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Run-off webinar in partnership with AIRROC

LEGACY SOLUTIONS 2020

REDEPLOY
Releasing trapped capital

INNOVATION
An ever-evolving sector

LEGACY
A strategic tool

From the publishers of
CAPTIVE REVIEW

Building on a legacy

This *Legacy Solutions* report features contributions which illuminate the sector and give some of its leading voices a chance to share their knowledge on the strategic advantages of a legacy solution along with the structuring types available.

The legacy solutions marketplace (historically known as 'run-off') is a growing market segment. While the segment has been traditionally viewed with some degree of scepticism, the contributors within dispel some of the common myths surrounding the actual purposes of legacy solutions, especially within a captive insurance vehicle context.

The report also features a summary of *Captive Review*'s recent panel. Featuring R&Q Bermuda, Sirius and Milliman, the panel sought to educate attendees as to the virtues of this industry.

Overall we hope this report will inspire our readers to consider how a legacy solution could benefit them.

Ross Law
Report editor

CAPTIVE

REPORT EDITOR
Ross Law
+44 (0)20 7832 6535
r.law@pageantmedia.com

CAPTIVE REVIEW EDITOR
Lauren Ingram
+44 (0)20 7832 6684
l.ingram@captivereview.com

HEAD OF PRODUCTION
Claudia Honerjager

HEAD OF DESIGN
Jack Dougherty

PUBLISHING DIRECTOR
Nick Morgan
+44 (0)20 7832 6635
n.morgan@captivereview.com

SENIOR PUBLISHING EXECUTIVE
Mansi Khatwani
+44 (0)20 7832 6582
m.khatwani@captivereview.com

BUSINESS DEVELOPMENT MANAGER
Richard Freckleton
+44 (0)20 7832 6593
r.freckleton@pageantmedia.com

DATA/CONTENT SALES
membership@captivereview.com
+44 (0)20 7832 6513

HEAD OF EVENTS
Beth Hall
+44 (0)20 7832 6576
b.hall@captivereview.com

CEO
Charlie Kerr

pageant media RIRG

Published by Pageant Media,
One London Wall, London, EC2Y 5EA

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THE LONGSTANDING RUN-OFF ACQUIRER

Paul Corver of R&Q outlines the firm's history in the legacy space

Captive Review (CR): How long has R&Q been active in the captive space, and how did you first get into it?

Paul Corver (PC): R&Q, established in 1991, was one of the first acquirers of run-off portfolios to appear, initially operating in Europe and North America. Our first real foray into the captive space was not until 2009 when we acquired the Guernsey domiciled captive from the liquidators of the insolvent Woolworths retail chain. The liquidators were realising assets of the group and wanted the capital that was trapped in the captive.

CR: How important is the captive business to R&Q?

PC: The captive and wider self-insurance sector is very important for R&Q. We have completed over 100 transactions in the last 11 years across 35 different regulatory jurisdictions. Over 70% of these deals have been with captives, cells, workers comp trusts or other self-insurance vehicles. We utilise a wide array of structures including outright acquisition, retrospective reinsurance, novation, assumption agreements and deductible reimbursement policies, all of which have been adapted for captive structures.

CR: Is the economic downturn good news for R&Q as a legacy player? Is there an inverse correlation between economic performance and opportunities in legacy/runoff?

PC: It is inevitable that any event that causes an economic impact on insurers' balance sheets will give rise to opportunities for the legacy sector. By removing or protecting legacy liabilities from deterioration we provide capital efficiency to the seller. The capital, or in some instances the collateral, that is released can either be distributed to shareholders, recycled to support new underwriting or simply used to bolster the balance sheet. At times like this some people unkindly refer to the legacy players as vultures; I prefer to think of us as lifeboats providing a secure and safe passage out of a difficult situation.

Paul Corver

Paul Corver is the group head of Legacy M&A at R&Q and has been active in the run-off space for almost 30 years. Aside from managing both solvent and insolvent run-off companies, for the past ten years he has been actively acquiring portfolios of legacy liabilities for R&Q. These have included acquisitions, LPT's, Part VII and business transfers, novations, mergers and assumptions. Transactions have been concluded in numerous territories and with companies such as Unilever, John Laing, Virgin Atlantic, Clariant, Astra Zeneca, Chubb and Axa LM.

CR: What makes working with captives different to other insurers in the legacy space? What do you need to succeed in this business?

PC: The obvious difference is that captives are created by companies that specialise in a wide range of industries, whether pharma, retail, transportation, etc. They are very knowledgeable about the sector in which the parent company operates but can have limited knowledge about insurance compared to a commercial insurer. We therefore find that captive owners and captive boards are not as familiar with run-off or restructuring solutions as some commercial insurers. We have spent the last ten years meeting, talking with and presenting to representatives from across the captive sector about how effective management of legacy liabilities can enhance and benefit the operation of an ongoing captive operation.

CR: Do you specialise in certain types of captive or certain types of risk?

PC: One benefit of operating in the captive space is that we get good diversification of risk from the business that we assume. As mentioned above, captives are created by companies across a wide range of industries so while we may take on a lot of workers compensation risk, for example, the underlying exposures can vary enormously between different industries.

Most opportunities we see relate to long and medium tail exposures. It is inevitable as those are the liabilities that will take longer to mature and settle and absorb capital or collateral requirements in the meantime. This will therefore include classes such as workers comp, commercial auto, general and public liability, medical malpractice and professional indemnity. R&Q has the knowledge and experience to assume these and other classes of business and if we lack that knowledge we have access to TPA's and other service providers to support our transaction.

