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Feature

End of the Line

When insurance companies find some lines unprofitable or want to change their strategy, they often turn to runoffs.

by Carolyn Fahey

The term "runoff" applies to water flow: "water from rain or snow that flows over the surface of the ground into streams," according to Merriam-Webster.

It's also used in terms of an election: "an additional race, contest or election that is held because an earlier one has not resulted in a winner," the dictionary says.

Interestingly, insurance runoff isn't that much different. It originated in the insurance and reinsurance sectors as a means to distinguish contracts that are cancelled on a cutoff basis—in which the reinsurer is not liable for losses taking place after the date of termination—from cancellation on an ongoing or a runoff basis, where the reinsurer remains liable for losses until conclusion of all activity on the contract.

Over the past two decades, the term "runoff" has been expanded to refer not only to the runoff of a particular contract, but also to entire books of business, to the insurance or reinsurance company itself and finally, to the entire sector of the market in which such business is administered.

Insurance and reinsurance companies go into runoff for varying reasons: the results from particular lines are unprofitable, the company changes its business strategy or needs to focus more on chosen core business lines. A state regulator can also put the company into receivership, insolvency or liquidation to protect the rights of policyholders. In this case, the state-assigned liquidation bureau or receiver administers the runoff.

After a line of business (or the business itself) is discontinued, the company stops writing new policies and pays any remaining liabilities until normal expiry. Insurance runoff is a business, but it is a different business than ongoing insurance enterprises in that the mission has changed from one that is marketing- and underwriting-driven to one that is keenly focused on asset and liability management.

Once the decision is made to go into runoff, a company has a few options: execute an outright sale of the company or book; perform a loss portfolio transfer; or run off the liabilities to conclusion.

For a company that decides to run off the liabilities themselves, the operations are somewhat as would be expected from an insurance company: processing business, paying losses, recovering on reinsurance and consulting with actuaries to project reserve requirements.

Some entities establish separate departments internally to do so while others outsource management of the runoff to a company that offers this service. These managers operate much like the insurer or reinsurer that handles these things internally, focusing on operations and performance of the day-to-day claims and accounting functions.

Key Points

- **The Big Picture:** Insurance and reinsurance companies go into runoff for varying reasons.
- **What Changed:** Recent market activity reflects more acquisitions and fewer commutations.
- **What's Ahead:** In the past 18 months, runoff specialists for the first time are becoming visible in insurance M&A activity.

The basis for their compensation, however, is different, with models that provide incentives for the accomplishment of predefined milestone goals and objectives. No matter which structure a company decides on, the focus on the key objective—maximizing assets and minimizing liability—remains prevalent.

Current players in the legacy business are creative and strategic in determining which methods will best benefit their business strategy, making the legacy sector a very entrepreneurial and sophisticated facet of the big-picture financial services industry.

Using Commutations

In the early days, the transaction most associated with runoff was the commutation. A commutation is an early termination of a reinsurance contract in return for a mutually agreed upon consideration. Similar to a policy buyback with an insured, a commutation allows the reinsured to receive the cash now and the reinsurer to end its obligations to make payments in the future.

Contributor Carolyn Fahey is executive director of the Association of Insurance and Reinsurance Run-off Companies. She can be reached at carolyn@airroc.org

The reasons for commutations are diverse, differing from company to company and from line of business to line of business.

Factors that play into the decision to commute include:

• Allowing a company in runoff to remove itself from entire lines of business and providing a welcome infusion of cash for a ceding company.

• Maximizing reserves for transfer or sale to another entity.

• Alleviating credit concerns regarding a particular assuming reinsurer.

• Improving a reinsurer's underwriting results, since the price of the commutation is often less than the carried reserves.

• Producing favorable tax advantages as a result of the commutation for either or both parties.

• Resolving disagreements over the appropriate reserves to be carried, or in general, over the reinsurance contract's terms.

Recent market activity reflects more acquisitions and fewer commutations. Companies that aren't selling or buying legacy liabilities might start to feel left out of the runoff world—but likely not for long. If history dictates, commutations will follow acquisitions as the acquirers look to cut expenses.

In the past 18 months, runoff specialists—previously focused more on buying discontinued business—are looking for deals in ongoing books of business, and for the first time are becoming visible in insurance merger-and-acquisition activity. Once the business is acquired, these specialists have the option of either putting the business into runoff or operating on an ongoing basis.

Over the past two decades, the term 'runoff' has been expanded to refer not only to the runoff of a particular contract, but also to entire books of business, to the insurance or reinsurance company itself, and finally to the entire sector of the market in which such business is administered.

This is a definite shift from five or 10 years ago when runoff specialists were purchasing latent liabilities such as asbestos and pollution. They acquired the liabilities and became experts in running them off. From there, other long-tail liabilities such as workers' compensation were the focus. More recently, companies that have typically only acquired and managed insurance and reinsurance companies in runoff, and portfolios of insurance and reinsurance business in runoff, are moving in the direction of purchasing "live" companies, or companies that still have an active ongoing underwriting entity.

Both large and midsize companies are active acquirers in the runoff space. These companies may acquire the live company with a goal to place some or all of the assets into runoff and release value over time—which has also been termed a "buy to kill" business model. Given this, private-equity players in the capital markets are becoming more interested in the transactions and the legacy market as a whole.

Why Work in Runoff?

Returning to the concept of runoff in the context of water, the question is: Why would companies or individuals entertain the idea of "swimming" at the bottom of the mountain? Every day, runoff professionals face dealing with companies' toughest challenges—often challenges that have become so insurmountable that a corporation has been forced to shut down or has voluntarily admitted that it cannot continue to operate or underwrite particular lines.

Added to this is the need to pay claims to insureds and reinsureds that have sustained terrible losses, and to make good on the promises for protection—the fundamental reason that insurance exists. Further swirling into the water is strict regulatory oversight; the need to show stakeholders that there is a way to positively generate capital; to make sure that assets are distributed to creditors equitably; and that runoff is often incorrectly viewed with skepticism and mistrust.

Probably one of the most frequently heard things concerning runoffs is, "I am glad that I am not in that end of the insurance business." But why? In runoff, the sky's the limit—it is where the greatest need lies, as well as the greatest opportunities for resolution of the biggest problems. BR

About AIRROC

AIRROC, the Association of Insurance and Reinsurance Run-off Companies, was founded in 2004 as the only U.S.-based association targeting companies with legacy business in their portfolios.

AIRROC's mission is to promote and represent the common interests of insurance and reinsurance companies with legacy business, to improve professional and managerial standards and practices, and to enhance knowledge and communications within and outside of the industry.

Membership is on a corporate level, and given the impact and importance of legacy business to the entire industry, AIRROC has attracted many talented and experienced participants. The association has 47 members, including major U.S. and international insurance and reinsurance companies, well-known rehabilitations, receiverships and liquidations that impact a significant portion of U.S. and overseas business, insurance/reinsurance brokers, third-party administrators and runoff managers that handle business for risk-bearing entities.