PwC Advisory
Crisis Management

US discontinued insurance business survey 2006: How US run-off liabilities are managed*

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Overview
Trends and challenges in US run-off market management

In 2004, PricewaterhouseCoopers LLP (PwC) published a first-of-its-kind survey of the run-off market, primarily focusing on run-off insurers operating in the UK. The survey shed light on working practices within the industry's most mature market for discontinued insurance liabilities. Since the survey's publication, the UK market has continued to mature and explore innovative techniques designed to preserve and extract value from discontinued liabilities.

In contrast, much less information is known about the run-off market in the US. Although the US market is generally acknowledged as the largest in the world, with estimated liabilities of $150 to $200 billion, run-off as a stand-alone business is less mature.

Recent numerous high-profile exits from the US underwriting market have put a spotlight on run-off liabilities. The number of exits appears to be based on the realization that companies must take a proactive approach to run-off liabilities to preserve value for all stakeholders.

To gain a better understanding of the current trends in US run-off management, PwC's Insurance Restructuring Group distributed a survey in August and September 2006 to a group comprised mostly of property and casualty insurance and reinsurance companies with discontinued insurance operations across the US. The companies invited to respond included entities solely in run-off, as well as major ongoing companies known to have significant portfolios of discontinued business. The questions were focused on their profile/background, run-off management and strategy, regulatory issues, claims and claims strategy, ceded reinsurance, and IT systems.

The survey identified trends in US run-off market management, as well as the key challenges to the success of such management. While the survey results were not intended to recommend the optimal way to manage a run-off, they did identify common themes among the survey participants.

Key findings:

1. Run-off is a substantial business in the US insurance market, and is steadily gaining visibility and focus.

2. Companies have strategic plans for managing their run-off, with tangible financial goals, but challenges exist in the implementation of effective operational plans to meet these strategic goals.

3. The key goals in most respondents' strategic plans are to gain finality to assumed exposures and remove volatility.

4. Staff retention and incentives were seen as key issues in achieving run-off objectives, yet 50 percent of respondents do not have a retention plan and 32 percent do not have an incentive plan.

5. Outsourcing of run-off management appears to have been more focused on specific specialized tasks than on the outsourcing of overall run-off portfolio management.

6. Run-off appears to generate additional regulatory interest and scrutiny; however, relationships with regulators appear to be sound. While the vast majority of respondents indicated that their run-off strategy is supported by a plan and financial model, 65 percent of respondents noted that they are not required to file their run-off plans with regulators.

Challenges

Despite the desire to achieve finality, respondents acknowledged difficulties in doing so, and face challenges in attaining successful conclusion of their run-off exposures. Such challenges include:

- The impact of adverse claims development on the enterprise
- The ability to retain and motivate staff who are key to the effective management of the run-off
- Increased reinsurer scrutiny of run-off cessions or the reinsurers' own inability to meet their reinsurance obligations
- The ability to gain finality to the companies' assumed liabilities
- The ability to conclude commutations with ceded reinsurers

It is critical to overcome these difficulties to achieve successful run-off management. The US insurance market is taking an increasingly proactive approach to identify and resolve market issues through initiatives such as the establishment of the Association of Insurance and Reinsurance Run-Off Companies (AIRROC). Participation of key run-off entities in this market survey further indicates that US management is willing to examine its run-off management strategy and seek new approaches to solving legacy problems.

The US run-off landscape is undeniably different than its UK counterpart. Liabilities in the US run-off market are more focused within the large ongoing insurers and reinsurers that house significant run-off portfolios. Less prevalent in the US are the smaller, stand-alone run-off entities that have characterized the London market. To date, the US has had very limited access to the types of structured run-off exit mechanisms offered in the UK through the "scheme of arrangement" concept. It remains too early to tell if such approaches will become a widespread part of state or federal insurance law in the US. However, the answers in this survey indicate that the US run-off market is beginning to vigorously pursue finality to discontinued business.

About this survey

This survey was designed to identify common trends and issues within US run-off management and to identify drivers for strategic and operational review. It also allows respondents to benchmark their own practices in relation to those of an anonymous subset of their peers.

