RUN-OFF ROUNDTABLE

Participants in the run-off space provide their views on some of the key challenges and developments being seen in the space

In a discussion moderated by Carolyn Fahey, the executive director of AIRROC, some of the leaders in the run-off market gathered to offer their opinions on the growing interest in exit solutions for captives.

In a recently issued A.M. Best Company report, the rating agency offered data from Strategic Risk Solutions, Inc. which showed that the number of new formations in the US was relatively flat but there was an increase in captives that closed.

As far as the AIRROC membership – we have seen an increased interest from captives in learning about exit solutions for captives. We find this to be a very exciting and growing area for AIRROC members.

Carolyn Fahey (CF): What are the main reasons that a captive might need a run-off solution?

Eric Haller (EH): There is a long list of reasons why a captive may look for a run-off solution. Most commonly, it will be because the owners want to release trapped capital. Another common reason is the desire to eliminate operating expenses. Many captives end up not having the scale to make it economically feasible to support the operating expenses once they are no longer writing new business. A relatively large operating expense base creates a situation where the captive is no longer a valuable tool operationally. Another common reason, and one where we've seen a significant amount of activity recently, is driven by the corporate

Carolyn Fahey, moderator

Carolyn Fahey is the executive director of AIRROC (Association of Insurance and Reinsurance Run-Off Companies). In that role she works with the AIRROC Board of Directors to set and execute the overall strategy for the association, as well as having responsibility for AIRROC's operations. She is a frequent speaker and author on the run-off industry for regulatory bodies, other associations and industry groups.

Michael Terelmes

Michael 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.

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 10 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.

Matt Kunish

Matt Kunish is the chief business development officer at RiverStone, a run-off and legacy solutions provider. With over 25 years of insurance industry experience, he leads the actuarial and business development groups in the US. Kunish began his career as a consulting actuary for Deloitte (formerly Bacon & Woodrow) in London. He earned a BSc with honors, in mathematics and economics from the University of Bristol.

Tom Booth

Tom Booth joined DARAG in July 2018 after almost 10 years at R&Q, mostly as group CFO. He worked primarily on legacy M&A activity during his tenure at R&Q. He has extensive experience of portfolio transfers and insurance company acquisitions across a wide range of European markets. Booth previously held insurance M&A and capital markets roles at Numis, a London based investment bank and at Aon.

Eric Haller

Eric Haller is CEO of Fleming Re, a specialist run-off reinsurer based in Bermuda. Haller's reinsurance experience spans more than 20 years and includes business development, underwriting, treasury, accounting, investment management, risk and regulatory compliance. Haller has held senior roles at various companies; Safe Harbor Re (CFO & CRO), Randall & Quilter Investment Holdings (head of North American M&A), Athene Holdings (head of strategic planning), XL Capital's Investment Management Group and Deloitte & Touche. He graduated with honours from Marquette University.

M&A process. The acquiring company wants to complete a run-off transaction to eliminate the pre-existing liabilities of the company being acquired.

Paul Corver (PC): In Europe, we have seen opportunities arising out of the impact of Solvency II. This led to positions where captives were leaving the EU, either selling their captives outright or transferring business. Across the globe we see concerns from corporate parents about the possible impact on their reputation of being seen to have an offshore company into which large sums of premium are being paid. This has caused corporates to rethink their strategies and contemplate disposal of their offshore entities.

Tom Booth (TB): I was going to pick up on the same point that Paul raised about how multinationals have in recent times been wanting to exit some of the offshore jurisdictions. We have also seen and worked on a number of transactions that are motivated by taxation reasons and jurisdictional perception.

CF: Why is there now a surge in the utilisation of run-off solutions?

Mike Terelmes (MT): The captive markets are maturing and when you have mature markets, you generally have captives that are either coming to an end of life situation or to a point where they want to change direction or strategy. The run-off market used to, almost universally, be a tale of distress and failure. Sirius has been in this space since the late 1990s, and back then, people came to us with 'bad news' and were looking for an exit strategy to reduce P&L volatility and capital erosion. The run-off market was a backup camera evaluating what was behind the captive; however, now run-off is being used as a strategic tool that can provide sources of capital for new business or can provide a way to return capital to owners. Notwithstanding the name 'run-off', the run-off market is not about closing down captives, rather it is about helping existing captives become as efficient as possible and providing owners with exit strategies from the earliest stages of formation through dormancy.

Matt Kunish (MK): We too are definitely seeing run-off being used as more of a strategic tool in the present day. We're still relatively new to this space, but I see that there's still a lot more education needed. Certainly in the US, perceptions of run-off remain somewhat fragmented. As time goes on, it will be important to educate owners as to the benefits of run-off. Once the owners understand how everything works, they're more likely to get on board with the concept.