CR: How well understood do you think the legacy space is among captives today? Is there a lot more work to do explaining how legacy can help captives, and if so, how do you do that?

PC: The captive sector understands legacy a lot better now than ten years ago when we first started focusing on this space. Education is key to raising awareness of the benefits of effective legacy management. But the captive sector is not that far behind the commercial insurer sector in that regard.

I have been working in the run-off space since 1990 when the insurance agency I worked for in London ceased underwriting due to the overwhelming volume of losses coming out of asbestos and pollution exposures in the US. At that time a number of large insurers went into run-off, or even insolvency, on both sides of the Atlantic. Run-off became associated with failure and companies generally avoided mention of it or that they had any. This was how R&Q started as the founders saw opportunities to take away those toxic liabilities and specialise in handling them.

It has taken many years for the insurance sector to fully appreciate the benefits and advantages of active management of legacy liabilities, whether in-house or through disposal to a specialist such as R&Q. We now see many large commercial insurers, such as AIG, Zurich, Allianz and QBE transacting with the legacy acquirers.

CR: How can captives and captive owners learn more about legacy management?

PC: There are two key market associations that provide education and skill development in the legacy space. In the UK and Europe there is the Insurance and Reinsurance Legacy Association ("IRLA", www.irla-international.com) of which I was Chairman from 2009 to 2019, and in the US there is the Association of Insurance and Reinsurance Run-Off Companies ("AIRROC", www.airroc.org). Both have been valuable resource for the insurance sector over the past twenty years and would provide equal benefit to those in the captive sector that would like to increase their knowledge about effective management of legacy liabilities.

Another key source is to attend the various captive market conferences such as ECF, CICA, VCIA, WCF and the Bermuda and Cayman events. R&Q always attend such events, albeit in a virtual capacity at present, and have developed long lasting relationships across the sector. Education is key as it enables captives and their owners to make informed decisions about the management of their legacy. That does not mean that they have to transact with a legacy acquirer but simply have gone through the process to determine what route suits them. It is perfectly acceptable for the captive to continue managing their own legacy if that is the outcome of their analysis.

> "A key part of the transaction is having open dialogue with the captive to understand what they want to achieve and then deliver the best solution to accomplish that"

CR: How much of R&Q's work with captives involves repeat business versus one-off opportunities? Do you have the same opportunities to build lasting relationships with captive clients as other service providers?

PC: We are very fortunate to work with some great companies and people in the captive sector. We have had repeat business from a number of companies, such as Astra Zeneca and Akzo Nobel, although many like to remain anonymous. We also have referrals from non-exec directors where we have transacted with one company on which they are a board member and they say, "We did not know we could do this. I am on another board and they should consider a similar deal".

One area of increasing interest is providing a rolling programme of assuming liabilities. We work with a number of captives where we assume liabilities over a certain age, say five years, and each year take on another tranche so that the captive is only ever carrying the liabilities from the last five underwriting years. This is an effective way of recycling the capital from old years to support new years, or to avoid an increasing stack of collateral. R&Q takes on the collateral obligations associated with the assumed liabilities.

CR: What advice do you have for captives thinking about working with a legacy/runoff provider? What actions should they be taking, and what questions should they be asking, to improve their chances of a successful transaction?

PC: The key advice is for the captive to be fully informed of the options available. R&Q has a very broad platform of solutions as within its Group there are AM Best A- rated carriers in the US and Europe alongside consolidator vehicles in Bermuda, Cayman, Guernsey, Isle of Man and Vermont. We often see a captive or their representative come to us with a proposal which we do not believe is the right proposal for the captive. A key part of the transaction is having open dialogue with the captive to understand what they want to achieve and then deliver the best solution to accomplish that.

While R&Q are not the only legacy acquirer operating in the captive space, we have probably been doing it the longest, have the broadest capabilities and completed over 70 deals. A key determining factor for anyone transacting with the legacy market is the experience of the counterparty and their ability to deliver. Price is clearly a key consideration but so too are execution risk and reputation.

Key questions therefore are (i) have you done this before, (ii) are you known to the regulator, (iii) how will you handle the claims and of course (iv) how much will it cost me.

The legacy sector has developed considerably in recent years and many transactions are conducted giving benefit and efficiencies to the seller. The captive space is increasingly becoming aware of such benefits.

WEBINAR: RUN-OFF IN FOCUS

IN ASSOCIATION WITH AIRROC®

LEGACY SOLUTIONS IN THE SPOTLIGHT

Ross Law gives a round-up of the recent run-off in focus webinar

Moderated by Carolyn Fahey of AIRROC, *Captive Review*'s virtual Legacy Solutions panel featured some of the most significant players in the run-off space. Featuring Stewart Ritchie of R&Q Bermuda, Derek Jones of Milliman, and Michael Terelmes of Sirius, the panel provided a great opportunity to educate the attendees – 53% of whom had not participated in a run-off solution before – on the virtues of a legacy solution, and to dispel some common misperceptions about the run-off market.