The survey focused on the following areas:

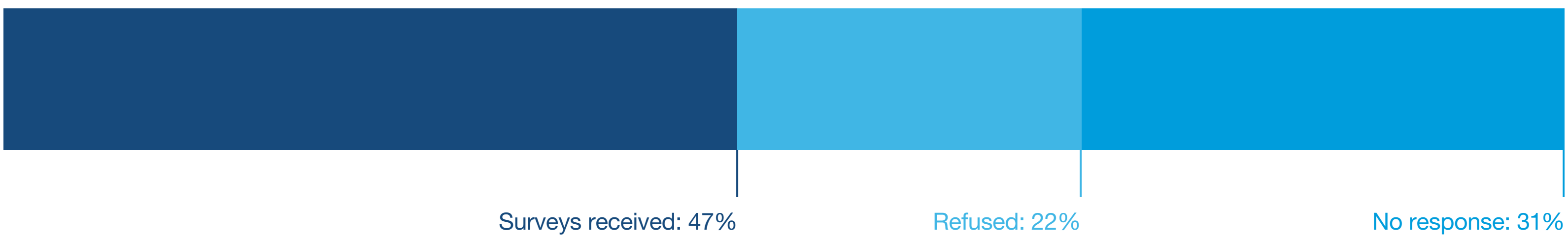
- Background/profile: Basic information relating to the identity and profile of the respondent company
- Strategy: The extent of strategic planning and financial modeling utilized within the run-off company as well as consideration of ultimate exit strategies for the business
- Regulatory: Reporting and relationships with regulatory bodies
- Claims: Key priorities and challenges that exist when dealing with assumed liabilities, including the approach to assumed commutation initiatives
- Reinsurance: Key priorities and challenges that exist when dealing with the billing and collection of ceded reinsurance, including the approach taken to ceded commutation initiatives
- IT systems: The extent to which respondents' existing technology was able to support run-off operations and strategic objectives.

The survey was provided to approximately 60 US insurers that were either completely in run-off or were carrying significant run-off liabilities along with their ongoing operations (see figure 1). Of the 60 companies invited to participate, nearly 50 percent responded in time to be included in this report. This number of respondents is considered more than sufficient to produce statistically sound results.

Of the total respondents, 46 percent are companies whose sole business is run-off, while the remainder are companies that have significant run-off liabilities alongside their ongoing operations.

The maturity of the respondents' run-off portfolio was also varied, but the majority had been administering run-off liabilities for a relatively short time.

Figure 1
The survey was distributed to approximately 60 companies in the USA.



Companies who received the survey fell into two categories.

