

EY and AIRROC survey of the US (re)insurance runoff market Summary of results

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In early 2016, Ernst & Young LLP teamed up with AIRROC, the Association of Insurance and Reinsurance Run-Off Companies, to conduct a survey of industry experts on the current state of the US insurance runoff market and predictions for the future. The goal was to understand the key strategic objectives for companies with runoff business, how the runoff business is managed and options for dealing with the many challenges of runoff business.

The Survey primarily targeted members of AIRROC, the only US based non-profit association focusing on the legacy sector of the insurance and reinsurance industries. The survey respondents were predominantly senior executives and management of US-domiciled insurers and reinsurers with runoff business, as well as runoff acquirers and foreign carriers with US-domiciled policies in runoff. Respondents came from a variety of organizations, including mid-sized carriers and some of the largest international organizations.

From the survey responses, we identified five key findings.

1. Finality is at the top of the agenda for managers of runoff business.

The majority of respondents reported that runoff business is being managed through the use of strategic runoff plans indicating that runoff managers are taking a structured approach to runoff business. A full 88% of survey respondents reported having a strategic runoff plan in place. This acknowledges that management sees the importance of a strategic runoff plan and that opportunities are available to deal proactively with runoff business.

Finality is at the core of these plans. The majority of survey respondents identified finality as the most important objective for runoff plans. The respondents identified long-tail claims, availability of exit mechanisms and counterparty interest as the most important concerns influencing their ability to gain finality for runoff liabilities. This validates senior management's frequently cited frustration with the lack of progress in managing runoff claims and the limited

¹ A.M. Best Releases Annual A&E Study — February 5, 2015, by KCIC.

available options to address legacy liabilities. Many owners of long-term runoff portfolios — for example, those containing asbestos exposures — believe they have no viable exit option for restructuring runoff business. Notably, 73% of respondents reported that their runoff is expected to take more than 10 years, suggesting that finality is a somewhat elusive goal that requires a long-term pursuit.

These findings highlight the need for more efficient and effective exit options for companies continuing to grapple with managing discontinued businesses. Currently, the most frequently utilized “exit solutions” include loss portfolio transfers (LPTs) and commutations. However, these options do not provide the comprehensive finality most companies are seeking. Rhode Island is the first state to approve regulations providing for insurance business transfers (IBT), which offer both economic and legal finality for the transferring company. Time will tell if companies decide to use the Rhode Island regulations to achieve the finality they are seeking.

2. Restructuring is becoming more significant in the US runoff market, and finality is the key driver influencing runoff restructuring activities.

Restructuring activity in runoff is becoming more significant in the US runoff market as there is a growing market to acquire runoff business. Worldwide, acquisitions of P&C runoff business have increased in the years since the financial crisis, especially from 2011 to 2013. The UK has been a core market for legacy acquisitions — no surprise given its favorable legal and regulatory environment. With the UK non-life runoff sector reaching maturity, legacy acquirers are reportedly looking to expand in the US, where the size of runoff portfolios is significant.* Notably, 52% of survey respondents reported total gross runoff reserves in excess of \$1 billion.

Survey respondents also identified finality as the key influence in runoff restructuring activities, with elimination of the risk of adverse development and capital efficiencies also cited as key influencers. The interrelatedness of finality, adverse development risk and capital efficiencies highlights that respondent organizations want to focus on core business and exit non-core lines. Companies appear willing to consider new tools and approaches to address the challenges of

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runoff; multiple respondents believe that Rhode Island's IBT regulation will be the single most significant development in the US runoff market over the next three to five years.

Most respondents expect the amount of restructuring activity to remain roughly constant with the last three years, although a greater number of respondents expect an increase in restructuring activity than a decrease. Notably, many respondents (42%) have not restructured in the last three years. For those that have, the majority of deals average less than \$50 million. These responses indicate a need for new restructuring tools in the runoff industry. Companies are looking for ways to restructure their runoff business to achieve finality and release excess capital.

Whether the entity is a small P&C company or an international insurance group, there is a continual need for effective restructuring tools to optimize capital deployment as well as to manage runoff liabilities. Historically, Berkshire Hathaway has dominated the market. Three of the larger insurer groups — representing 50% of losses incurred in 2013 from asbestos and environmental — engaged in large loss portfolio transfers with Berkshire Hathaway's National Indemnity.¹ While larger insurance groups can afford to enter into these sophisticated reinsurance transactions, there are fewer options for many small and midsize insurance companies. However, the new Rhode Island runoff regulations providing for insurance business transfers may lead to more transactions among midsize and smaller firms.

3. Commutation remains an important part of the runoff toolkit.

Nearly three-quarters, or 72%, of survey respondents have considered an exit option, acknowledging that managing runoff business to expiration does not provide control over the timing of closure for the business with the result that liabilities remain on the balance sheet and capital is tied up rather than being redeployed to core areas or returned to shareholders. Survey respondents report that the acceleration of runoff through commutation is the most common strategy for dealing with legacy business. A full 83% of respondents report considering commutation, with loss portfolio transfers cited by 76%. Commuting policies and

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contracts on an individual basis is a lengthy process, as confirmed by the overwhelming majority of respondents reporting that the expected duration of runoffs will exceed 10 years.

Other exit options being considered are novation (50%), policy buyback (41%), sale (39%) and the recently passed IBT regulations (30%). Even though the Rhode Island regulations are relatively new to the industry, it is no surprise to see that 30% of respondents are already considering them as an exit option, given that, unlike most currently available exit options, the IBT regulations provide finality for the transferring company.

Since finality is the primary objective of most runoff plans, the industry appears to be looking for alternatives to commutation and LPTs to achieve a more efficient and effective exit that provides finality. The survey results show hopefulness that the Rhode Island IBT regulations will provide an effective exit solution and will expand to other states.

4. Asbestos claims continue to plague the industry.

Respondents cited adverse loss experience as the most important challenge facing runoff businesses, with the overwhelming majority of respondents citing asbestos claims as the most frequent challenge to effective runoff. The survey responses indicate that the majority of runoff portfolios are reserved for asbestos claim exposures with the mean percentage of total reserves for asbestos claims at 41.6%. Respondents indicated environmental claims exposure would be another frequent challenge. It is clear that respondents expect asbestos and environmental liabilities to continue to strain capital going forward.

5. Future developments include ongoing focus on finality, asbestos concerns and IBT regulations.

Most survey respondents indicated that Cyber and CTE (head trauma) claims are most likely to create the next major exposure for the industry. Whether either of these exposures will rise to that of asbestos is uncertain, but clearly the industry is concerned.

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As for the single most significant development in the runoff market over the next three to five years, survey respondents identified Rhode Island's Regulation 68 providing for insurance business transfers. In light of the fact that the key objective of most runoff plans is finality and that finality is also the key driver for runoff restructuring, many companies appear to be considering these new regulations as a means to gain finality.

Conclusion

Finality is at the top of the agenda for insurers with runoff business. While many companies continue to use commutation and loss portfolio transfers as "exit" solutions for runoff business, these options do not provide the finality that most companies are seeking. Companies appear ready and willing to consider new tools and approaches to address the challenges of runoff. Certainly, that's one reason many respondents expect Rhode Island's IBT regulation to be the single most significant development in the US runoff market over the next three to five years. The future may prove to be an exciting time for runoff business in the US, with new restructuring tools enabling more efficient management of runoff business and focused solutions being applied to runoff liabilities.

* Swiss Re Sigma No.3/2015 M&A in insurance: start in a new wave?

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