reserves, this represented unfunded liability of $7B for asbestos and $4B for environmental. Total A&E incurred losses (paid claims plus reserves) have increased in five of the last seven years, including a 16% increase in 2013.[1]

It appears that asbestos claim counts, losses, and loss estimates are unlikely to decline given latency periods, the size of the affected population, the increase in lung cancer claims, and recent court decisions. Many companies continue to struggle with retaining these risks on their balance sheet.

[1] *A.M. Best Releases Annual A&E Study – February 15, 2015 by KCIC*

Restructuring and exit solutions

What insurers have done and plan to do

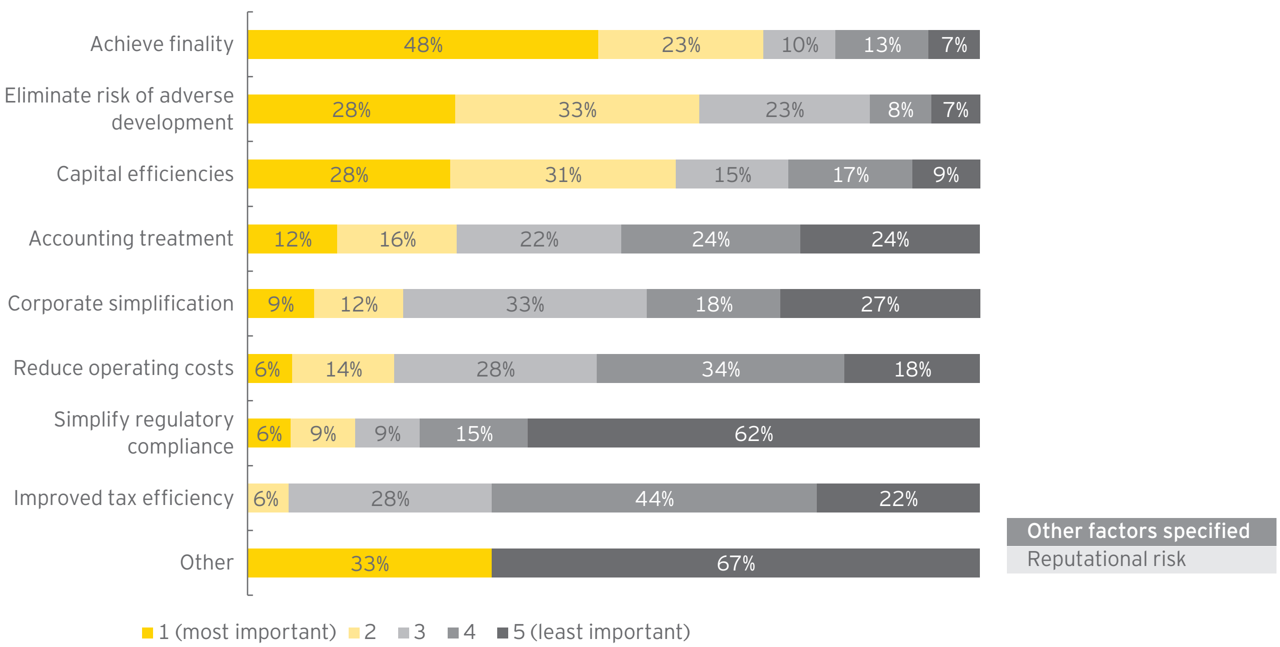
Respondents identified the key drivers that will influence restructuring activity. Finality is again at the top of the agenda, with a significant proportion of respondents citing finality as the key influence in runoff restructuring activities. Companies appear willing to consider new tools and approaches to address the challenges of runoff. Multiple respondents found that Rhode Island's Insurance Business Transfer regulation will be the single most significant development in the US runoff market during the next three to five years. Among the comments from respondents:

- *"Rhode Island's new 'Part 7' law."*
- *"Expansion of programs similar to Rhode Island's to other states."*
- *"Utilizing Rhode Island regulations as a simplified process to end future liabilities."*

What are the key drivers that influence or would influence your or your client organization's runoff restructuring activities?* Rank the drivers on a scale of 1 to 5, with 1 being the most important.

(See figure 11.)

Figure 11



Numbers may not add due to rounding.

Runoff restructuring activity is becoming more significant in the US market. According to a recent Swiss Re survey, worldwide acquisitions of P&C runoff business have increased since the financial crisis hit, especially from 2011 to 2013. The UK has been a core market for legacy acquisitions given its favorable legal and regulatory environment. With the UK non-life runoff sector reaching maturity, legacy acquirers are reportedly looking to expand in the US, where portfolios are large.[2] In fact, 52% of survey respondents reported total gross runoff reserves in excess of $1 billion (see figure 2).

