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MANAGING A BUSINESS IN RUN-OFF

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1.0 AN OVERVIEW OF THE RUN-OFF INDUSTRY

The run-off industry is large. It has grown as a consequence of well publicised losses arising from, for example, asbestos, pollution and catastrophe exposures.

The main types of run-off portfolio relate to Companies, Lloyd's syndicates and Agencies/pools.

There are around 250 Lloyd's syndicates and 125 UK non-life companies in run-off. Of the non-life companies over 20 are in the insolvency process. The gross liabilities involved are estimated to exceed £25bn.

In these circumstances it should be no surprise that particular features of the industry are: claims management, reinsurance recovery and, inevitably, litigation.

The players directly involved in the industry are 'Advisers', 'Run-off management companies' and 'In-house' professionals at Lloyd's and within insurance companies.

A 1994 survey of the run-off industry lists the following numbers of organisations involved in run-off management:

Management Companies		
	London Market	12
	International Market	8
	Lloyd's syndicates	11
	Broker run-off	8
Advisers		
	Reinsurance consultancy firms	25
	Solicitors firms	44

'Advisers' also include accountants, brokers and actuaries.

Whilst no figures for 'In-house' professionals are presented their involvement is substantial.

2.0 THE TRANSITION FROM UNDERWRITING TO RUN-OFF

The immediate task facing the senior management of a company which is about to go into run-off is to plan ahead.

From a financial point of view it is necessary to determine whether the company is solvent or insolvent, whether it will be supported by a parent company, and to project its future financial position under alternative assumptions.

This information will enable the company to determine the nature of the run-off and plan accordingly for, for example, pending insolvency or the injection of cash from the parent.

From an operational point of view the infrastructure required to run a business efficiently when it is open to new business differs significantly from that which is appropriate when it is in run-off.

It will be necessary to decide whether the company should adopt a passive approach - paying claims and dealing with commutations as they arise, or an active approach which seeks to dispose of liabilities quickly. The approach adopted will impact staff levels and initial investment requirements.

One approach is to put together a 'blueprint' for the desired run-off company to incorporate reengineered administrative departments with redefined costings and headcounts. A change of premises may be necessary. A detailed project plan will be required to manage the transition to the downsized operation. The plan will include issues such as:

- Liaison with staff, policyholders, the media, regulators, reinsurers
- Documentation of departmental procedures
- Claims management and reinsurance recovery policy
- Systems requirements
- Outsourcing options
- Ongoing reinsurance requirements
- Redundancy arrangements
- Key staff retention
- Security arrangements

3.0 MANAGING THE SUBSEQUENT RUN-OFF

3.1 Claims management and Reinsurance recovery

Run-off highlights the importance of claims management and reinsurance recovery. The circumstances of the run-off industry encourage disputes about the interpretation and extent of cover granted. It is crucial that coverage is rigorously checked and that the market place is monitored to keep abreast of current and emerging issues.

Even with key staff in place the strains placed upon a recently downsized company will expose the company to the risk that the control over administrative processes is weakened. It will be necessary to carry out post implementation audits to identify problem areas.

3.2 Litigation

A key feature of the management of a run-off company relates to the management of the company's interests in relation to, inter alia, litigation surrounding the problems at Lloyds - indeed it is often the case that the problems are the cause of the run-off.

The sheer size of the losses is such that there are many disputes as to the legal obligations of insurers and reinsurers with regard to the interpretation of contract language. In addition, there is a tendency to attack allegedly negligent parties with a view to gaining access to any available professional indemnity cover.

It is important for a company to keep abreast of developing legal actions and to be aware when it should enter into litigation itself.

Litigation involves significant cost. It is necessary to consider carefully the benefits of successful litigation and the likelihood of success in the light of the costs.

3.3 Commutation strategy

It may be advantageous to enter into negotiations to commute various of the company's insurance liabilities and reinsurance assets.

Commutation may be considered where there is a desire to reduce uncertainty arising from:

- A dispute as to the extent of liability
- A concern about the financial position of a reinsurer
- Liabilities which are difficult to quantify and are significant in the context of the balance sheet

Commutation will also be considered if there could be an economic benefit arising from:

- The transfer of liabilities which are small and uneconomic to administer
- The risk being commuted at less than the expected cost of the liability

Practical points to mention include the need to gain the support of the company's reinsurers for inwards commutations and the need to consider the right of set-off between principals.

