LIMA in the Limelight

Opportunitites Created by the Vermont LIMA Act

Often times, insurance professionals at large, mistakenly view the world of insurance and reinsurance run-off from the exclusive perspective of poorly performing, environmental liability-oriented business that is financially impaired. While clearly much of the run-off of the past has encompassed this variety of insurance and reinsurance business from legacy operations, there is a much broader strategic opportunity around run-off that is emerging. Such opportunities constitute the future of run-off.

Going forward, organizations will increasingly utilize the concepts of run-off and novations as a strategic tool to allow global insurance groups, captive insurance companies, and others to exit certain lines, or portfolios of business to unleash capital for better emerging opportunities, and to free management attention and oversight to more core activities. As such a strategic tool, this theme is only nascent and is just beginning to come to full fruition.

Additionally it bears mention, that our industry is heavily focused on mass tort exposures arising from the pre-1986 environmental crisis – EIL and Asbestosis liabilities that have had such a profound impact upon the industry for decades now and are not abating. However, to only view mass tort from the perspective of these well understood legacy issues is a limited view.

There are a variety of emerging mass tort issues that will, invariably, impact the insurance industry over time as the plaintiff's bar examines potential claim opportunity areas to exploit. Such themes include:

- Obesity claims from fast food and consumer food products companies;
- Global warming suits;
- Food additives;
- EMF claims arising to utility companies; and
- Shale development and related issues around "fracking".

These emerging nascent mass tort areas could have as profound an impact to the global industry, over time, as EIL and Asbestos have in recent decades – if not more. In my view, it is not a matter of "if"; it is a matter of "when".

Thus, from the prism of emerging tort issues, very proactive global insurance groups may begin to evaluate such current liabilities for strategic "culling" efforts – to "laser them out" today of a broader liability portfolio, to avoid future claim actions.

Some of these applications are probably best illustrated by hypothetical examples.

First, let's assume the case of a London-based Lloyd's syndicate and global underwriting group is merging with a major Asian insurance group. From an over-arching perspective, such a hypothetical merger is highly complementary as London and Asian-focused operations are combined for a more global risk platform and a more diverse insurance portfolio with lower overall risk is created (under the tenet of portfolio theory that risk diversification tends to reduce overall volatility of results as well as to mitigate the impact of regional pricing trends).

However, let's also assume that, over time, both of these organizations have also created North American underwriting facilities, though not highly core to either organization, and have been profitable and well controlled. But in this case, they are redundant and duplicative as they operate in similar lines of business and market niches. There is no compelling strategic rationale to keeping both segments post-merger, as they compete against each other and, thus, would only serve to destroy owner capital through channel conflict. Thus, a strategic exit from one platform would be a logical next step to pursue, thus freeing capital for a higher and better use.

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Second, let's examine the hypothetical case of a captive of a major Fortune 500 company in the food business. Let's assume this longstanding captive (say, 25 years in business) has been providing an excess casualty program to the parent of, say, $250MM in limits over this period. Further, let's assume the captive has been assuming one layer of this program (say, the $25MM excess of $25MM layer) for this entire period under review.

As a result, the captive has accumulated a significant degree of capital from favorable underwriting results from this program; the parent has well controlled commercial auto, products, and general liability risks; the related loss experience over time has been favorable due to its stellar risk management and safety culture. These exposures are further reviewed annually by a major actuarial firm that fully develops the IBNR reserves based on overall industry factors. The business has produced an assumed 35% loss ratio over this period on this basis. Taken together, this case is a text book case of a captive "success story".

Management, however, is increasingly concerned about emerging mass tort exposures and is beginning to become nervous about the potential for mass tort suits across the United States related to obesity issues. Some of the concepts advanced by the plaintiff's bar in this context include the deleterious mass marketing of such food product to children, and other creative tort concepts.

The stacking of $25MM limits across 20 years is starting to make management concerned; while there is a very real possibility that such a threat will never really manifest itself to the point of creating a financial issue, the potential "worst case" scenario over time could eventually threaten the financial viability of the captive.

Thus, a "lasering" solution might be in order that would allow this captive to transfer some degree of its assumed exposures to a different capital provider base with a higher tolerance for volatility and downside risk. In other words, such a move would align an upwards shift in the relative risk profile of the insurance liabilities to a new capital provider with a higher risk tolerance and appetite (such as a hedge fund).

