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Runoffs

The Rise of Runoffs

After transforming its reputation and broadening its scope, the run-off market could play an important role in the wake of COVID-19.

KATE SMITH | MAY 2020

Key Points

Versatile Tool: Once used to offload toxic liabilities, runoffs now are a strategic tool for capital efficiency.

Promising Partner: Runoffs could be a prime source of liquidity as insurers try to rebound from the coronavirus.

Interest Abounds: Investors have already shown interest in the run-off space.

“How do you feel about the term 'vulture capital'?”

That was the first question Eric Haller faced in an interview last year about the run-off market. The CEO of Fleming Re, a Bermuda-based run-off provider founded in late 2018, wasn't surprised by the question. Run-off providers long had a reputation as picking over the remains of struggling businesses.

But the nonlife run-off market of 30 years ago, or even 10 years ago, is not the run-off market of today. The segment has evolved, particularly over the past three to five years, into a versatile tool for life insurers. And as the threat of global recession looms, this segment of the industry could find itself taking center stage by year end.

“Historically, because of the toxic liabilities—asbestos, environmental, etc.—there were a lot of distressed positions and solvency issues,” Haller said. “Some in the industry had the perception that run-off carriers acted as 'vultures.' Due to this, runoff didn't have the best reputation associated with it.

“But we've seen a shift in that paradigm, where both the run-off providers and the counterparties have recognized that transactions can be used as a tool to help with risk management, to help with liquidity, and to solve other problems beyond just disposing of bad liabilities.”

That shift shows in the deal flow. According to PwC, the nonlife run-off and legacy management market has been tremendously active. The consulting firm, which publishes an annual survey on the global run-off market, said nearly 100 deals were completed between its 2018 and 2019 surveys. And nonlife run-off liabilities rose to $790 billion in 2019, an 8% increase over 2018.

Sellers, PwC said, are looking for capital efficiency, profitability and operational savings.

“You didn't see the appetite to exit five or 10 years ago,” John Marra, senior partner and insurance deals leader at PwC, said. “Management teams have a lot more confidence and empowerment to think strategically about liabilities that are distracting the management team. They're not core to the businesses. There's clearly a mandate for companies in the industry to ring-fence those liabilities and to effect a reasonable exit. I call it a determined seller. That's the profile we see today.”

Distress in the market can often benefit the run-off industry because companies will want to do something proactive to stabilize or normalize their business, and that could be disposal of legacy liabilities.

Paul Corver
Randall & Quilter

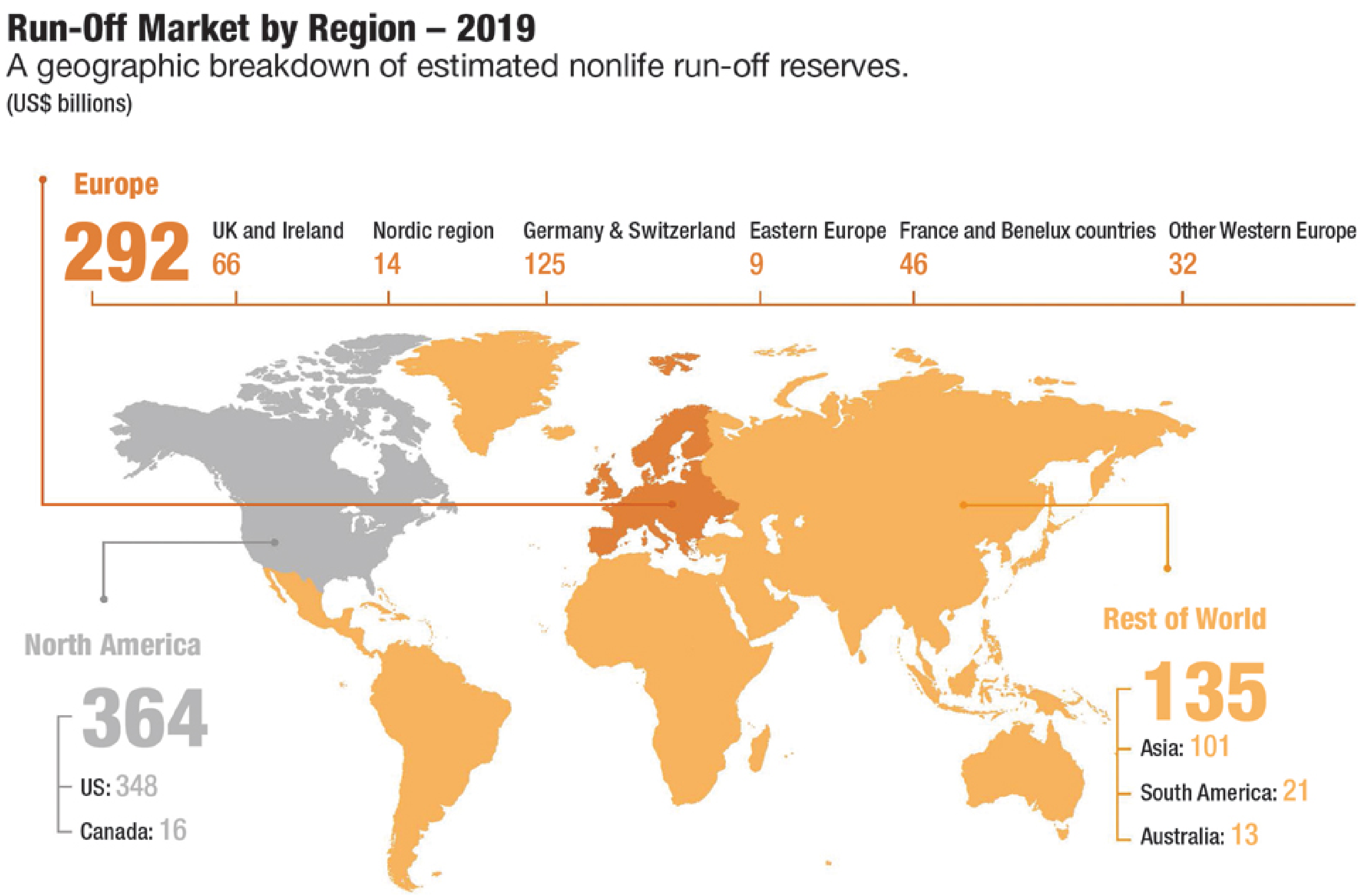
Before the coronavirus pandemic battered the globe, experts would have said run-off deals were likely to continue increasing in 2020. Now, they say, deals are all but certain to increase.