TB: I think people are gradually growing more aware of there being solutions available in the market. And obviously these solutions will need to be well priced for these types of transactions to make sense. There's obviously a balancing act between getting administrative ease out of a run-off solution against the cost of doing it. The more of us trying to find cost-effective solutions and the more people there are in the market, the easier it should be to make people realise what the benefits of run-off are.

PC: I agree with that. I think one of the things we also have to be aware of is that these are insurance companies that are owned and run by corporates in completely different segments, whether it's retail, transport, energy, etc. Therefore, the directors may only have a limited working knowledge of insurance and likely know nothing about run-off or the process of restructuring what they already have on their books.

We're very much reliant on captive managers, who can then bring these opportunities and take the benefits of run-off restructuring to the board. But that's not always possible. So I think there's a greater onus on us as the run-off acquirers to get the message across, because we can't necessarily rely on all the others that are in the chain of decision-making in the captive process.

CF: What exit solutions have you recently worked on?

TB: There are a number of potential solutions we can bring to the market depending on their needs. There still continues to be a flow of such opportunities, and a number of which we've done ourselves, where it's been a straight acquisition of the captive which is a fairly simple and clean way of doing it. At the same time, it certainly doesn't stop there and it's not just a question of people wanting to completely dispose of a captive; it can be that they simply want to make it more efficient. They may have a line of business they're no longer writing through the captive and they perhaps want to free up some collateral and get early liquidity on that, as well as chop off the tail and redeploy the capital elsewhere if they're growing the captive in a different direction and with different coverages.

At least in the captive space, there is a well-established and relatively straightforward path to create finality where you can novate the policies over to another entity. And a number of us have entities that can assume captive policies that have been originally written from a corporate captive and put it into one of our facilities. It tends to be these types of covers that predominate because those finality tools are available.

MK: I echo what Tom says, certainly the ones we've seen in the US, the corporate M&A that was mentioned has been the reason there's an orphan captive looking for a home. The more interesting one we've looked at recently was a Reinsurance To Close (RITC) concept where the owner was looking to 'carve off' the older years but was also looking to form an ongoing relationship and slowly cash-in the older years as they reach a certain level of maturity.

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> Paul Corver

CF: What helps make the run-off process run as smoothly as possible?

PC: We operate from the UK and Bermuda so we see the process on both sides of the pond, but I think the key element of the process, whether it's a captive or a regular commercial insurer, is primarily good data. We're very much reliant upon getting quality data from the captive or captive manager, and timeliness of such data, too. If as much as possible is provided upfront, the bid that goes in is as close to possible as what the final number will look like and doesn't produce too many surprises.

Other aspects to make the process smooth, are the experience and track record of the buyer. Not all aspects come down to price, there's also the reputation of the buyer to bear in mind and the ability for the buyer to evidence that they are not going to 'rock the boat' with regard to claims handling.

MT: I agree with Paul's comments about good data. One thing we see with run-off transactions typically is that the data tend to be a little bit stale and oftentimes inconsistent. When the data are good, the underwriting of the transaction becomes far more efficient. In addition to good data, I would also say that the people involved are critical for execution and transition, both from the acquirer and the seller's side. The seller's staff have the vital information the buyer needs to continue working the transaction after closing. Transition and post-closing execution are almost as important as the due diligence process, so having good people on both sides is essential.

EH: I very much agree with the point about having good people on both sides of the transaction. Overall, we've found that the process runs more smoothly by simply having an initial conversation with the client, identifying their goals and setting key milestones for the transaction. This allows all parties involved to have the same expectations throughout the process and facilitates an efficient transition.

CF: How do the levels of complexity vary depending on a captive's size? What other factors may change the way in which the process is conducted?

EH: In terms of the captive's size, it's not necessarily the factor that will add complexity. Complexity tends to be more a function of a captive's structure, lines of business, any reinsurance in place, as well as other unique characteristics specific to the captive.

If comparing a large and smaller captive, arguably a small captive could be more complex from a transaction perspective because it lacks diversification of exposures. It's a little counterintuitive but when looking at the risk of a smaller transaction, the outcome could be more binary due to that lack of diversification.

Other factors to consider are the existing structure of the captive, the type of transaction and jurisdictional considerations as different regulators have different requirements. With differing types of transactions, an acquisition of a captive will potentially have additional risks such as legal exposures and third-party collectability issues for non-insurance balances, compared to a novation-type transaction.

Then there's the matter of transaction timelines. For example, when completing a transaction related to a corporate M&A process, the timelines can be very tight and lack flexibility on deadlines. This can certainly add to the complexity of the overall transaction.