This final point is a natural segue into the concept of risk adjusted insurance capital and the varying degree of appetites for risk and volatility that it naturally presents.

The traditional insurance platform is organized for risk adjusted returns in the 7 to 10% rate, normalized for any potential volatility over time due to shock type severity losses. Such platforms are not seeking out-sized financial returns; rather, they are looking for more orderly returns that do not present the insurance policyholders, claimants, or capital providers to undue solvency risks or

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shock events that might give rise to either regulatory concerns (i.e. adverse RBC ratio changes) or rating agency downgrades, or negative outlooks. In this traditional insurance model, no undue asset or liability risk is sought and the investments, counterparty risks, and liabilities (through reinsurance) are monitored over time accordingly for conservatism.

The "hedge fund" backed insurance capital model is one where out-sized ("alpha") returns are sought both on the asset side and on the underwriting side. Superior investment results allow for more competitive insurance pricing and when that model is coupled with unusual underwriting risks with opportunistic returns, or ones exposed to undue volatility, very potentially compelling economic returns can be achieved (ROE).

With all of this as a back-drop, the Vermont Legacy Insurance Management Act (LIMA), enacted by Governor Peter Shumlin in February, 2014 creates opportunities to address these sorts of issues with innovative platform solutions. LIMA is the first U.S legislation that allows the formation of specialized, Vermont-based companies to acquire and manage closed blocks of non-admitted commercial insurance policies and reinsurance agreement. A 'Closed Block' requires no more business written in the future, policies must have expired for a period of at least 60 months, and there must be no active premiums to be paid. LIMA enables a non-admitted insurer from any jurisdiction to transfer closed blocks of business to a special-purpose corporate entity domiciled in Vermont. LIMA transfers are limited to commercial insurance policies and/or reinsurance agreements protecting underlying American liability that have continued exposure to claims. No personal insurance, such as life, health, auto or homeowner, or workers' compensation, is involved. LIMA requires the assuming company to establish a new entity domiciled in Vermont, which will be subject to the continuing authority of the Vermont Department of Financial Regulation (DFR)[1].

LIMA creates new investment opportunities. Since the blocks of policies involved are closed, the investors need not be active as an insurance company, thereby expanding possibilities for increased investment. A lot of investment companies are expected to be formed in Vermont.

How LIMA Works

The transferring company will want to relieve itself of contingent liabilities that may never amount to a claim, but are sitting on its books as liabilities. Policyholders and reinsurance counterparties are allowed to opt out of the transfer transactions since acquiring companies must provide 'direct written notices' to them prior to any transfer. Under LIMA, the commissioner of the Vermont DFR would review the acquiring company's solvency before and after the implementation of the proposed transfer of the closed blocks of business. Once a transfer is approved by the Vermont Insurance Commissioner, it acts as a statutory novation. LIMA creates new investment opportunities. Since the blocks of policies involved are closed, the investors need not be active as an insurance company, thereby expanding possibilities for increased investment. A lot of investment companies are expected to be formed in Vermont.

As respects captive insurance companies, the application of LIMA currently is limited to the ability for such a captive to novate reinsurance agreements into LIMA compliant SPVs in accordance with the statute above.

That said, the hypothetical captive situation outlined above would be permissible and, thus, appears to have a ready opportunity for transactions to evolve as Fortune 500-type captives seek to "fine tune" their assumed reinsurance exposures to date, in the face of potential emerging tort exposures. While no such deals have been formalized, it is assumed there will be several under review shortly.

As LIMA potentially evolves in future Vermont legislative sessions, it is conceivable the statute will be broadened to allow dormant captives to move their exposures in total into capital market backed insurance SPVs (again, with capital provided by external providers) to achieve a complete finality to the captive and wind-up. Theoretically, a capital markets-backed vehicle could achieve superior investment returns applied to a base of assets acquired in this manner, to achieve sufficient size and scale to pursue a global alternate risk investment mandate and, in turn, utilize an established claims management and run-off organization to aggressively run-off this portfolio of liabilities over time. In other words, hope to achieve superior claims results over time through a dedicated run-off structure.

From the perspective of Vermont, such an expansion of LIMA would increase captive assets in the state; presumably dormant captives in various other domiciles would be consolidated into

Steven M. McElhiney is the CEO and Chairman of EWI Re (Dallas and London)
smcelhiney@ewiretx.com