“Absolutely I think there will be more transactions,” Marra said. “Not immediately. But we do think later this year into next year there will be more folks looking to exit.”

While there is speculation that the global pandemic could put pressure on liability lines, there is near certainty that it will create strain on the investment side. As insurers seek greater liquidity, they very well may consider run-off transactions.

“There could be a host of potentially distressed runoffs coming out of the current situation,” Paul Corver, global head of M&A for Randall & Quilter Investment Holdings, said. “But it's not necessarily caused by impacts on the liability side of the balance sheet; the impact is perhaps more likely on the asset side of the balance sheet, where maybe the investments by the company have not been as risk averse as they thought, which can result in a significant hit to the capital supporting the business. In addition, reinsurers may be equally impacted, creating greater credit risk for the company.

“If companies begin to be concerned with the asset side of the balance sheet, then they might start looking at a transfer of some of their liabilities in order to free up capital.”



Excludes long-term-care business.

Broadening Scope

Run-off transactions rose to prominence with the asbestos crisis. But today's deals have broadened beyond toxic liabilities.

The most commonly transacted lines in the United States, which accounts for 44% of global legacy liabilities, are workers' compensation, commercial automobile and professional indemnity, according to PwC. Global liabilities are $790 billion, with $348 of that in the United States.

In the United Kingdom, cargo and construction lines are most active. And motor deals are driving growth across the globe, ranking among the top two most popular lines for runoff in Brazil, Argentina, Japan, South Korea, Germany and Switzerland.

"There's a growing realization by insurance and reinsurance companies of the benefits of doing something proactive with their run-off business," Corver said. "I've been in the run-off industry for 30 years. Run-off business used to be deemed to be a dirty, toxic matter, and people steered away from admitting they had any, even though runoff is inevitably a straightforward part of the insurance cycle. In theory, every policy goes into runoff when it expires."

Mergers and acquisitions have become a common source of deal activity, as acquirers look to transfer liabilities they do not have the desire or expertise to manage. Captives also are a prime source; in the face of a hardening market, risk managers might run off certain years of a program in order to free up capital to support their new strategy of increasing retentions. And sometimes companies change jurisdictions or fronting companies and would like to get rid of certain liabilities as a result.

"It's important to clarify that it's no longer limited to discontinued lines," Haller said.

Since the financial crisis of 2008, companies have become more focused on capital efficiency and analyzing their balance sheets to see which liabilities are absorbing capital that could be used better elsewhere.

At the same time, run-off providers have been looking for new ways to service the industry.