A 'legacy solution', also known as 'run-off', has traditionally been viewed with a degree of scepticism. To those unfamiliar with the run-off marketplace, the mere idea of a company requiring a provider to assist them in 'selling off' old, discontinued lines of business, was the clanging death knell of an organisation in hot water, desperate and close to financial ruin. Historically, the practice has therefore been viewed as a last-ditch attempt for a company to save themselves before getting out of a given market segment.

> "A legacy solution is a standard, practical way of tying up and moving on from old books of business, opposed to paying (surplus) on them for no good reason"

However, this is simply not the case; and this perception is now beginning to change as the market continues to develop and grow, although it will only continue to change with education. As was well evidenced by our panel's speakers, a legacy solution is a standard, practical way of tying up and moving on from old books of business, opposed to keeping them hanging around and paying (surplus) on them for no good reason.

The panel began with some of the speakers outlining their experience in the space. Having been involved in the space since 1991, when thinking about the misconception around what run-off is, Stewart Ritchie of R&Q conceded that back at this time, the vast proportion of those looking at a run-off solution were likely only doing so "as a result of being a company that was in trouble and didn't have sufficient capital to pay these remaining liabilities". However, he went on to state that run-off is "[nowadays] a much more acceptable mechanism for capital management strategy", noting that R&Q

are "beginning to see a general acceptance of the marketplace that these are not only solutions for failed businesses, but are actually very strong capital management tools".

Sirius's Michael Terelmes went on to point out – and this may be an enduring reason as to the suspicion of those who have never been involved in a legacy solutions themselves – that when Sirius entered the space, a large amount of clients they worked with were using the strategy as a lifeline opposed to a considered risk management solution or means of extracting trapped capital. He said, "[Back then] it was essentially people looking for an exit strategy because they had made horrible underwriting decisions."

Terelmes went on to contrast this past perception with the materially altered understanding and utilisation at present, suggesting that those who have learned about the run-off market have attained an understanding about its beneficial powers, and perhaps even more so in 2020 amid the coronavirus pandemic. Terelmes noted: "We've seen people who are taking very profitable books of business and looking to monetise them or create additional cashflows with them. A whole different model is out there now than what was there historically."

The speakers outlined how strategies may simply come down to, for instance, a parent company holding a different view of the line of business, and who may wish to pull out and focus their energy on another more profitable line, noting that run-off can be a sage way of extracting trapped capital out of old lines, which may well run into millions of dollars of trapped capital, simply sitting there and going to waste when the parent has moved on from those old lines of business.

Following this notion, Derek Jones of Milliman stated that "if you can find a partner to help you get some relief, the legacy market offers an opportunity for good capital management".

The conversation evolved towards Fahey determining that a run-off solution can encompass many different forms of business strategy with those inexperienced in the market having perhaps been too focused on the force majeure adoption of run-off for those in severe financial difficulties when, nowadays, run-off is simply a reasonable solution not simply to remediate poor underwriting decisions, but for strategic decisions that make sense for the parent and the policyholders involved in lines of business not necessarily yielding profit. "At AIRROC, we always say yesterday's underwriting is today's legacy," she remarked.

The speakers went on to note how, in many cases, a run-off solution simply makes practical sense. As with trapped capital and a sense that money is being placed into old lines now irrelevant to the business, Terelmes noted that, particularly in the captive space, there are situations where M&A activity results in two companies merging who are doing the same thing, and as a result they have old lines which are no longer relevant, with Ritchie adding, "A lot of captives may well be surplus to requirements because of changes to the corporate entity," and noted a common case being that collateral posted becomes tied up and could be released with a run-off solution and repatriated back to the captive manager.

> "Partnering with a run-off provider can simply take liabilities and exposures off a captive's book that they no longer have an interest in dealing with"

In the case of a captive, many of the reasons for run-off are simply pragmatic, the panel noted. Partnering with a run-off provider can simply take liabilities and exposures off a captive's book that they no longer have an interest in dealing with or have the risk appetite for.

Especially given the pandemic, many captives have capital tied up and may readily benefit from a run-off solution, and even more so, Ritchie commented, as many captives "have reduced cashflows because of Covid-19".

Ritchie went on to share that in 2020, R&Q have been seeing run-off used as "a solution for them to actually infuse cash back into the parent company and allow the parent company, with several we've dealt with on the brink of bankruptcy, who were looking to avoid and get additional cashflow back onto their balance sheet".

The conversation later turned to outlining the various different run-off options, with the most common being the Loss Portfolio Transfer (LPT). LPT is generally used for M&A activity or in situations where a business simply wants to move forward and focus their efforts on lines of business that may be viewed as more valuable to them.

Simply put, the LPT is a transfer of old business. As Ritchie explained, "LPTs protect the cedant from the deterioration of any past written business," going on to note that "the premium paid to transfer the uncertainty is going to be a function of the present value of the liabilities". In this situation, a risk margin is also added to the LPT to reflect that the reinsurer is now responsible for any future development of the liabilities. Effectively, the LPT makes it so that the risk and responsibility is wholly removed from a captive's, or any other form of client's, books.

Adverse development cover, while similar, doesn't reduce the leverage to the same extent of an LPT. The panel overall were in agreement that ADC's are generally deployed as finality solutions for larger books of business opposed to single lines with which an LPT would be sufficient.

