

Land of opportunity

The US wants answers to its legacy issues. The choice of exit routes is increasing, and a creative approach is what's required, say **Jerry McArthur** of Tawa and **Chris Reichow** from Pro



With the US coming out of recession, albeit slowly and with federal debt concerns still making headlines, the climate for dealing with legacy business, for both live re/insurance entities and more traditional run-off portfolios, looks to be slowly improving. It is still a tough environment to do business in, but for companies that can offer real creativity in what they offer, in addition to traditional run-off, there are opportunities as carriers look for financial solutions to help them utilise their capital more efficiently while refocusing on their core business lines.

What makes the US an exciting place for legacy business is its sheer size and variety. Fifty states means

50 different regulatory agencies, and while that's a challenge in itself, the multiplicity of regulation does have the happy consequence of delivering an element of competition, with some states wanting to deliver progressive and innovative options in the re/insurance segment.

This may be specifically related to legacy business, or to the re/insurance sector more generally, as they look to attract carriers to set up business in their state, encouraging competition and spurring on the development of a wider range of risk transfer solutions. Take for example Rhode Island's recent signing into law of legislation that allows the creation of captive insurers; while a handful of states, starting with Florida and New

York and now most recently Indiana and New Jersey, have moved to relax collateral requirements for alien reinsurers.

Scant resources

Against this encouraging regulatory backdrop, the economic downturn has also raised the imperative on risk carriers to return profitable results across their entire portfolio of business. Managements are not only facing pressure on their balance sheets, but also have pressure in terms of the scant resources available – be it capital or manpower, or both.

A company wants and needs its people to be working on projects that are critical to the organisation and generate solid financial returns – anything

else is simply a distraction. If a book of business isn't performing and perhaps is also not a core activity, why should a company carry on servicing and supporting it?

Senior management will want to look for solutions to help them refocus and exit from areas that are no longer seen as core to their overall business strategy. This has opened up the door in the US to conversations on dealing with legacy amongst live groups that might not have happened pre-credit crunch.

Given a growing willingness to deal with legacy, or even orphan business which is profitable and viable but perhaps just not core to a particular carrier, what options are out there in the market? The good news is, the number of exit routes are on the increase, ranging from the sale of the whole book or only the renewal rights, to companies looking to a reinsurance solution or alternatively going down the path of an outsourcing or insourcing arrangement. Whichever route the carrier chooses, their overriding principle will be a maximising of their capital with minimal rating risk.

Here is an example of a creative solution to the run-off issue. Earlier this year, Tawa set up a specialist run-off reinsurer in Bermuda to provide protection for Penn National from adverse development, specifically arising from lead paint exposure related to real estate cover in Baltimore, Maryland being run off.

The reinsurer was funded with a

premium payment by Penn National and an equity injection by Tawa. Penn National additionally entered into an Administrative Services Agreement under which Pro IS, Inc manages the adjustment of claims, the collection of related reinsurance receivables, the pursuit of subrogation or other recoveries and any other required services relating to the reinsured portfolio. Penn National benefits by moving a piece of business, which is no longer core to its operations and which allows them to focus resources elsewhere, over to a specialist unit within Pro.

Penn National has chosen to remain involved by monitoring the programme through monthly reporting, but it could have chosen to continue managing the day to day functions with the reinsurance solution or alternatively drop all involvement and simply receive quarterly or annual reports on the run-off. Creativity and flexibility to adapt to the needs of the company were critical in finding the right solution.

Open minds

The growing creativity in this market is to be welcomed, but despite signs that the regulators are becoming more open to ways of dealing with run-off, aside from traditional receivership, there are still regulatory hurdles to be cleared. A white paper, launched with some fanfare by the National Association of Insurance Commissioners (NAIC) in 2009, in an attempt to respond to criticism at the lack of options available to insurers

not entering receivership, did little to advance matters and simply seemed to outline how equivalent mechanisms work in UK/Europe. That said, some states have led the way, for example Rhode Island's adoption of its 2002 Restructuring Act, which could provide a potential major boost for solvent run-offs.