3.4 Expense control

Apart from claims payments the main item of net cash outgo will relate to management expenses. The conflict between expense reduction and optimal claims management needs to be handled with particular care.

3.5 Investment Policy

The immediate consequence of closure to new business will be a rapid reduction in premium income receipts resulting, ultimately, in a net cash outflow. The speed at which investment funds run down will depend upon the classes of business underwritten and the effect of commutations.

It will be necessary to review investment policy to consider:

- The projected cash flow situation
- The term and nature of the assets and liabilities
- The impact of commutations
- Information to be supplied to the investment managers
- Taxation implications

4.0 REGULATORY ISSUES

The main focus of this section is the approach of the DTI to run-off companies. The Lloyd's market is self-regulating - the DTI does not formally regulate units within Lloyd's. However, EQUITAS, as a reinsurance company will be authorised by the DTI.

4.1 The DTI approach

The DTI is concerned with the interests of all policyholders worldwide, in general, and classes of policyholder. This contrasts with USA regulation where only USA policyholders are protected.

As far as companies and the DTI are concerned there are 3 stages of run-off:

1. Underwriting ceases
2. Company formally deauthorised to write (Section 11, Insurance Companies Act 1982)
3. Company completely deauthorised at completion of run-off (Section 13, ICA82)

Until the stage of complete deauthorisation is reached, the following apply as for a company continuing to write:

- Solvency margin requirement - even if assets are less than liabilities the requirement remains to prevent the distribution of assets and to allow for cases where windfall gains return the company to solvency
- Localisation and matching of assets
- Notification of changes of control
- DTI powers of intervention

With reference to run-offs the Supervisory approach depends upon the reason the company entered run-off:

- Unilateral act by company
- Company decision at DTI prompting
- DTI formal action - such action is rare, the threat is usually sufficient

The majority of companies go into run-off as a unilateral act because of profitability problems. The trend has been for companies going into run-off to become insolvent subsequently due to increases in their liability estimates compared with the estimates at the time underwriting ceased.

The DTI approach is to progressively remove authorisation, with the company's consent.

Most companies in run-off retain their licence, either to ensure that reinsurance recoveries continue to be paid, to keep the business options open, or to retain the perceived financial value of the licence. The DTI can temporarily suspend the licence (Section 45, ICA82) or permanently remove it (Section 11, ICA82). The majority of companies voluntarily give up their right to write new business unless they have an insurance industry based parent.

Companies in run-off will normally be subject to a notice of requirement, to control the flow of value out of the company, particularly limiting transactions with related parties through: management charges, dividends or reinsurance premiums.

4.1.1 Commutations

It is believed that the general policy of the DTI is not to obstruct commutations - the informal view is that commutations are a means of freeing up capital.

Problems can arise with the DTI from an aggressive policy of commuting claims to the disadvantage of policyholders in general.

The DTI has no powers to restrict a policyholder's rights, i.e. regarding a payment of claim.

4.1.2 The powers of the DTI

The DTI has 'General' powers and 'Special' powers.

The General powers are:

- To stop a company underwriting
- To stop value leaving a company through control of:
    - new service agreements

- new reinsurance commitments
- dividend payments

Special powers are:

- To require assets to be retained in the UK/EU up to the value of the liabilities
- To require the placement of assets in trust
- A general power to impose requirements

4.2 Insolvent Insurance Companies

This section has been included due to its relevance to the run-off industry.

If an insurance company is unable to pay its debts there are four ways in which it may proceed:

1. *Liquidation*
2. Company Voluntary Arrangement
3. Scheme of Arrangement
4. Reduction of Contracts

Each of the above approaches has its own particular difficulties but all suffer from difficulties in treating creditors fairly, and in protecting the company from creditors, because:

- All current creditors may not be known
- Events may transpire which create future creditors

The Scheme of Arrangement is often chosen as the most appropriate approach. With this approach proposals for the discharge of the company's liabilities are drawn up. Meetings are held with each class of creditors. For a scheme to be successful it must be accepted by 75% of the creditors by value and these creditors must represent at least 50% of the number of creditors voting in each class. Following class approval the scheme must be sanctioned by the Court.