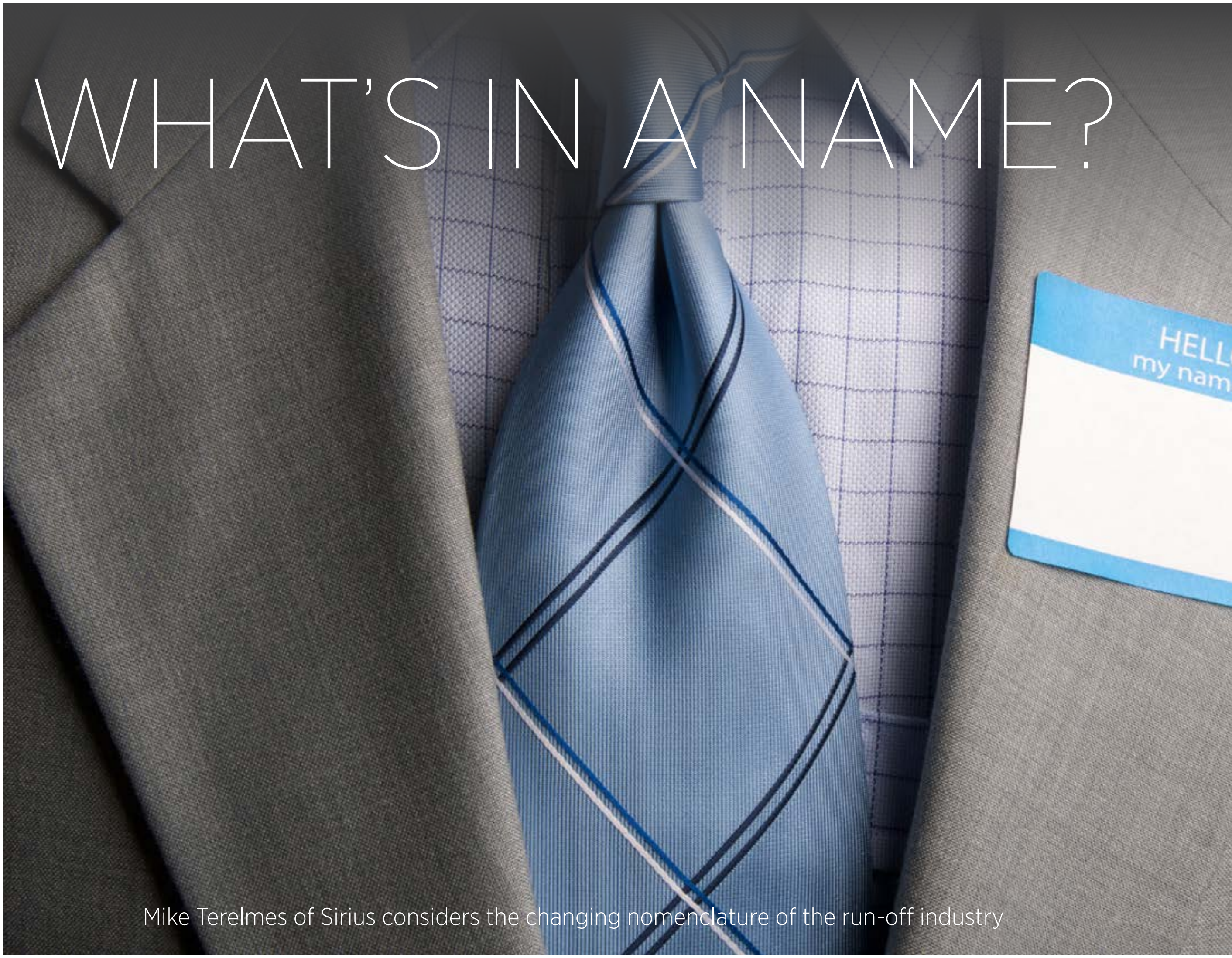
Ritchie said, "I would characterise the first three, the ADC, the LPT and the hybrid LPT as being what I would call an economic finalities solution.

Of these three most common options, Stewart notes, "you're still on the hook for the original risk that you reinsured into your captive, but you've now built protection on the back end". The panel also went on to note that there are further options for structuring these solutions, all with a view to tweaking the structure to individuals' specific circumstances.

Summary

The panel overall showed our attendees that the run-off market is an incredibly useful proposition for those looking to 'move on' from old lines of business, either for organisations involved in M&A, a focus on new lines of business or with a desire to repatriate trapped capital. And while improving cashflow and restoring a balance sheet may be the overall aim, utilising the legacy marketplace has since evolved beyond those using it in a last-ditch attempt to avoid bankruptcy in view of poor underwriting decisions.

WHAT'S IN A NAME?



Mike Terelmes of Sirius considers the changing nomenclature of the run-off industry

In Shakespeare's Romeo and Juliet, Juliet poses the following questions…

What's Montague? it is nor hand, nor foot,
Nor arm, nor face, nor any other part
Belonging to a man. O, be some other name!
What's in a name? That which we call a rose
By any other name would smell as sweet.

A few years ago, the run-off industry posed a similar question and while no official vote was taken, we unofficially changed our name from 'run-off' to 'legacy'. Even the name of this publication, the *Legacy Solutions Report*, has adopted the unofficial name change. While names are sometimes superficial or unimportant, they do conjure certain images. For the legacy industry, the term 'run-off' conjured an image of insurance professionals on their last legs, arguing about decades-old issues that had little or nothing to do with capital, live business or much of anything of concern to shareholders. In fact, the run-off operations were often found in the back office using dated equipment and 'legacy' systems. It is interesting that they were not called 'run-off' systems, but then again, what's in a name?

