ASSOCIATION OF INSURANCE AND REINSURANCE RUN-OFF COMPANIES

AIRROC® MATTERS

A NEWSLETTER ABOUT RUN-OFF COMPANIES AND THEIR ISSUES

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Message from CEO and Executive Director

A Leap of Faith


Trish Getty

A lesson learned, an attitude acquired.

Approximately thirty years ago while diving in the Virgin Islands, I was awarded the PADI certification of Certified Open Water Diver. A few years later while diving in the Cayman Islands, I was challenged by a fellow diver from Chicago to take the ultimate dive. Always open to challenge, I accepted. One afternoon, under proper surveillance, we dove and dropped to 60 ft. below surface, and positioned ourselves on similar level stone pinnacles that grew from the ocean's floor. At 60 ft. from the surface, light disappears. We allowed a certain amount of air out of our vests, then back dived into an abyss of black water. I trusted my training, capabilities, equipment and diving buddy. The experience was one of the most exhilarating moments of my life.

I took a similar dive six years ago when I agreed to build AIRROC. When I met with the interested parties in August of 2004, it became clear that there was a need and this was the time to establish this run-off association. I continue to believe that our mission statement is on track as we further define our objectives. Before the release of this newsletter, your board of directors will meet (May 10-11) to consider our accomplishments and to further define our future objectives because AIRROC matters.™

continued on page 19

Think Tank

Shedding Liabilities


Nick Pearson

By Nick Pearson

Insurers in run-off have two powerful tools for de-risking their book – novation and assumption transactions, and loss portfolio transfers. The only way for a company to truly legally and statutorily eliminate the liabilities associated with books of business is through a novation and assumption transaction (often referred to as "assumption reinsurance"). This entails substituting another insurer for the issuing carrier and in almost all circumstances requires consent of the insureds. The other option for companies seeking to transfer the liabilities associated with discontinued operations are loss portfolio transfers ("LPT"s), which are a form of reinsurance and, therefore, do not legally cut off the issuing carrier's liability to the insureds, but can result in transfer of the past liabilities for statutory accounting purposes.

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Assumption Reinsurance

An assumption reinsurance transaction is one in which the original contract of insurance between Insurer A and the Insured is extinguished and replaced by a new contract between Insurer B and the Insured, typically granting the Insured the same rights against Insurer B as it had against Insurer A, with Insurer A having no further obligation to the Insured. A novation and assumption contract therefore operates as a release between Insurer A and the Insured with respect to all rights, duties and obligations under the novated policy.

Many states have adopted a version of the National Association of Insurance Commissioners Model Assumption Reinsurance Law, which generally requires insured consent to the novation and assumption. In addition, in those states that have not adopted the Model Act, there is often

continued on page 7

Shedding Liabilities *continued from page 1*

case law establishing that a novation requires the consent of the insured. The law of the state in which the insured is found will determine whether and by what means the insured's consent is required. The consent requirement can make assumption reinsurance transactions difficult and costly to implement, particularly for large books of personal lines business. This has acted as a deterrent to their more widespread implementation.

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Typically, in an assumption reinsurance transaction the assuming insurer will be licensed in the jurisdiction where the insured is located, as the new insurer will be deemed to be transacting insurance in that jurisdiction. However, in some commercial transactions if the insured is willing and the placement satisfies the requirements, the replacement insurer could be a surplus lines writer, or even an unauthorized insurer if the insured was willing to travel to the jurisdiction where the insured is licensed so that the policy could be written as a direct placement. Alternatively, there are some states that have industrial insured exemptions to their insurer licensing laws, which could be applicable depending upon the location of the insured and whether it qualifies as an "industrial insured" under the statute.

These possible alternatives to a licensed assuming insurer may make it easier for the issuing carrier to find a replacement insurer willing to assume these risks at a more favorable price. However, it should be kept in mind that the insureds must be willing partners and may be adverse to insuring with an unlicensed carrier.

Whether or not insurance department approval will be required for an assumption reinsurance transaction will typically depend upon its size. Many states regulate bulk reinsurance transactions, which require approval if certain thresholds are tripped. For example, New York requires approval if, during any consecutive 12 month period, a domestic P&C insurer were to cede an amount of insurance for which the total gross reinsurance premiums are greater than 50% of the company's unearned premium on the net amount of its in-force book at the beginning of the period. New York exempts reinsurance "made in the ordinary course of business reinsuring specified individual risks under reinsurance agreements relating to current business" from this calculation. The law of the domiciliary jurisdiction of the issuing carrier should always be consulted to determine whether regulatory approval is required. Of course, a company in solvent run-off under regulatory oversight will probably have more stringent approval requirements imposed upon it.