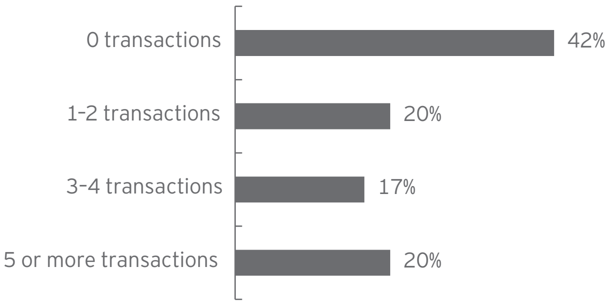
Many respondents cite achieving finality as the most important influence in restructuring. Eliminating risk of adverse development and capital efficiencies are also key influences. Collectively, the need for finality, the risk of adverse development and the prospect of capital efficiencies confirm that more insurers want to focus on core business and exit non-core lines.

** For purposes of the survey, "restructuring activity" was defined as"reorganizing the financial, legal, or ownership structures of a company, whether internal to an insurance group, or with a third party, to achieve a specific strategic objective."*

[2] *Swiss Re Sigma No.3/2015 M&A in insurance: start of a new wave?*

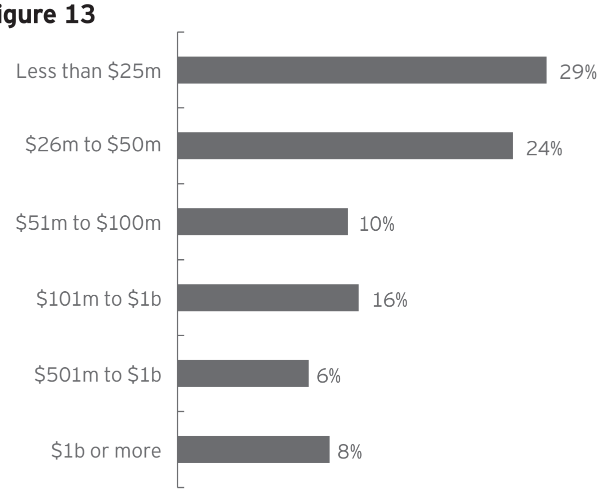
In the last three years, how much restructuring activity in the runoff market has your organization been involved in? *(See figure 12.)*

Figure 12



If you answered 1 or more to the previous question, what is the average deal size for these transactions? *(See figure 13.)*

Figure 13

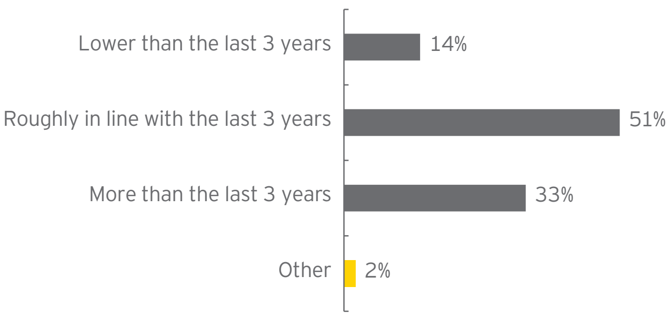


Numbers may not add due to rounding.

Most respondents report at least one restructuring transaction in the last three years. The majority of deals average less than $50 million. Importantly, many respondents (42%) have not engaged in restructuring activity in the last 3 years. Both small P&C companies and international insurance groups have a clear need for effective restructuring tools to optimize capital deployment and to manage runoff business.

How much insurance restructuring activity do you expect to take place in the US over the next three years? *(See figure 14.)*

Figure 14



Numbers may not add due to rounding.

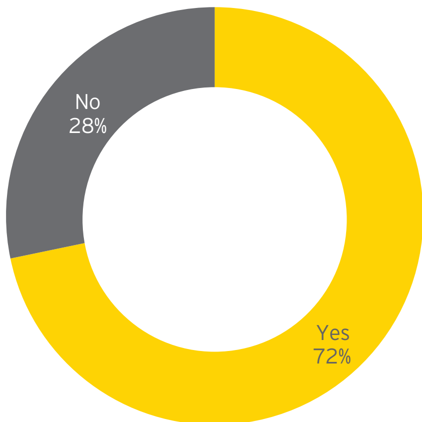
The majority of respondents expect the amount of restructuring activity to remain roughly constant with the last three years, although a greater number of respondents expect an increase in activity rather than a decrease. The recently approved Rhode Island regulations providing for Insurance Business Transfers for commercial runoff insurers indicates that the US regulatory environment is beginning to acknowledge the need for new restructuring tools for the industry.

Historically, Berkshire Hathaway has dominated the market in transaction activity. Three of the larger insurer groups — representing 50% of losses incurred in 2013 from A&E — engaged in large loss portfolio transfers with Berkshire Hathaway's National Indemnity.[3] While larger insurance groups can afford to enter into these sophisticated reinsurance transactions, there are fewer options for many small and midsized insurance companies. However, the new Rhode Island runoff regulations are likely to lead to more transactions among midsized and smaller firms.

