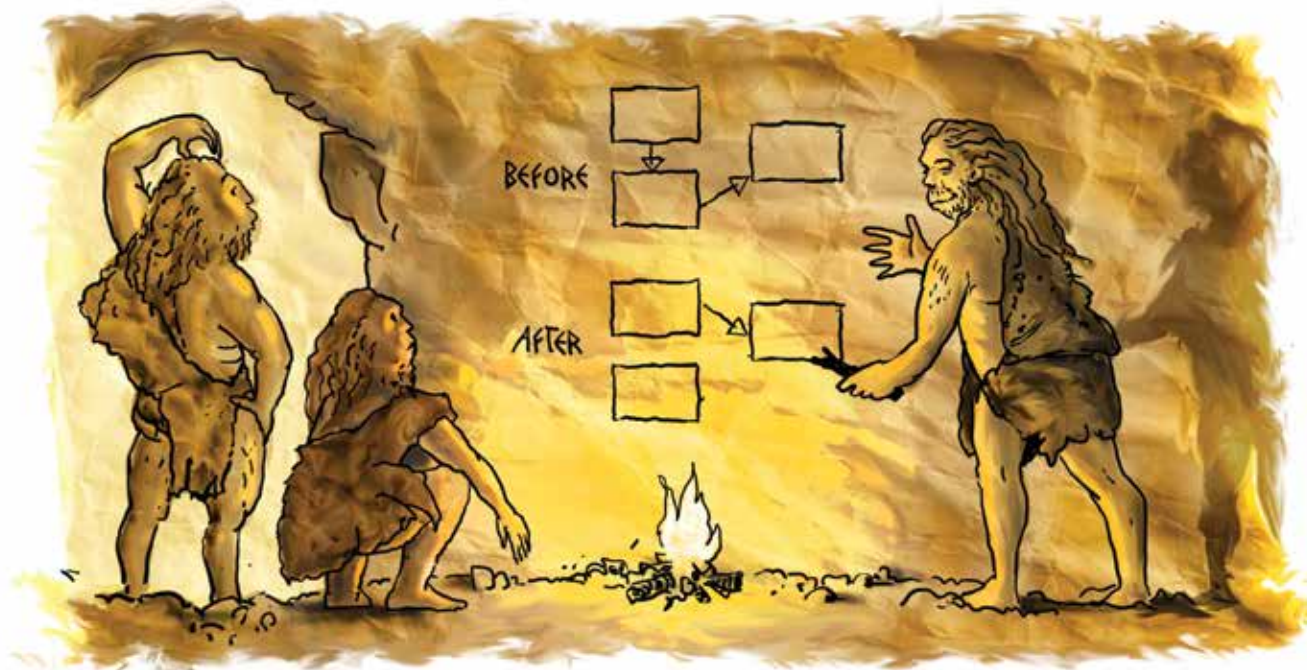


Welcome to the New World of Run-off

Part 2: New Restructuring Opportunities for the U.S. P&C Market



The global financial crisis of several years ago forever changed the way business looks at itself – as well as the way the public and regulators view business. The outlook of most business leaders has changed from the pre-2007 expected future of unlimited growth to a more somber and practical outlook – with more focus on potential loss of wealth, asset protection, increased scrutiny and higher levels of financial risk.

The near-death experiences and forced restructurings of several large insurance companies provide the best examples of how companies must carefully avoid complicated and constrictive financial structures, if they are to effectively manage operating businesses in the post-crisis financial environment. They also confirm and clarify why new opportunities for restructuring are so important to U.S. property and casualty (P&C) carriers.

Restructurings

Restructurings are more complicated for those companies which operate in regulated industries. For example, increased regulatory scrutiny of the banking industry since the financial crisis has led several large non-bank companies to be designated as SIFIs, or systemically important financial institutions, and undergo restructurings. SIFIs are banks, insurance companies or other financial institutions whose failure might trigger a financial crisis¹, in the eyes of regulators. Others in financial services are now asking when SIFI-style oversight will become the norm across the industry.

The insurance industry is well aware that increased oversight, ongoing expansion of state regulation and limited restructuring options have created operating issues, increased compliance costs and raised additional concerns that consume management time and attention.

A.M. Best A&E study

Recent asbestos and environmental (A&E) loss development experience

clearly illustrates the risks confronting the P&C insurance industry. In a recent study, A.M. Best estimated the industry's ultimate net liabilities have increased to \$85 billion for asbestos and \$42 billion for environmental. Given current industry reserves, this represents an unfunded liability of \$7 billion for asbestos and \$4 billion for environmental. A.M. Best also reported that total A&E incurred losses (paid claims plus reserves) have increased in five of the last seven years, including a 16% increase in 2013². Many P&C insurers and reinsurers with runoff business struggle with retaining these risks on their balance sheets.

Current state of the U.S. runoff market

Both small P&C companies and global insurance groups have a need for effective restructuring tools to optimize capital utilization, as well as to manage runoff liabilities. Three of the larger insurer groups that represented 50% of the A&E losses in 2013 have engaged in large-loss portfolio transfers with Berkshire Hathaway's National Indemnity. These

larger insurance groups can afford to enter into such sophisticated reinsurance transactions, but what about the rest of the insurance industry? There are limited runoff options for many small and mid-sized insurance companies.