No matter what we call it, it is still necessary to understand what the business of run-off or legacy actually encompasses. It's hard to move forward when you can't escape the past, and historically the run-off market has served as a solution for legacy liabilities that have haunted insurers and driven down underwriting results. Traditionally, prior years' underwriting was the primary motivator for insurers and reinsurers to seek exit strategies such as loss portfolio transfers (LPT), dispositions, novations or adverse development covers (ADC). However, with each M&A trans-

Mike Terelmes

Mike Terelmes is the chief financial officer of Sirius Global Solutions, a subsidiary of Sirius Group (NASDAQ: SG), that specialises in providing exit strategies and run-off solutions to insurers, reinsurers, captives and risk retention groups. As a founding member of Sirius Global Solutions, Terelmes has played a primary role in the acquisition of several companies and in the underwriting of a variety of insurance and reinsurance solutions. He also serves as the CFO of a number of subsidiary insurance companies and is a member of their boards of directors.

action, LPT, novation or ADC executed, management would have to acknowledge at some level that yesterday's underwriting had become today's nightmare. What had traditionally been a tale of distress and failure, now has a different look and a different name.

If you type 'how to start a business' into a search engine, few if any of the first 50 hits will tell you how to get out of the business that you want to start; yet there is a proverb that says, "the end of a matter is better than the beginning". Success is far better measured by the end result than by the beginning, so it is important to be aware of exit options that exist before the first premium dollar is written. An exit strategy keeps that endgame in view and makes day-to-day decisions more strategic in nature. Nearly every successful project starts with an implementation plan and also has a plan for what the end will look like. This is the case in both the insurance world and also in our personal lives. Whether it is colour by number artwork or the first model car you built as a kid or the IKEA furniture that you put together when you re-modelled your house during the Covid-19 lock down, knowing what the final product would look like before starting the project was important.

There are plenty of consultants that can help a parent company design, form, organise and operate a captive so that it can be the most efficient tool for their business, but there is also a need to know how to close part or all of the captive down when the time is right. The legacy marketplace can take the parts that don't serve you best and help them serve you in a more efficient way or serve you in a different way by taking the capital that is tied up in old reserves and freeing up capital and cash for new opportunities. This is not your daddy's run-off; while the legacy market still has vestiges of traditional run-off, it is now also a marketplace for using capital efficiently and effectively and maximising cashflows.

> "No matter what you call it…run-off or legacy, it has been around for decades and surprisingly the basic mechanics haven't changed"

Nearly every carrier has run-off liabilities on its books. That is, liabilities for business once written. When management makes a strategic move to transition their premium composition from one line of business to another, it's considered good leadership. We call it 'reading the market and being proactive'. Companies will proudly tout the fact that they are 'looking to the future' or 'embracing the challenges of an ever changing world', yet when they look to transition the historic liabilities associated with that premium, it's considered an underwriting failure.

The run-off world has historically been a backup camera evaluating what is behind the company that could cause damage; however, run-off is increasingly being used as a strategic tool that provides competitive advantage and excess capital for new ventures. Insurers have in the past looked to the run-off markets for an 'exit visa' to eliminate troublesome legacy business and drive future profitability. Now there is a paradigm shift and insurers are looking to the run-off markets for capital efficiency, rating agency capital relief and even underwriting gains.

Additionally, during the Covid-19 pandemic we have seen an uptick in captives and parent companies looking for cashflows from their legacy portfolios. That is, the captive had considerable amounts of cash tied up in collateral supporting loss portfolios that were well underwritten, and they wanted to transfer those portfolios to a third party in order to free up cash for operations.

Traditional run-off still has its place in the market, and there are advantages to insurers to avail themselves of this sort of reinsurance protection. Although ADCs or LPTs will not fully extinguish the liabilities like a novation would, they are still effective tools for reducing P&L volatility and allowing owners to sleep better at night.

In the early stages of captive formation, the various domiciles' efforts were concentrated on captive formation. At nearly every opening session at a captive association meeting, the regulators would share the number of new captives formed in the past year. The business reality is that while owners are excited about new ventures, they also want to know that there is a way out should their situation change. Many domiciles now have more dormant captives than active ones, and the legacy marketplace has been able to respond to those needs. The legacy market is not about closing down captives, rather it is about making existing captives as efficient as possible and providing owners with exit information at the earliest stages of formation.

No matter what you call it…run-off or legacy, it has been around for decades and surprisingly the basic mechanics haven't changed. However, over the past two decades we have seen a change in the perception of the product, an increase in the number of captives currently utilising the legacy market and the number of insurance carriers participating in the market and a surge in the amount of capital being deployed to underwrite these transactions.

SHORTCHANGING CLAIMS IN THE DUE DILIGENCE PROCESS: A COSTLY TRAP

Christine Fleming and Suzanne R. Fetter (consultant) of Milliman emphasise the danger of shortchanging claims and reflect on how to mitigate this potential issue

When it comes to run-off, the mission should always be the same… closing claims. Handling and reserving claims correctly facilitates prompt claim closures – thereby capping losses and increasing the confidence around actuarial projections. Whether companies are considering a loss portfolio transfer (LPT), an Insurance Business Transfer (IBT), an acquisition, a novation, or an assumption of liabilities, making a claims operational review part of the due diligence will identify important hidden risks and help to ensure a profitable transaction. As with continuing business for liability lines, the handling of claims often has a material impact on the ultimate loss costs for run-off business.