[3] *A.M. Best Releases Annual A&E Study — February 5, 2015, by KCIC.*

Have you or your client's organization considered an exit option for its runoff business?
(See figure 15.)

Figure 15

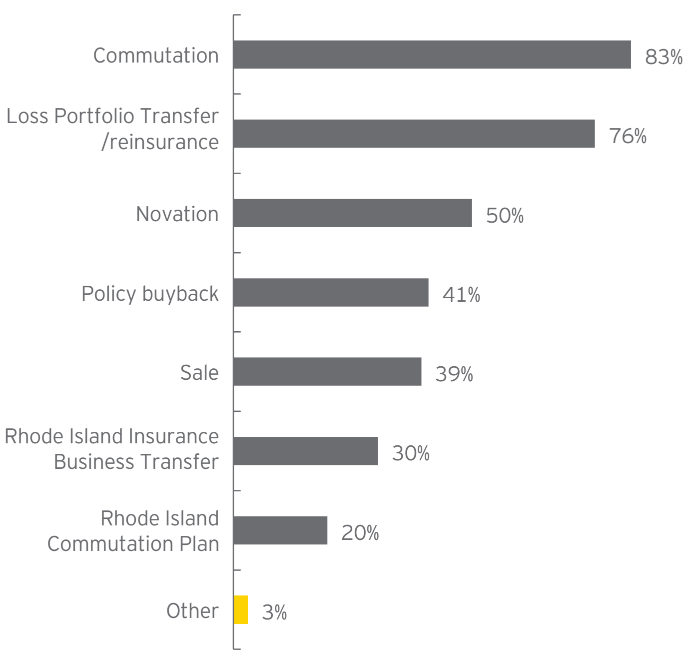


Numbers may not add due to rounding: multiple responses allowed.

Nearly three in four respondents (72%) have considered an exit option. These results seem to be a clear acknowledgment that managing runoff business to expiration does not provide control over the timing of closure for the business, with the result that liabilities remain on the balance sheet and capital cannot be redeployed to core areas of the business or returned to shareholders.

Which exit options have been considered? *(See figure 16.)*

Figure 16

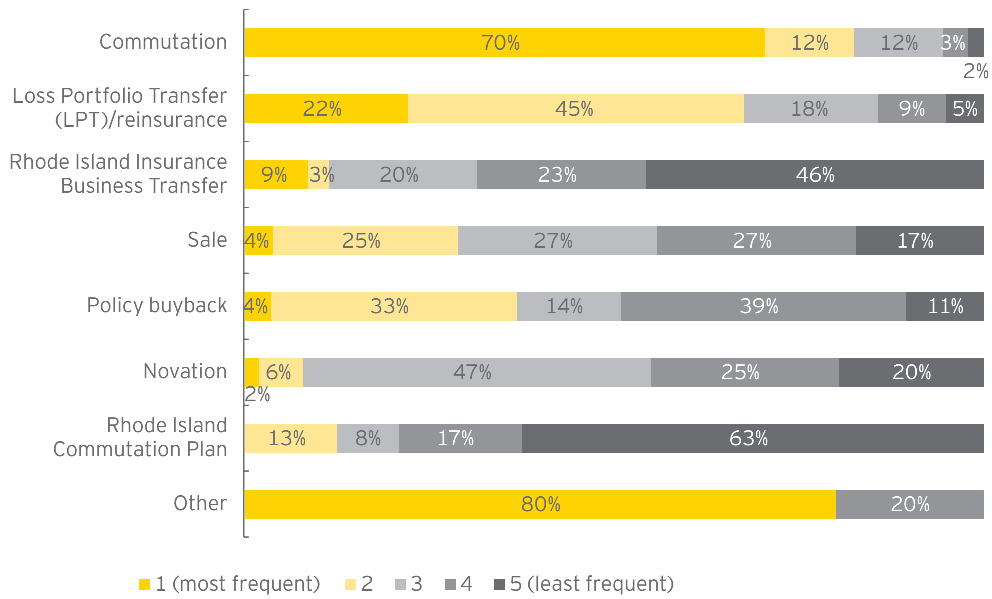


Survey respondents reported that the acceleration of runoff through commutation is the most common strategy for dealing with legacy business among companies seeking early finality. A full 83% of respondents reported that commutation was being considered, followed closely by loss portfolio transfers at 76%. Commuting policies and contracts on an individual basis is a lengthy process, as confirmed by respondents' expectation that the duration of runoffs will exceed 10 years (see figure 5).