The drawbacks in the regime applicable to insolvent non-life companies are recognised by the DTI and are the subject of proposals for reform.

Should an insurance company be unable to settle its liabilities in full the Policyholders Protection Board may provide additional amounts to the policyholder to increase the overall settlement to 90% of the full claim amount. Such payments apply to individual policyholders and in some circumstances to groupings of individuals under one policy. Companies are not covered, for example, in the event of the failure of a reinsurer.

5.0 ACTUARIAL INVOLVEMENT

Most actuaries involved in run-offs work in-house or for consultancy firms. There is a growing involvement of actuaries in run-off management companies.

The principal activity is believed to be the assessment of the value of insurance liabilities and reinsurance assets in the context of commutation and reserving.

5.1 Commutations

The commutation 'process' often proceeds as follows:

Following initial contact between representatives of each party the scope of business to be commuted will be agreed. This will involve the inclusion or exclusion of certain classes, treaties, contracts and types of loss. The final commutation agreement may cover anything from one to several hundred contracts across a large number of underwriting years.

The accounting records for claims, premiums and unpaid balances will then be reconciled and agreed.

Notified outstanding losses will be reconciled at a detailed level. This often results in large differences even when data has been drawn from the central processing bureaux (such as LPC, LIRMA). Sometimes the reinsurer will hold out-dated notifications that the reinsured may have taken off its books without notifying the reinsurer. There is a possible tendency of reinsureds to overstate outstanding losses, perhaps to improve commutation values or to appear as a larger creditor in the event of liquidation.

Separate IBNR calculations will be performed by both parties and this is the area where actuarial input is important. Each party will have different interests and this, combined with different calculation methods and assumptions, provides much scope for disagreement and negotiation. The parties will have differing strengths and weaknesses vis a vis their level of information, for example: the reinsured may have a better understanding of its own business but the reinsurer may have a better understanding of the type of business due to its wider exposure.

5.1.1 Actuarial issues

There follows an outline of the sort of issues that actuaries involved in commutations need to consider.

- Statistical methods which may be appropriate when dealing with a large number of contracts may be unsound, and hence inappropriate, when dealing with a small number of contracts. For example, claim and premium development factors relevant to several hundred contracts are unlikely to be appropriate for a single contract.

- It is sensible to check that projected ultimate losses do not exceed the maximum possible liability.

- It is important to consider carefully the effect of complications such as 'Tops and Drops' and Reinstatement premiums.

- Latent claims, such as pollution, are difficult to project - in this situation a range of values can be particularly helpful.

- Projected future cash flows will be discounted to a present value at a rate of interest chosen with reference to the timing of the cash flows.

- Some allowance may be made for savings in expense that the arrangement can be expected to bring about and for the possible non-payment of future claim amounts.

- Senior management may misunderstand the true value of a commutation if the commutation amount is compared with the equivalent balance sheet value and this has not been calculated on a 'realistic' basis.

The reinsured will wish to obtain as high a commutation value as possible but the reinsurer will wish to minimise the payment. However, the final decision as to whether to commute will depend only partly upon the work of the actuary. It is important to realise that the arguments are not just financial - it may be necessary, for example, to allow for the chance of winning a legal case or the possibility of the insolvency of the other party.

5.2 Reserving

5.2.1 Actuarial Issues

There follows an outline of the sort of issues that actuaries involved in reserving need to consider.

- The way in which bad debt provisions have been made.

- Undiscounted reserving bases can become unrealistic and impractical as a company gets close to insolvency.

- If reserves are to be discounted then interest earning assets must be available to support the selected discount rate.

- The extent to which reserves should allow for any benefit that can be expected to come from post accounting date commutations.

- Discounted reserving bases will reduce the ability to cushion adverse experience - second order uncertainties may become first order.

- As commutations progress the remaining business mix will change - possibly invalidating previous reserving assumptions.

- Commutation will bring cashflows nearer in time - this will impact investment policy and discount rates.

- The way in which to reserve for future expenses when they are impacted by commutations.

- The attitude of the DTI.