TB: It doesn't necessarily follow that a captive's size makes it more complex. We've looked at a number of situations and have just done a transaction where the captive is operated over a long period of time and has itself assumed business from prior captives through to the loss portfolio transfer, and sometimes the transaction can be relatively small but complex given its long history and the fact management changes over time can mean that there might be record and data gaps and even things as simple as not having full policy listings or copies of the individual policies. Often as you go further back in time, there can be significant knowledge gaps in terms of what actual coverage was written by the captive. Age may in fact be the overall variable which can create complexity. It may follow that larger captives have written different types of business over longer periods of time in more complex structures.

PC: The larger the transaction, the higher the likelihood it's still going to be on the selling company's agenda as a priority. We've often found some deals go into a dormancy stage because the parent company gets distracted on some other important matter they're attending to themselves. Therefore the larger ones tend to retain the focus of the senior and authoritative level within the seller whereas the smaller captives can sometimes drift off.

CF: Are there any differences in dealing with captives in the US versus other markets?

MK: The regulatory environment is quite different in the US and likely also the most complicated. The lines of business also vary. Workers' comp, for example, exists in the US unlike elsewhere in the world.

PC: We have employers' liability in the UK which is similar to workers' comp, but I think one of the key areas is that the US has a significantly higher level of different structures – including risk retention groups, self-insured trusts, and group captives – all vehicles which don't really exist elsewhere. While this means one needs a more flexible approach in the solution you can provide, it does also present a far greater level of opportunity for providing innovative solutions to meet the seller's ambitions.

CF: What newer risks are emerging in this market and could captives benefit from an emerging risk transaction?

MT: Emerging risk and run-off may initially seem to be at opposing ends of the spectrum – with one being something new and the other end-of-life. When I think about emerging risks, I think first of new risks such as artificial intelligence or nanotechnology, but I also think of risks that have been around for a while but whose context has changed. There is clearly a market for emerging risk run-off transactions in that light, including the likes of the opioid crisis, sexual misconduct and other social inflation exposures that are on the rise. There is an increased need for captives to wall off these exposures and move forward. For example, general liability and auto are not new lines of business, but the increased level of attorney involvement in these exposures is clearly an emerging risk. Captives may have had such lines of business on their books for a while, but they are not necessarily prepared for the exposure that is now arising. The run-off market can provide captives with an opportunity to address those liabilities and move on.

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EH: I agree with Mike on this. The simple question and answer is 'can the captive benefit?' Absolutely they can. As with any run-off transaction, including those with emerging risk, all the benefits we have previously mentioned can be achieved. Some of the risks seen recently are newer exposure types and these are taking the forefront in terms of a lot of class action lawsuits. Even though the exposure has been there for a while, the dynamic has changed and they may want a way to be able to deal with that risk.

Cyber risk is another newer risk that could look to the legacy market for solutions in the future. We've also seen demand from industry sectors like insurance-linked securities (ILS) that are looking for an exit or liquidity solution. In terms of jurisdictions, Latin America, although it is a newer captive market, has experienced significant growth and given the life cycle of a captive, at some point they will be looking for legacy solutions. I think it is also worth mentioning that with a lot of what we're calling emerging risks, there can be some challenges, especially if it is truly a 'new' risk. These challenges stem from the overall evaluation of the newer risk types, the limited development history, and in certain instances there could be a lack of data which makes it even more challenging.

CF: How do you foresee the continued evolution of the run-off space in the future?

PC: We see a good future for the provision of run-off solutions within the captive sector. As greater awareness appears on board agendas, then hopefully it will continue even further. Probably more on the line of achieving capital efficiency by managing existing captives rather than the pure disposal of run-off captives. I'd like to think that as the professionalism and acceptance of run-off by the captive owners continues, that owners may consider putting more lines of business into captives knowing that if it doesn't work out they have an exit solution lined up and will not be stuck with it forever.

TB: I think the RITC transaction will continue to develop as a number of us are seeing approaches from captive owners where they would like to chop off their tail on certain policies, ending minus one-year, and would like a mechanism where they can buy cover of this nature on a rolling-forward basis. I'm hopeful this becomes more of a routine type of solution which fits in with some of the aforementioned themes of this discussion.

MT: We touched on this earlier but looking ahead there is potential for new mass tort for emerging risks in the industry. Companies with exposure to the likes of vaping, fracking and other exposures which didn't exist a decade ago, may want to move those liabilities to counterparties. With the influx of capital into the run-off space, captive owners have more counterparty options for these exposures.

MK: I think the opportunities are almost unlimited and we have the chance to be very creative in our solutions. I expect more capital to come into the space and as time goes on the acceptability of run-off will increase.

EH: The outlook for the run-off space looks very positive overall. Captive owners are beginning to realise they can use legacy solutions as a liquidity tool, a financing tool and a risk management tool, which has changed a lot over the past decade compared to what the reputation of this space was previously.