Loss Portfolio Transfers

Under LPT agreements, the issuing carrier remains legally liable to its insureds, but would transfer to the assuming reinsurer(s) 100% of the liabilities associated with known losses and IBNR. LPTs are always retrospective in nature, which differentiates them from contracts for new business. New York's definition of a loss portfolio transfer is illustrative:

> *Loss portfolio transfer* means an agreement: (1) by which a transferer increases its surplus to policyholders as a result of payment of consideration to a transferee for undertaking any loss obligation already incurred in excess of the consideration paid; or (2) where the consideration paid by the transferer, in connection with transferring any loss obligation already incurred, is derived from present value or discounting concepts based upon anticipated investment income. See *New York Regulation 108.*

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In order to realize the economic benefit of LPT agreements to transfer the liabilities relating to the insureds' reserves, the issuing carrier would need to be able to take statutory statement credit for the liabilities ceded, or obtain qualifying collateral to set off against those liabilities. The same premium volume criteria as discussed in connection with novation and assumption agreements will apply to LPTs in determining whether departmental approval is required.

In addition, depending upon the domiciliary jurisdiction of the cedent ("transferer") LPT contracts generally need to meet some or all of the following criteria in order to obtain statutory statement credit:

(a) The agreement shall provide that the obligations of

continued on page 31

Shedding Liabilities *continued from page 7*

the transferee are payable on the basis of the liability of the transferer without diminution because of the insolvency of the transferer.

(b) The agreement shall be noncancellable, except at the discretion of the superintendent acting as rehabilitator, liquidator or receiver of the transferer or transferee.

(c) The agreement shall not contain terms permitting, or operate to permit, the transferee to exercise influence over the claim settlement practices and procedures of the transferer by delay of payment of balances due or otherwise, except that, subject to the ultimate responsibility of the transferer, the transferee may participate in the defense of claims in a manner that shall not constitute unfair claim settlement practices.

(d) Recoveries due the transferer must be available without delay for payment to losses and claim obligations incurred under the agreement, in a manner not inconsistent with orderly payment of incurred policy obligations by the transferer.

(e) The agreement shall constitute the entire contract between the parties, and must provide no guarantees of any kind to the transferee by or on behalf of the transferer, whether directly, by side agreement, or otherwise.

(f) The agreement must provide for quarterly reports by the transferer to the transferee, setting forth the transferer's total loss and loss expenses reserves on the policy obligations subject to the agreement, so that the respective obligations of transferer and transferee will be recorded and reported on a consistent basis in their respective annual and interim statements required to be filed in New York.

(g) The consideration to be paid by the transferer for the loss portfolio transfer must be a certain sum stated in the agreement.

(h) Direct or indirect commissions to the transferer or transferee are prohibited.

(i) Any provision for subsequent adjustment on the basis of actual experience in regard to the policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a loss portfolio transfer, except that provision may be made for the transferer's participation in the transferee's ultimate profit, if any, under the agreement.

Assumption reinsurance and LPTs are powerful tools for insurers to transfer liabilities. However, these transactions require careful attention to detail in order to ensure they achieve the economic benefits desired and do not run afoul of regulatory requirements. ■

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Policyholders' Response to Proposed US-Based Schemes of Arrangement *continued from page 22*

especially when it comes to receiverships. The current systems of receivership in the US are unique to the states which oversee them. The NAIC distributed a questionnaire in 2009 to various Receivers and professional administrators in the industry to question them about current challenges in their markets and in their experience. 37 states responded with issues that were summarized in six aspects. The following will show what delays are faced by receivers in trying to collect $2.610 Billion in reinsurance, of which $2.237 Billion (or 85.7%) is over 90 days past due. Average number of days overdue is 1,812. The reasons for delay are as follow:

Disputes = 38% this is $994 Million part of $2.610 Billion

Slow Pay = 16% this is $418 Million

Insolvent Insurer = 10% this is $261 Million

Commutations = 4% this is $104 million

Other = 25% this is $653 Million

Not provided = 7% this is $183 Million

The above numbers are *recoverables*. If one applies similar anticipated delays to the amounts which will become recoverable going forward, the implications are profound. In addition, it is not unlikely that the US may see another round of insurance company insolvencies within the next 10 years. Unless there are solid, uniform practices in place, there can be no consistent method of closure. ■