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Transferring legacy books of business

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Introduction

Legacy business in insurance companies can create a drag on performance and soak up capital. With the ever-greater focus on capital, risk management and resources, it is no surprise that the market for the sale and management of run-off is as lively as ever. The ways in which (re)insurers deal with their run-off remain as they have been for some years: internally (or externally) managed run-off, reinsurance and sale.

In each of these alternatives, the owner of the book of business is likely to be concerned with the reputational risk associated with the treatment of its legacy business, not only with insureds and brokers but, importantly, also regulators. Interestingly, the market reputation issues are generally less critical than the regulators' reaction and perception.

Although the number of plausible, well-funded, buyers is probably lower than in the past, the market for buying other companies' legacy books remains an active and relatively competitive one. Prices, however, seem to have dropped in recent years. There has also been a shift by the run-off acquisition market to move into full-scale going-concern bids, with a view to putting live entities into run-off and transferring renewal rights to others. This is a logical consequence of a period when the price of pure run-off seemed on occasions to be higher than that of whole businesses.

So, for any company or group looking at legacy business, exploring alternatives to disposal of legacy books of business may be timely. Moreover, time and expense spent addressing the fiscal hygiene of run-off management is unlikely to be wasted, since what may begin as an internal exercise can also optimise the books for external sale or reinsurance.

Managed run-off

For large (re)insurers, the run-off of legacy books of business ought not be limited to maintaining the status quo. There are many ways to centralise and streamline claims handling, collection of reinsurance and reduction of expenses to mitigate the ongoing drain on the company. There are many third-party administrators willing to take some or all of the administration from the original company, and some relatively innovative pricing structures for doing so. Interestingly, even with Solvency II and equivalent regimes looming, there are large groups that still hold their run-off business in separate silos; few have found a way of centralising it efficiently, managing global off-set and commutations across their whole operation, and also reducing operational risk and friction between different profit centres.

We are likely to see this change across Europe in anticipation of Solvency II, which comes into force on January 1, 2016. The change will almost certainly result in a series of major group reorganisations spinning off books of run-off into consolidated administration, if not also separate vehicles. What these books of business have in common is that they are now seen as a drag on the owner group's resources, as a consequence of the extensive reviews of capital and risk in preparation for Solvency II.

Managing run-off is very much about planning. Aside from the capital and claims managements aspects, other issues that have been encountered include IT systems migration, regulatory issues for the retention of records, and the potentially adverse consequences on banking and other covenants when entering into run-off. New, and sometimes aggressively opportunistic, creditors/policyholders can and do emerge during run-off reorganisation – particularly to seek advantage during a closure process, such as business transfer, redomestication or scheme of arrangement. Time spent mapping the process and identifying the likely hazards is rarely wasted.

Reinsurance

Retrospective reinsurance arrangements, loss portfolio transfers and adverse loss development covers can be used to effect an economic transfer of legacy books of business – although without providing true exit finality, because the original carrier remains ultimately liable if and when the cover runs out. As most know, Berkshire Hathaway's National Indemnity Company (NICO), through the use of reinsurance, has been taking on discontinued books of business from companies (including Lloyd's 1992 and prior business) for the past 15 years. As a result, NICO has accumulated significant portions of the US asbestos and pollution claim exposures for pre-1986 insurance contracts.

Sale and sanctioned transfers

In the UK and some other EU jurisdictions there are statutory mechanisms for the transfer of business from one insurer to another. The UK version, Part VII transfers, enables not only the liabilities to be moved to a transferee, but also the assets supporting them, including inuring reinsurance.

In other countries, the sale of a legacy book of business first involves isolating the business in one or more entities that do not have active books of business. This "ring fencing" provides an opportunity to isolate the book of business with the possibility of then selling the shares of the company. The challenge is to find a way of effectively isolating the business.