"We recognized that we could use these same tools and start providing other benefits to our counterparties—whether it be releasing trapped capital, cutting off a tail, providing a solution for an M&A transaction where the acquired company does not want the historical liabilities," Haller said. "There are additional solutions that the run-off providers have been able to offer. There is an increased level of recognition and appreciation from the industry and counterparties. Overall, the reputation of the run-off providers has improved. The combination of those three items has driven the demand and the increased number of run-off transactions in today's market."

As companies have more demand for liquid capital, they're going to turn to as many sources as they can to unlock capital within the company to support its operations.

Eric Haller
Fleming Re

Run-off providers make money in several ways—by favorably managing claims, investing reserves (i.e., "float"), consolidating lines of business to reduce costs and, of course, by pricing the transaction properly. It seems not a week goes by without an announcement of a new run-off deal. Firms like Enstar, Premia, Catalina, Randall &Quilter and RiverStone regularly are floated as potential bidders on transactions. These well-established run-off providers, along with new providers like Fleming Re, have proven they can see deals through.

"Because the transactions have gotten done, there's credibility and a diminished view on execution risk," PwC's Marra said. "That makes the folks looking to exit feel better, that the buyers can get these transactions done, that they can get regulatory approval, that they can get good outcomes in discussions with rating agencies."

That reputation will serve the market well in the coming year, when the aftermath of COVID-19 sends sellers and investors to the run-off space.

Coronavirus Crisis

The coronavirus pandemic has created economic uncertainty and distress. Both of those dynamics create opportunities for run-off providers.

“When market conditions start to go south, run-off opportunities increase,” said Scott Mangan, associate director, global reinsurance, AM Best Rating Services. “So it's very reasonable to assume we'll see more run-off activity if there's a recession.”

Respondents to PwC's survey described the run-off space as “recession proof.” R&Q's Corver wouldn't go that far, but understands that rationale.

“Potentially it is, because where there is distress there can be opportunity for us,” he said. “Distress in the market can often benefit the run-off industry because companies will want to do something proactive to stabilize or normalize their business, and that could be disposal of legacy liabilities.”

The coronavirus crisis has put the world on tilt, halting the global economy and sending shock waves through the stock markets. Though the total insured losses from the pandemic are still unknown, the expectation is the crisis will lead to a bump in run-off activity later this year.

“This has had a significant impact on global markets. As with most market disruptions, it causes a demand for liquid capital,” Haller said. “Given that a significant driver for run-off transactions is to release encumbered capital, demand for run-off solutions should increase.

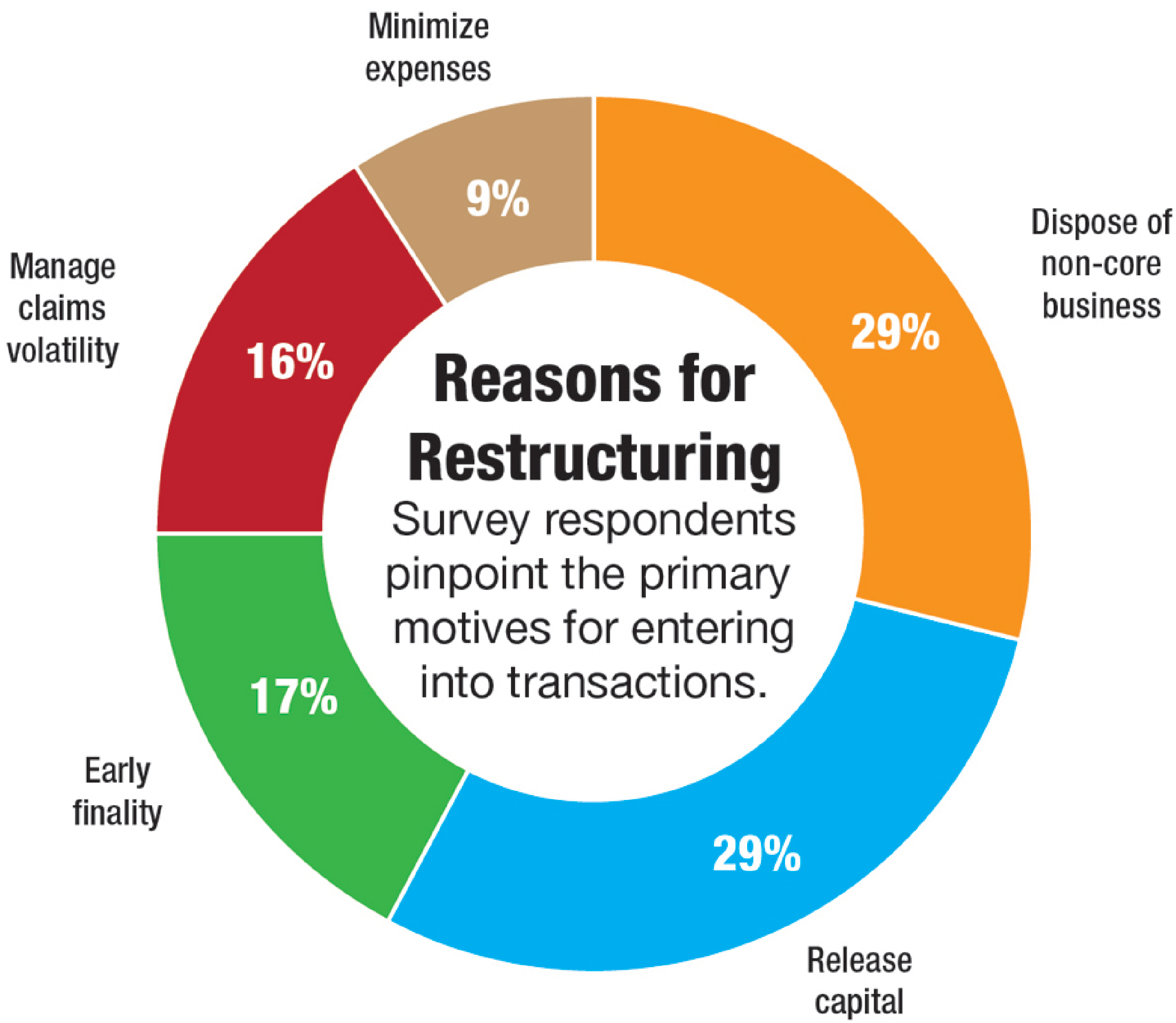
“As companies have more demand for liquid capital, they're going to turn to as many sources as they can to unlock capital within the company to support its operations.”