Christine Fleming

Christine Fleming is a principal at Milliman and leads the casualty claims & underwriting practice. Prior to joining Milliman in 1996, she practiced law at a national insurance coverage defense firm where she specialised in complex litigation claims handling. Fleming's area of expertise includes claims operational assessments for M&A due diligence projects, and valuations of run-off liability and WC claims for LPTs, IBTs, and commutations. She is an Associate of the Casualty Actuarial Society and a Member of the American Academy of Actuaries.

While actuarial estimates are often expressed in terms of wide ranges, including expenses, claims operations are held to a stricter standard of establishing a specific amount based on several ever-changing variables. Claims personnel are expected to know with great precision the probabilities associated with each exposure of a claim: indemnity, medical, expense, coverage disputes, etc. Many times, these exposures require expertise in areas outside the actuarial wheelhouse. Medical case reserving, for example, requires significant research within the context of an individual's medical treatment plan, understanding inflationary factors for serious and catastrophic claims, weighing different treatment options, applying medical fee schedules, and effectively coordinating with the nurse case management team that is managing medical treatment. Coverage disputes require legal expertise specific to a jurisdiction. Expense projections require a concrete strategy through specific phases of the litigation process, with each phase posing a new set of outcome probabilities and associated costs.

Yet despite the major complexities involved in establishing case reserves, which drive loss payments, when due diligence is undertaken the correct claims questions are often not addressed. Too often, the company performing the review does not know to probe into key areas of case reserving practices, such as the potential medical exposure not reflected in the case reserve, the strength of the legal position in the declaratory judgment action, or the probability of taking litigation all the way through trial and appeal. Frequently in a due diligence discussion the company will simply represent that it set case reserves reflecting the probable ultimate value of the claim, or perhaps that it set case reserves 'conservatively' or faster than seen in the industry. At that point, the discussion usually moves on to an examination of the actuarial estimates. In fact, it is critical to validate the case reserving practices and case reserve adequacy of a book of run-off claims.

Moreover, reviewing claims operations not only sheds light on case reserve adequacy, but also helps to uncover risks that are often not adequately addressed in high-level management presentations and discussions. Claims and legal operations are the bulwark of a run-off operation, and due diligence scrutiny of coverage actions and poor claims handling can detect unrecorded liabilities that may come as a surprise to investors. An erroneous coverage position, for example, exposes the company to allegations of bad faith claims handling and potential extra-contractual damages. Does this happen frequently? Failure to meet certain deadlines in the claims handling process could also result in a company paying fines or paying damages well in excess of the policy limit. What controls are in place to prevent that from occurring? It is imperative to obtain a thorough understanding of the expertise of the individuals handling the claims to ensure appropriate claims handling. A close inspection of the claims organisation can also be revealing – are supervisors proactively managing small teams of claims handlers? Are managers generating meaningful reports of key metrics indicating potential problems and opportunities? Does the company have adequate training programmes, professional development, and succession plans in place? What automated controls are in place to limit payment authority and prevent fraud? If coverage is denied on a claim and the file is either closed or remains open with a zero reserve, there could be a very sudden and significant increase with a single court ruling or unfavourable mediator opinion, resulting in liquidity challenges. A comprehensive review of key areas that significantly impact losses or cashflows is crucial to avoiding unpleasant surprises after a deal closes.

Perhaps most important, the actuarial assumptions and methodologies could be impacted by findings regarding the claims handling and case reserving practices. For example, if the plan is to replace the current claims team, what are the differences and how will that impact selection of link ratios and tail factors in the actuarial triangles? Have there been changes in legislation that will affect claims across an entire diagonal, or for specific accident years? What is the company's practice with regard to closing claims, and are the reopen rates going to continue? If adjusters are not on diary and there is a backlog of claims, when will those case reserves be adjusted and what will be the quantitative impact? Perhaps the most important question for run-off is, are the claims adjusters charged with closing claims with finality in order to reduce incurred-but-not-reported (IBNR) reserve exposure, and if so at what cost? Alternative ways of looking at the actuarial estimates and even employing additional methodologies may be called for to increase the confidence in those estimates, as well as to explain the inherent uncertainties with more detail and precision.

According to a September 2019 run-off survey conducted by PwC, roughly half of the $800bn in legacy non-life run-off liabilities are managed in the United States. Survey respondents expected increased growth in the restructuring and investment in the run-off market, and the majority felt increased activity in the next few years would occur in the United States. Most survey respondents expected the typical deal would involve a discontinued portfolio exceeding $100m in size. With the largest majority of the risk in California, Florida, Illinois, New York, and Texas, where social inflationary factors and insured liabilities in those locations present the largest exposure, it is imperative that the acquiring claims operation have an established record of expertise in these jurisdictions. Often, the acquiring company must study the incoming losses rapidly.

A claims component can be an important element in the deal-making process for a run-off book. As challenges unfold in the run-off environment, there is a greater need to identify the elements of the book of business that require the most activity, and to unwind deals that are loss leaders. Additional claims staffing and a more robust human resource initiative will be required. Where a third party is responsible for the claims book and has an entirely different agenda of keeping claims in open status, it is imperative that in-house claims staff manage these third-party relationships and in some cases prepare for termination, claims system conversions, and overhauls of outside legal counsel. In cases of reinsurance exposures, claims commutations may provide a strategy for closing large portfolios of claims in one transaction. All of this activity requires a claims focus and deal-making skill set that can aid in the run-off decision-making process.