In addition, many companies have portfolios of business that are either inconsistent with their core competency or provide excessive exposure to a particular risk or segment of the market. These non-core and/or discontinued policies and portfolios are often associated with potentially large exposures. Further, they are characterized by lengthy time periods before resolution of the last remaining insured claims, resulting in significant uncertainty to the insurer or reinsurer covering those risks. Collectively, these factors can distract management, absorb capital, reduce return on equity and negatively impact the credit ratings of both insurers and reinsurers. All of these factors make the disposal of the portfolio an attractive option.

Runoffs: the management view

Management at many U.S. carriers is frustrated by the lack of exit options available to them. Large amounts of insurance capital are utilized to support runoff portfolios that are generally viewed negatively by rating agencies and investors. Sale, commutation, reinsurance and loss portfolio transfer have been the available runoff exit mechanisms. But each of these have limited applications and, in many cases, are not practical solutions, particularly in the low interest rate environment of recent years. Most companies have considered these alternatives and are looking for other more effective ways to deal with the “rump” of the runoff legacy liabilities that remain on the balance sheet.

Rhode Island Insurance Regulation 68: the Insurance Business Transfer

The Rhode Island Department of Business Regulation has approved Amendments to Insurance Regulation 68, providing for insurance business transfers (IBT). The

IBT is a carefully monitored, transparent and court-sanctioned novation process for the transfer of some or all of a company’s commercial runoff liabilities to a newly formed or re-domesticated Rhode Island-domiciled company. The transferred policies move from one company (does not have to be a Rhode Island company) to another company (must be a Rhode Island insurer) and include the attaching reinsurance.

As a public policy matter, the proposed amendments fill a huge void in the current regulatory environment for run-off business...

The IBT applies to all lines of reinsurance, other than life, and all lines of insurance, other than life, workers’ compensation and personal lines. It applies to U.S. and foreign carriers with U.S. domiciled business. The transferring policies must have a natural expiration date of more than 60 months prior to the date of filing for an IBT and be in a closed book of business or a reasonably specified group of policies. The bottom line is that the IBT provides an effective restructuring tool for commercial P&C insurers or reinsurers with runoff business.

The IBT approval process requires rigorous financial scrutiny including a report from an independent expert and both regulatory and judicial approval. This robust review of the economic feasibility of the transfer plan ensures that the viability of the transferring company and assuming company are sustainable over time.

The importance of the IBT transaction is its ability to provide a fair solution that balances the needs of all company stakeholders. Companies with runoff business can transparently exit from these liabilities, while the interests of policyholders are protected by a closely monitored and judicially-approved transfer process.

Impact of the RI runoff regulations on the U.S. P&C market

The IBT allows for a more level playing field for all sizes of insurance carriers in addressing their runoff exposures. Because of its versatility, the IBT provides expanded options for management of runoff liabilities and – for the first time – brings finality to legacy liabilities.

The IBT will permit more efficient management of transferred books of business, and allow dedicated capital and focused solutions to be applied to runoff liabilities. It also provides a reasonable framework for transfers of insurance business while safeguarding the interests of policyholders, resulting in a fair outcome for all parties involved.

UK experience

The Insurance Business Transfer is modeled on the UK Part VII Transfer that has been in place since 2001 and has resulted in hundreds of successful transfers of business. To date, no Part VII transfers have subsequently encountered financial difficulties. Investors have come to view the UK market more favorably because a large amount of captured surplus has been freed up for re-deployment.

The UK has seen the Part VII Transfer used to consolidate runoff within a single entity, within a live insurance group. In some cases, the consolidated runoff entity has subsequently been sold to firms specializing in acquiring runoffs. The Part VII has also been used as a pure exit mechanism to dispose of portfolios of runoff business.

Benefits of the RI IBT

Similar to the UK Part VII Transfer, the IBT is very versatile and can be applied to discrete portfolios, individual policies or to change a company’s entire business. Because of the IBTs flexibility, there are significant benefits to both transferring and assuming companies. Some of these benefits include:

New World of Run-off (continued)

Transferring company

- Increased capital efficiency
- Group restructuring
- Regulatory and operational efficiency and expense reduction
- Simplification and consolidation of legacy business portfolios
- Removal of non-core lines
- Economic and legal finality (if an external transfer)
- Removal of risk of adverse loss development
- Favorable consideration from regulators and rating agencies

Assuming company

- More rational process to enter an expanding runoff market
- Opportunity to increase market share of legacy market
- Creation of center of excellence for runoff
- Regulatory and operational efficiency
- Opportunity for enhanced profit from efficient management and exit solutions
- Consolidation of legacy business

The bottom line: a new and improved restructuring opportunity

For restructuring to be accepted by regulators, policyholders and other constituents, it must be fair to all parties. The IBT process requires that both transferring and non-transferring policyholders be treated fairly within the regulatory and legal framework. Combined with a rigorous review process that requires extensive financial disclosure; the IBT ensures stability to both the transferring and assuming companies. The future success of the company, after recognizing its obligations to all policyholders, ensures the integrity of the regulatory process.

With the IBT now available, we are seeing the market poising for action, looking to understand the cost, benefits, risks and process to effectively leverage this tool to achieve its goals for restructuring and finality. ●

Part 1 of this article, "Insurance Business Transfer: Rhode Island's Answer to Part VII," appeared in the Fall 2015 issue of AIRROC Matters.

Notes

1. Wikipedia definition
2. A.M. Best Releases Annual A&E Study – February 5, 2015 by KCIC

The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or the global EY organization.



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