While that capital may come at a loss, it could have the upside of improving a company's capital position.

“Here's where this gets really interesting,” Marra said. “What's sort of unique about run-off transactions is that a realistic goal is exiting a block of business without having significant loss. It's rare that you exit with a gain or on a positive cash basis. It's often a loss, often net cash out of the company.

“But the pluses are an improved RBC (risk-based capital) ratio because those liabilities are removed and, importantly, the ability to tell a different story going forward to shareholders, policyholders, reinsurers, regulators and rating agencies.”

The prospect of more deals raises questions about capacity and whether there will be enough buyers in the market to support deal activity.



Source: PwC *Global Insurance Run-off Survey 2019*

Investor Interest

Wealth investors and capital funds are already involved in this space, and more are standing at the door. “I've never seen this level of capital interested in this space,” PwC's Marra said. “That's a comment I've been making for three years. And every time I say it, there's even more capital that comes into the space.”

More than 70% of respondents in PwC's survey said they expect investor interest in runoffs to increase over the next two years. There is a risk of investors being swayed elsewhere, though.

“There's definitely an interest,” AM Best's Mangan said. “That said, because of what is going on in the capital markets right now, maybe some of these investors may think they could get a better return in other asset classes.”

Fleming Re's Haller sees the diversification offered by the run-off market as a draw that should keep investors interested.

“The run-off markets aren't closely correlated to other investment opportunities,” Haller said. “Market disruptions are going to increase demand. From an investor standpoint, they will consider the uncorrelated nature of a run-off business and our ability to generate attractive risk-adjusted returns, and they'll want to deploy capital into attractive run-off opportunities.”

Randall &Quilter's Corver doesn't anticipate a rush of new players entering the market. Rather, he said, new capital likely will be funneled through established players.

“They'll tap into established run-off players to take advantage of the expertise and experience of the sector,” Corver said. “A new player coming in with new faces and just a big bag of cash wouldn't necessarily be attractive to sellers or to regulators.”

That's already been happening. In November, The Carlyle Group and T&D Holdings announced plans to acquire a 76.6% ownership stake in Fortitude Re from American International Group for $1.8 billion. The deal, which is expected to close in mid-2020, positions Fortitude Re to become a “premier provider of retroactive reinsurance and legacy run-off management solutions.” One month later, the Ontario pension plan for municipal employees (OMERS) announced it was buying a 40% stake in RiverStone UK, Fairfax Financial's U.K. run-off provider.

“We've clearly seen an interest from private money—financial sponsors, alternative asset managers, private equity, pension funds,” Marra said. “There's so much capital ready to jump in.”

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