"A claims component can be an important element in the deal-making process for a run-off book"

Suzanne R. Fetter

Suzanne R. Fetter is a contract consultant affiliated with Milliman. She has extensive experience in claim management, claim resolution, and coordinating successful build-up and run-off of insurance operations. Fetter's responsibilities include auditing in-house claim departments and third party administrators, due diligence transactional assignments, reengineering/redesigning claims operations, using data to design metrics and KPIs. Fetter is an Attorney, a certified ARIAS Arbitrator and holds AIRROC's Certified Legacy Insurance Professional designation.

THE EVOLUTIONS OF RUN-OFF INNOVATIONS

Eric Haller of Fleming Re considers the growing applicability of the run-off solution to address a broader range of risk

Run-off transactions have historically been more prevalent for 'toxic' liabilities, insurance companies with solvency issues and entities looking for a solution to manage exposures in excess of their risk management guidelines. Pricing of these transactions reflected the desperate nature of the situations.

Over the last decade, the benefits and goals achieved by run-off transactions have expanded to include more proactive risk management and capital solutions. There is an increased level of appreciation for the benefits surrounding run-off and it is gaining wider recognition as a risk management and liquidity solution in addition to addressing distressed insurance liabilities. The evolution in the sector has been driven by tangible benefits that can be offered to counterparties versus transactions driven by negative factors.

Today, run-off solutions are utilised for a wider range of reasons including: capital and liquidity management; corporate structural changes; risk and exposure management; as well as market and macro economic factors. As run-off solutions have been gaining greater acceptance, the industry is experiencing an increased demand for transactions from counterparties.

Eric Haller

In addition to the change to more 'benefit-focused' solutions, the industry has experienced a significant amount of advancement as a result of a variety of other factors. These include market disruptions, changes in the regulatory environment, client-driven innovations and the application to new industries.

During times of uncertainty and turmoil as we are currently experiencing, companies will look at additional sources of capital to meet their changing needs. As market disruptions drive demand for new products and solutions, run-off is unquestionably becoming more readily accepted as a strategic tool in the overall efficient management of capital through insurance cycles.

The financial benefits provided to counterparties demonstrate the 'value add' in run-off as corporates, captives and insurance companies are using legacy solutions in new ways.

Reassessing emergent risk

Most business leaders, as part of their enterprise risk management, are faced with emerging risks and consideration of events such as cyber breaches, pandemics, business interruption, trade and political risks. Now with the unprecedented risk of Covid-19, it has become even more important to reassess risks and determine the most effective strategies to efficiently manage them.

As a result of market disruptors, we expect to see the creation of new opportunities. In certain instances this will simply be one-off transactions to address the challenges resulting from the market disruption. In other instances, the disruption could change the industry dynamics and lead to new partnerships, on-going transactional relationships and implementation of new and emerging strategies that are mutually beneficial.

Changing regulations and legislation have also been a contributing driver resulting in new solutions. In 2007 Rhode Island enacted Insurance Regulation 68. This was amended in 2015 to allow for protected cell structures and received much more attention. The legislation enables insurers to transfer and novate certain books of business (excludes life, workers' compensation and personal lines) to another insurer with regulatory and court approval. Previously, all policyholders were required to provide consent to the insurer's transfer, which resulted in a more cumbersome and lengthy process.

A more recent example is Oklahoma's Insurance Business Transfer Act (the "Oklahoma Act") which became effective on 1 November 2018. The Oklahoma Act allows insurers to transfer and novate books of business to an Oklahoma-domiciled insurer without the affirmative consent of policyholders (an "Insurance Business Transfer"). This must be approved by both the Oklahoma Insurance Commissioner and the District Court of Oklahoma County. Under the Oklahoma Act, property, casualty, life and health policies are included. Oklahoma is the latest state to pass a run-off law in response to increasing demand for these types of transactions.

These changes to the North American regulatory environment will facilitate the evolution of the run-off sector and have created a new type of run-off solution for the jurisdiction. A similar solution has been available for quite some time in the UK market through a Part VII transfer.

Although the run-off market has evolved there are still significant inefficiencies to be noted. The run-off sector, especially in the middle market, is very fragmented. In order to move the market to the 'next level', solution providers need to continue to evolve and innovate. This involves identifying new markets and products that can benefit and improve the run-off sector.

The Fleming Re approach

Fleming Re's board and management made a commitment that the company would approach the market in a new and exciting light with thought and purpose in everything we do. We have developed new products that enhance our offerings to our clients and foster long-term relationships built on transparency and trust.

We have a different approach when compared to our competitors and these differences have facilitated the innovative solutions and products we are bringing to the industry and helping shape the future of the run-off industry.

Being at the forefront of identifying, structuring and implementing innovations will help defragment the inefficiencies in the captive insurance space and advance the sector. At Fleming Re, we have already developed two unique solutions for our clients: Tail Fund Legacy Solution and Fleming Re Legacy Control Rights™.

Although the concept of a tail fund is not unique, Fleming Re's solution has built upon historical proven structures and enhanced them to bring even more value to the counterparty. Our solution was developed to provide finality from liabilities (i.e. no claw back provision), on a recurring basis, with terms and pricing certainty agreed at the inception of the facility. The structure creates efficiencies for both parties and will streamline the transaction process in future years. We have successfully structured this solution for clients and have additional transactions in the pipeline.