An early example of such restructuring was the Cigna/Brandywine division that occurred in 1996. The transaction involved the transfer by Cigna of its pre-1987 inactive business associated with the Insurance Company of North America (INA) to the new Brandywine entity (while retaining the active business in INA). The old asbestos and pollution exposures were then reinsured with a new entity, Century Indemnity Company, which then ran off the asbestos and pollution books. (Interestingly, as part of a subsequent sale to ACE in 1999, Century entered into an adverse loss development reinsurance agreement with NICO.) Some of the Brandywine business was eventually sold to Randall & Quilter in 2006. The 1996 restructuring occurred under Pennsylvania corporate law (not insurance law). Subsequent restructurings using the same law have occurred in Pennsylvania. Other state laws may provide additional mechanisms for consideration of the splitting of an insurance company's business between "inactive" and "active." (See the discussion below.)

In general, however, the US insurance market lacks widely available mechanisms to facilitate the transfer of legacy books of business and indeed the UK Part VII mechanism is controversial in the eyes of many US reinsurers. This may change, State by State, as the US insurance regulatory regimes tighten capital requirements in ways that are not dissimilar to Solvency II, and may well lead to the consolidation of legacy books through reorganisations.

US insurance regulators have shown some willingness to explore alternatives, particularly in the context of "troubled" insurance companies. See, for example, the supervised run-off of Lumbermens Mutual Casualty Company (IL) (2002-2012); and the restructuring of financial guaranty insurers (e.g., MBIA and AMBAC) following the 2007-2008 financial crisis to separate the municipal bond business from the troubled structured finance business. A December 2009, NAIC White Paper, *Alternative Mechanisms for Troubled Companies*, provides a discussion of these alternatives. The White Paper identified some of the advantages of using alternative mechanisms to traditional receivership and insolvency proceedings to achieve faster resolution, lower costs, financial flexibility, and continuity of claim payments, all with the purpose of freeing up capital. It also recognised the need for:

- Heightened regulatory oversight to avoid the risk of adverse effects to policyholders (e.g., circumvention of state priority and preference rules), and;
- Meaningful disclosure to constituents (including guaranty associations).

Some of the alternatives and concepts addressed in the White Paper are being used by state insurance regulators in the context of evaluating the transfer of legacy books of business.

Further examples of statutory support for transfers in the US are Rhode Island's *Voluntary Restructuring of Solvent Insurers*, Gen. Laws 27-14.5-1 *et seq* (2002) (which mimics the UK's Part VII transfers) and Vermont's *Legacy Insurance Management Act* of 2014, 8 V.S.A. Ch.147. §7111 *et seq* (2014) (which tends to follow the Part VII transfer process for old non-admitted and reinsurance books of business to specialised insurers created in Vermont).

Regulatory attitude to sales and closure of legacy business

Whilst the UK may have led the way in developing methods to achieve transfers and finality in respect of legacy books of business, UK regulators are very stringent in their approach to them. For example, solvent schemes of arrangement, once a popular tool for achieving finality for (re)insurers, have been slow to materialise in recent years because the regulators' view of these schemes, at least in their traditional form, seems to have hardened. However, "option" schemes of arrangement, in which policyholders have the ability to keep cover as an alternative to receiving a valuation of their claims, are being worked on and should provide a useful alternative to the 'cut-off' schemes which have attracted opposition and disputes.

UK regulators have also been playing an increasingly active role in the Part VII process. This came at a point where there was an uptick in the number of insurers seeking to make Part VII transfers ahead of the Solvency II implementation date, which led to the Prudential Regulation Authority (PRA) issuing a letter to directors in January 2015, essentially stating that unless a fee has been paid and an insurer has already indicated its intention to complete a transfer this year (and is on track to do so), it is unlikely that the PRA will be in a position to conduct its review of a potential Part VII transfer given competing priorities with other elements of Solvency II (highlighting the PRA's limited resources at this time).

Where to next?

It is trite to say that today's underwriting is tomorrow's run-off; there is no shortage of existing, burdensome, legacy business, and the market will continue to produce more in the future. It follows that there needs to be a capital-and risk management-efficient way for the insurance industry to deal with its past. Run-off, as a separate part of that industry is seemingly here to stay and will, in fact, expand in the next few years. Well-conducted run-off, with proper regulatory oversight, would appear to be in the interest of the live market and also of policyholders who need their insurers to be strong and financially viable. ●

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