The recent test of this Act earlier this year with GTE Reinsurance's application to wind down operations, which saw a Rhode Island state court uphold the statute allowing GTE to purchase back their liabilities, could well be a major tipping point in the trend towards dealing with legacy business in this way. Critically of course, this was essentially a business to business transaction and does not affect the man on the street with a workers' compensation claim, for example.

It is difficult to say that state regulators and judiciaries would look as favourably on the same sort of blanket commutation for policyholders if it involved the general public. A question that is always going to be raised is why should a policyholder accept that a company, that is not insolvent, withdraw from offering the insurance protection that a policy, bought in good faith, provides? The US of course loves a good litigation and there is no shortage of lawyers willing to take on this challenge.

Ultimately, however, no state wants insurance insolvencies as they're not good for the economy, employment and overall reputation of the state.



There are signs that, while there has been no dilution of capital requirements allowed by the regulators, some are more open to dealing with solvent run-offs. Pennsylvania, for instance, has many companies in run-off and has adopted a practical and efficient approach to looking at commercial solutions, with the overriding principle that policyholders are protected.

The US challenge

Given this context, is the market for acquiring run-off companies or portfolios becoming more attractive in the US? The short answer is no. There has always been a market for run-off as part of the natural cycle and nothing has really changed to make it more or less attractive, except perhaps the more practical approach coming from the regulators. To an extent, there is a bit of wishful thinking going on, as the UK/Europe run-off market reaches maturity and players look hopefully to other markets, such as the US, to ply their trade.

The US lags behind Europe, and particularly the UK, when it comes to risk based capital such that organisations may not appreciate the true capital supporting their run-offs at the firm's target internal rate of return (IRR) which would then allow them to assess what options there are plus any financial impact. First step is for a company to build a run-off model which will show the level of unallocated loss adjustment expense (ULAE), cost to the organisation and length of time required. This exer-

cise requires input from various areas within a company including actuarial, finance and operational risks.

Solvency II is driving this in Europe which in turn is leading to many orphan run-off books being disposed of, due to the adverse economics the results show when compared to retaining them. There is a chance that US firms will experience similar behaviour and may experience difficulties balancing their positions, creating opportunities to relieve them of their own orphan run-off books.

A challenge to a successful run-off is the alignment between buyer and seller and/or the run-off provider. There is no one solution or model that fits each situation. Depending on the circumstances, there is a range of solutions, including:

- An outright sale or reinsurance cover.
- Buyer financing or partial secured vendor financing, given the vendor should be well acquainted with the portfolio's risk profile and solvency confidence margins.
- Profit sharing where the buyer makes a reasonable return, but excess profits are shared back with the run-off provider.
- Success based fees where the run-off provider does not receive hourly fees, but is rewarded on performance based on portfolio owner's objectives and interests, such as descaling the book of business.

High barriers to entry

The growing sophistication in the US

run-off market is not to be downplayed and those offering high quality consultancy services have an opportunity even though barriers to entry in the US are still high. An overseas entity needs to be able to offer something very different from the locally based consultancies or else risk being seen as simply more expensive (by virtue of the higher cost base in setting up an overseas infrastructure) and not as knowledgeable.

An exception could be if the US entity is looking for help with a specific area outside of the US, whether that is London market driven or in Asian markets perhaps. For US consultancy providers, it is still a tough market as carriers look to keep things in house where possible, to keep costs down and maintain control.

Creativity with a cutting edge

So it's back to the original point; only the most creative consultancy providers will be in with a chance of making the most of what is undoubtedly a vast and potentially exciting legacy market in the US. If they can ally that creativity with cutting edge full service consulting operations, whether it is claims management, the billing and collecting of reinsurance, reporting to the regulator, or actuarial work for example, that risk carriers increasingly want to access, the opportunities will come. Much will depend of course on how the regulators arrange the red tape, but if recent activity is anything to go by, the outlook is encouraging. ●