> "New innovative products and solutions will demonstrate the continued evolution of run-off"

In each case, a customised tail facility is implemented that attaches to a captive programme at a historical policy year selected by the client. Fleming Re assists clients in determining the preferred attachment year by balancing a cost-effective solution with the captive owners' objectives of disposing of their legacy risk and/or accessing liquidity. We have found that the solution works particularly well for group captives and other shared risk entities.

Our trademarked Legacy Control Rights™ solution is a completely new and innovative product being offered to our clients. Fleming Re recognises that some counterparties would like to pursue a legacy solution to remove liabilities from their balance sheet but are concerned about headline risk that could be associated with the future administration of those liabilities. Our new solution mitigates the potential headline risk while still providing finality from the liabilities. We offer two variations of the Legacy Control Rights™ solution to better fit each client's specific situation.

New innovative products and solutions will demonstrate the continued evolution of run-off and enhance the ability to create value for counterparties. One of our key differentiators is the ability to quickly assess and understand a captive or company's objectives, clearly define their needs and then structure unique solutions tailored to align with specific goals.

Recent developments

Fleming Re is continuing the push toward innovation in the middle-market run-off space through creating efficiencies for counterparties, developing new products for the run-off industry and offering flexible structures to specifically address clients' transaction goals.

A recent development in solutions for legacy books of business or 'trapped collateral' is being seen in the Insurance Linked Securities (ILS) market. Due to the nature of ILS transactions, in certain circumstances, it can be challenging to provide certainty on timing of return of capital to investors. Run-off solutions can improve the ability for ILS managers to give their investors a return of capital on a timely basis. As the ILS industry begins to offer non-catastrophe (P&C focused) type investments, the run-off industry will be able to further integrate into and enhance the ILS industry. Not only will we be able to 'cut the tail' on these types of funds, they will also be able to act as an origination source for the ILS market. Fleming Re's Tail Fund Legacy Solution discussed above, can be easily integrated into a P&C focused ILS fund to enable investors to have certainty on timing of the release of capital. This will enable growth in both the run-off and ILS industries.

At Fleming Re, we expect to see an increased appreciation of the benefits surrounding run-off and its wider recognition as a viable liquidity and financing solution that works for corporates, insurance companies and captives. As run-off is becoming more readily accepted as a strategic tool for the overall efficient management of capital, counterparties will favour solution providers who have a proven track record, continue to innovate and help the market evolve. The run-off market is going to experience significant growth and change over the next decade and Fleming Re is excited to continue to influence that evolution.

Fleming Re is a Bermuda-based class 3A insurance company whose management has a deep track record in providing a full range of reinsurance structures and finality solutions for legacy liabilities and providing flexible and comprehensive liquidity and risk transfer alternatives to all entities in the middle market insurance sector.

www.airroc.org

AIRROC

Carolyn Fahey, email: carolyn@airroc.org, Tel: 703 730 2808

AIRROC is the only US-based non-profit association focusing on the legacy sector of the insurance and reinsurance industries. We are an organization of companies that have legacy business in their portfolio. Membership is on a corporate level and given the impact and importance of legacy business to the entire industry, AIRROC has attracted many talented and experienced participants. The members include major US and international insurance and reinsurance companies, well-known rehabilitations, receiverships and liquidations that impact a significant portion of US and overseas business, brokers, third-party administrators and run-off managers.

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FLEMING REINSURANCE LTD.

Eric Haller, email: ehaller@flemingreinsurance.com, Tel: 441 705 2898

FB Perry Building, 40 Church Street, Hamilton HM HX

Fleming Re is a Bermuda-based reinsurance carrier specializing in legacy P&C liabilities providing liquidity and risk transfer solutions to the middle market insurance sector. We seek to both consolidate and innovate the legacy risk transfer market through the use of unique structures, efficient capital, and ability to close within tight timelines. Leveraging our significant experience in underwriting, risk mitigation, and active claims management, we can opportunistically provide structured financial solutions around some of the most complex and difficult-to-place risks.

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MILLIMAN

Travis Grulkowski, email: travis.grulkowski@milliman.com, Tel: 1 262 796 3319

201 Edgewater Dr., Suite 289 Wakefield, MA 01180

Milliman is an independent consulting, benefits and technology firm. Our expert guidance and advanced analytical solutions empower leading insurers, healthcare companies and employers to protect the health and financial well-being of people everywhere. Every day, in countries across the globe, we collaborate with clients to improve healthcare systems, manage risk, and advance financial security, so millions of people can live for today and plan for tomorrow with greater confidence.

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SIRIUS GLOBAL SOLUTIONS

Michael Terelmes, email: Michael.Terelmes@Siriusgroup.com, Tel: 860 368 2006

628 Hebron Ave, Suite 106 Glastonbury, CT 06033

Sirius Global Solutions is a subsidiary of Sirius Group (NASDAQ:SG) that serves insurers, reinsurers, captives and risk retention groups seeking to mitigate or eliminate exposure to legacy liabilities and release trapped capital.
Formed in 2000, Sirius Global Solutions is one of the pioneers of the property/casualty runoff market and continues to focus on the acquisition of runoff insurance and reinsurance companies as well other reinsurance and insurance legacy solutions worldwide.


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