Can U.S. insurance companies afford *not* to restructure?

The case for expanding the Rhode Island Insurance Business Transfer to other lines of business

Written by Luann Petrellis

Entire industries are being challenged like never before to open up, innovate and reinvent themselves. In a world where everything is changing, the biggest risk is standing still. This is as true for the insurance industry as it is for any other industry seeking to stay competitive in a growing global economy.

The global game of (re)insurance is evolving at an accelerating pace. There are significant restructuring activities going on in the global and US market. In 2013, Fitch Ratings, when referring to accelerating restructuring in the life insurance industry, stated that there is an "*ongoing trend in the industry where many insurers are taking steps to refocus operations and discontinue or divest businesses that have underperformed and/or no longer provide a strategic fit. Some of this product rationalization has also been driven by persistently low market interest rates, which have lowered the relative profitability of some traditional products while also lowering the cost of borrowing if debt is used to finance the acquisition of these businesses…. We expect this rationalization process will continue to create opportunities for both traditional players looking to strengthen existing core business, reinsurers with an expertise in block acquisitions, and nontraditional players (e.g., private equity)"*

The pressure is now on all insurance carriers to manage their capital more efficiently. It is expected that continuing market conditions, such as the low interest rate environment, globalization, competition and other market trends, will force many insurance companies to continue to undertake significant restructuring activities. According to the 2015 Swiss Re Sigma Report, in Europe "*the introduction of regulations such as Solvency II will encourage insurers to restructure in pursuit of capital efficiencies and/or economies of scale or scope. Similarly, the*

influx of alternative capital will continue to stimulate deals, especially if financial investors become active sellers as well as buyers."
Moving discontinued or capital-absorbing product lines to another business's balance sheet is a huge advantage to an insurance group that has found itself with multiple portfolios of discontinued business, developed over many years and in many formats that can be resource-draining and possibly problematic to the modern insurance organization. Throughout the world there are many jurisdictions that have a restructuring tool to achieve this type of transfer. The most familiar is the Part VII Transfer in the UK — a court sanctioned novation of policies from one carrier to another carrier used by insurers to rationalize portfolio and corporate restructurings and to assist in the closure of businesses in run-off. Generically, this mechanism is referred to as an insurance business transfer.

An insurance business transfer involves the substitution of one counter party for another within the same contract. Its greatest value is the potential to conclusively relieve the transferor of its policy obligations and vest these in the transferee. As a restructuring tool, it is extremely advantageous to a sophisticated insurance industry in allowing firms to adapt themselves to changing business environments through group reorganization to streamline the corporate structure; to gain operational costs savings and efficiencies; to exit problematic lines of business; to bring finality to the business; and to achieve more efficient capital management and improved capital and solvency metrics by releasing excess capital tied up in insurance portfolios.

Prior to August 18, 2015, when the state of Rhode Island (RI) passed Amendments to Insurance Regulation 68 (IR 68), it was virtually impossible to achieve this type of transfer in the US. The RI Amendments to IR 68 set forth a process for transferring commercial property and casualty (P&C) runoff business from one entity that does not have to be a RI company to another company that does have to be a RI insurance company. This transfer process results in a novation of the transferred policies affected by a court order from the RI Superior Court after a robust regulatory and judicial review process. The insurance business transfer mechanism

allowed under the RI regulations (RI IBT), is modeled after the UK Part VII transfer, UK legislation that was enacted in 2001 and applies to all lines of business.

Since the Part VII legislation was enacted in 2001, hundreds of successful transfers have been completed, none of which have subsequently encountered financial difficulties. In a recent interview with David Scasbrook, Head of P&C Runoff Solutions for Swiss Re, Scasbrook commented that, *"Transactions have largely been entered into*, *by companies in run-off, or those with a very specific need. And those needs can be categorized into three main reasons: strategic orientation, so companies that have exited a line of business or are acquiring another company and wish to insulate themselves from the results of that company's prior year liabilities. People also enter into these transactions for operational reasons and then more commonly capital management reasons*." The Part VII transfer provides the UK insurance market with an effective restructuring tool, making it a vibrant market that is attractive to investors.

Since the UK adopted the Part VII transfer, similar laws have become more prevalent in other parts of the world. In the UK, as well as other jurisdictions that have a similar transfer process, companies have the ability to exit and enter lines of business more easily and to restructure their operations so that they may more efficiently and effectively deploy their capital and achieve greater operational efficiencies. Interviewed in RunOff & Restructuring's Yearbook & Directory 2016, Arndt Gossmann, CEO of run-off acquire DARAG, said of transactions in the European market, *'…we don't expect any slowdown in runoff activity. Quite the contrary, we expect that the volume will remain at high levels for at least three more years.'*

Prior to the approval of the Rhode Island Amendments to IR 68, there was no effective mechanism to transfer portfolios of business from one insurance carrier to another insurance carrier and achieve complete finality for the transferring company. For many years, loss portfolio transfers (LPT) have been the preferred runoff solution. While LPTs provide economic benefits to the transferring company, they do not provide legal finality. Also, Assumption Reinsurance statutes are available in some states and provide for a traditional novation.

However, these statutes are viewed as cumbersome and time-consuming and are not widely used outside the rehabilitation process. In some cases, management may choose to sell companies in runoff, but frequently this is not an effective solution because the runoff may be embedded in a much larger portfolio of active business. The court-sanctioned novation process set forth in the RI IBT provides companies with an effective means to transfer all or part of a portfolio to another company achieving complete finality for the transferring company while also adequately protecting the rights of policyholders through a robust regulatory and judicial review process.

Currently the RI IBT is restricted to commercial P&C runoff business. The RI IBT was written pursuant to RI's "Voluntary Restructuring of Solvent Insurers Act," which limits the application of transactions to commercial P&C business. However, there is no compelling justification to limit the application of the RI IBT to commercial P&C business. The exclusion of other lines of business such as life, workers' compensation, long-term care, etc., leaves carriers holding these liabilities with nowhere to turn to effectively restructure their runoff business.

The RI IBT transfer mechanism is an effective restructuring tool that could be applied to all lines of business to help companies increase capital efficiency, as well as address problem lines of business (i.e., long-term care). Real and tangible benefits can be gained from an insurance business transfer mechanism, and the decision to proceed with a transfer can be a catalyst and form the cornerstone for achieving operational and financial improvements for both the transferring and assuming parties. In order to stay globally competitive, the US insurance industry needs a restructuring tool that allows companies to transfer business from one company to another company and provides a clean exit for the transferring company. The RI IBT is a game changer, providing the US market with a new tool to compete in the global market.

The UK experience shows that the insurance business transfer concept is a successful business model for the transfer of all lines of insurance business. In the US, the insurance business transfer as a strategic restructuring tool is only nascent as we find ourselves to be new players

in an advanced restructuring game. RI took the first step in passing regulations allowing for insurance business transfers of commercial P&C runoff business. When RI and other states adopt legislation providing for insurance business transfers that apply to all lines of business, companies will have the ability to efficiently and effectively restructure all their runoff liabilities. Going forward, organizations will increasingly utilize the concept of an insurance business transfer as a strategic tool to allow insurance groups, captive insurance companies and others to exit certain lines, or portfolios of runoff business to unleash capital for better emerging opportunities, and to free management attention and oversight to more core activities.