Transfers bring new options for US market

Rhode Island's recent legislation could change the US re/insurance landscape. Kevin Gill and Luann Petrellis of EY* take a look back at the use of insurance business transfers in the UK run-off market and look forward to see how they may be used for US P&C run-off

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In August 2015 breakthrough legislation was enacted in Rhode Island that enabled the transfer of legacy US property and casualty (P&C) commercial lines (excluding workers compensation) and reinsurance business through an Insurance Business Transfer (IBT). IBT is closely modelled on the UK Part VII transfer process, which has been in place since 2001, and has resulted in hundreds of successful transfers of live and run-off businesses across both the P&C and life sectors of the UK insurance industry. It is widely expected that IBT should transform the US P&C legacy market.

Part VII transfers in the UK run-off market

'Part VII transfer' refers to a transfer of insurance business under Part VII of the Financial Services and Markets Act 2000. Part VII transfers have been used extensively to restructure run-off insurance liabilities, whether it be as part of consolidating capital into a single entity, to consolidate run-off portfolios, or as an exit mechanism to dispose of both non-core live and/or run-off business.

Consolidation of capital into a single entity

UK (and Continental European) insurers have been facing the challenge of operating in a Solvency II environment from 2016, which will result in increased levels of compliance with respect to reporting requirements, governance and risk management of subsidiaries. There was also early recognition by European insurers of the need to consolidate capital into a single entity to enable capital optimisation within a European insurance group.

Many of the large insurers in Europe, such as AIG, Aviva and Zurich, have executed business transfers to enable them to change their European legal entity structure from subsidiaries by jurisdiction to branches. Some of these transfers rolled up legacy business into larger live carriers, while others took the opportunity to move legacy business into dedicated run-off subsidiaries.

Consolidation of run-off portfolios

Part VII transfers have been very successful in consolidating legacy business within ongoing insurance groups into a single legacy entity. These transfers enable the simplification of legal structures, which had become complex after many decades of acquisitions, not only providing the opportunity to reduce costs and achieve some capital efficiency, but also to enable a clear focus on and strategy for legacy business.

Notable examples include RSA consolidating legacy business from many historic insurers in the RSA group into British Engine in 2006, Travelers consolidating the Unionamerica and St Paul run-offs in 2007, and very recently, the Hartford Group consolidating its UK legacy businesses from four entities into Hartford Financial Products International. These three consolidations alone accounted for some £2.4 billion of liabilities.

Many of the consolidations of legacy business into dedicated companies have been precursors to the disposal of the legacy entity itself. Indeed, from the examples above, both British Engine and Unionamerica were subsequently disposed of.

The Part VII transfer is also being used by run-off acquirers to consolidate their own acquired businesses. The run-off acquisition groups derive many of the same benefits from consolidation as do live insurers – primarily cost reduction, organisational simplification and capital optimisation.

As many of the acquirers now operate across Europe, some have chosen to consolidate their business outside of the UK into another EEA jurisdiction.

Disposal of run-off portfolios

The Part VII transfer process can apply to discrete portfolios, enabling insurers to exit portfolios in run-off directly into a run-off acquirer's balance sheet. This exit mechanism is appealing to both transferor and acquirer. The portfolio can be marketed and disposed of through an M&A style process that, if run competitively, can drive attractive pricing for the transferor. The acquirer can usually provide a capital efficient balance sheet to absorb the transferred run-off business, enabling better pricing for the vendor than a share sale might achieve.

Some of the most notable disposals of UK legacy have used a Part VII transfer to provide finality, including Zurich Specialities to Swiss Re in 2012 and Eagle Star to RiverStone in 2013. These two transfers alone moved over $1.2 billion of insurance liabilities through the Part VII transfer process.

The Part VII process is also available to non-EEA companies with branches in the UK to exit their UK branch business by way of a transfer and in doing so remove the exposure from the host company's balance sheet. Sompo Japan has made use of the Part VII process in transferring its London market legacy branch business to Transfercom (part of the Berkshire Hathaway group).

New possibilities for the US market

Effective 18 August 2015 the Rhode Island Department of Business Regulation approved Amendments to Insurance Regulation 68, providing for insurance business transfers. 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 US and foreign carriers with US 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.

Similar to the UK Part VII transfer, the IBT is also very versatile and can be applied to discrete portfolios, individual policies or to the whole of a company's business. The bottom line will be that the IBT provides an effective restructuring tool for commercial P&C insurers or reinsurers with US based run-off business.

The IBT is a carefully monitored, transparent and court-sanctioned wholesale novation process for the transfer of some or all of a company's commercial or reinsurance run-off liabilities to a Rhode Island commercial run-off insurer. The transferred policies move from one US company (does not have to be a Rhode Island company) to another company (must be a Rhode Island insurer). The transfer mechanism also provides for the attaching reinsurance to be transferred too.

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 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 stakeholders. Companies with run-off business can transparently exit from these liabilities, while the interests of policyholders are protected by a closely monitored and judicially-approved transfer process.

Exiting non-core business

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 polices and portfolios are often associated with potentially large exposures and risk of adverse loss development. Collectively, these factors can distract management, absorb capital, reduce return on equity and negatively impact the credit ratings of both insurers and reinsurers.

Impact on US P&C market

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

A new 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 both companies, after recognising obligations to all policyholders, ensures the integrity of the regulatory process.

With the IBT process now available for US run-off we are already seeing the US market poised for action, looking to understand the process, costs, benefits and risks to seize the opportunity that the IBT tool can provide to benefit the US market.

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