Other exit options cited by respondents include novation (50%), policy buyback (41%), sale (39%) and the recently passed Rhode Island IBT regulations (30%). Even though the regulations are relatively new to the industry, it is no surprise to see that 30% of respondents are already considering the use of the Rhode Island IBT as an exit option, largely because it provides finality for the transferring company.

Please rank the exit strategies that will be the most frequently used for US runoff business over the next three years on a scale of 1 to 5, with 1 being most frequent. *(See figure 17.)*

Figure 17



Other factors specified
Discontinuation of business/outsourcing runoff
Aggressively resolving claims
Claims settlement

Numbers may not add due to rounding.

Most respondents indicated commutation would continue to be the most frequently used exit strategy. Many respondents indicated that loss portfolio transfers also would be frequently used. Since finality is the primary objective of most run-off plans, the industry appears to be looking for alternatives to commutation and loss portfolio transfers. Survey responses indicate hopefulness that the Rhode Island IBT regulations will both provide an effective exit solution and expand to other states. As one responder commented, "Hopefully, companies will begin to use the Rhode Island plan or other plans like it to create an exit strategy for US reinsurers similar to what they have in Europe." Another referenced the need for an "exit mechanism with favorable regulatory and accounting [treatment]."

Looking ahead

Future developments

Which of the following types of claims are most likely to create the next major claims exposure?

Most respondents indicated that cyber and CTE, or head trauma, claims are most likely to create the next major exposure. Drones, obesity and cell phone use were indicated as less likely to start the next major claim exposure.

What do you expect will be the single most significant development in the US runoff market over the next three to five years?

Many respondents identified Rhode Island's Regulation 68 providing for Insurance Business Transfers as the single most significant development in the runoff market over the next three to five years. In light of the fact that the key objective of most runoff plans is finality and that finality is also the key driver for runoff restructuring, many companies appear to be considering these new regulations as a means to finality.

Here are some of the sample responses:

- *"An influx of capital from regions outside of the US and Europe to purchase runoff companies and portfolios (e.g., from Asia)."*
- *"Hopefully, the Rhode Island exit plan."*
- *"Asbestos reform will be the single most significant development. Until this takes place, we will see companies experiencing continued claims volume and payments and as a result the need to strengthen reserves."*
- *"Consolidation."*
- *"Spread of regulation like Rhode Island's."*
- *"Continued adverse development."*
- *"Governmental and/or legal changes that will materially impact future loss exposures in connection to asbestos and other cumulative injury claims."*
- *"Rhode Island's new Part 7 law."*
- *"Growing appetite to acquire runoff."*
- *"Improved regulatory support for winding up proceedings."*
- *"Interest Rate movement."*
- *"Solvency II compliance will significantly impact the way runoff is viewed and managed by companies."*
- *"Spike in the number of bankruptcies."*

The bottom line:

Significant activity to come across both in the short- and long-terms

The US insurance and reinsurance runoff market is poised for greater change and more activity than it has seen in many years, thanks to increasing urgency among carriers to achieve finality and new restructuring and exit options. Rhode Island's IBT regulation is expected to drive much change, especially as carriers try to navigate the considerable challenges associated with adverse loss experience and asbestos claims. There is a growing sense of clarity that run-off portfolios must be managed more proactively and efficiently (largely by dedicated teams and divisions), and growing consensus about the best approaches. That's why the runoff business will continue to be an interesting space to watch in the coming years.

The EY restructuring and runoff team

EY provides advice, support and assistance to companies on the following issues:

- Runoff plan review
- Evaluation of capital cost of runoff and alternative run-off structures
- Review of large exposures, including A&E
- Transactional support, including due diligence, claims reserving, debt provisioning and tax considerations
- Evaluation of sale or transfer of liabilities
- Project management for Rhode Island Insurance Business Transfer
- Evaluation of options to bring finality to runoff
- Evaluation of reinsurance and counterparty risk

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AIRROC
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AIRROC's Vision is to be the most valued (re)insurance industry educator and network provider for issue resolution and creation of optimal exit strategies.

Who is AIRROC?

AIRROC is a non profit association of insurance and reinsurance companies that have legacy business in their portfolio. Membership is on a corporate level and includes major US and international insurance and reinsurance companies, well-known rehabilitations, receivership and liquidations that impact a significant portion of US and overseas business. Brokers, third-party administrators and managers that handle run-off business are also members.

Why attend AIRROC?

Business. Connections. Education. Leverage your legacy liabilities.

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Additional reading materials

Welcome to the New World of Runoff
[bit.ly/EYNewWorldOfRunoff]

Part 1: What insurers and reinsurers need to know about the new regulations just enacted in the state of Rhode Island

Part 2: New restructuring opportunities for the US P&C market

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About EY

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AIRROC's Vision is to be the most valued (re)insurance industry educator and network provider for issue resolution and creation of optimal exit strategies.

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