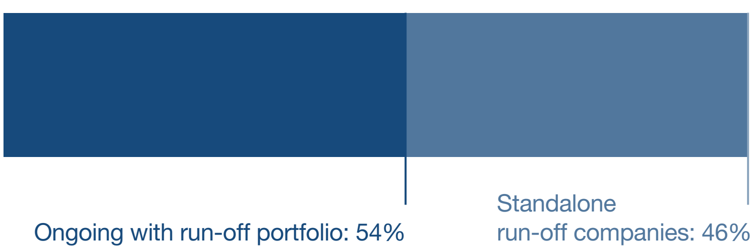
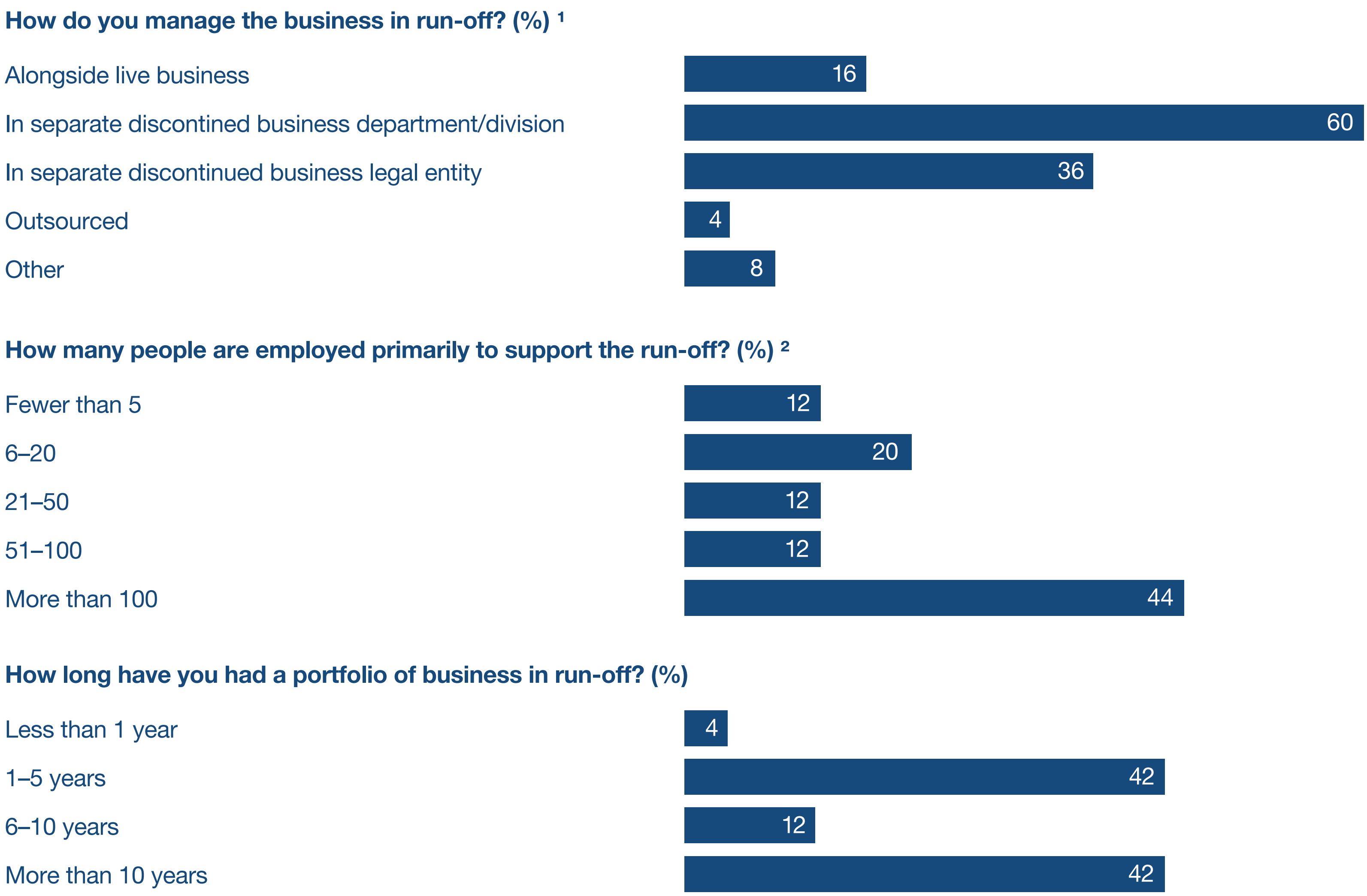


Figure 2
Profile of respondents based on the size of run-off liabilities was quite varied.



1 Total numbers exceed 100 percent. Respondents were asked to check all that apply.
2 Response stated as full-time equivalents.

Run-off management and strategy

A key factor that measures whether run-off liabilities are a primary focus for an insurance organization is the extent to which separate strategic plans and financial forecasts have been created for the run-off operations.

Eighty-three percent of respondents indicated that strategic plans are in place for their run-off operations (see figure 3). In most cases, those plans are supported by financial forecasts, and management and staff are measured by whether they attain the goals set out in the financial model.

Sixty percent of survey participants manage run-off in a separate discontinued business department or division (see figure 2), while thirty-six percent manage run-off in a completely separate legal entity devoted to discontinued business. This leaves a reasonable percentage of respondents who manage run-off operations alongside ongoing operations. This is in contrast to the 2004 UK survey, which found that almost all respondents had separate operations.

Survey respondents use outsourcing particularly in the claims and IT areas. Approximately one-third of respondents outsource these areas in full or in part. Interestingly, the majority of respondents compensated vendors on a fee-for-service basis rather than through an incentive-based compensation system. Overall, the vast majority of respondents were satisfied with the services provided by outsourcers. This may explain the lack of emphasis on incentive-based compensation.

Regardless of how companies segregate run-off operations, effective strategy and management methods are essential to achieving the desired goals.

Encouragingly, almost all respondents have a clear plan in place to bring finality to their operations (see figure 4).

Figure 3

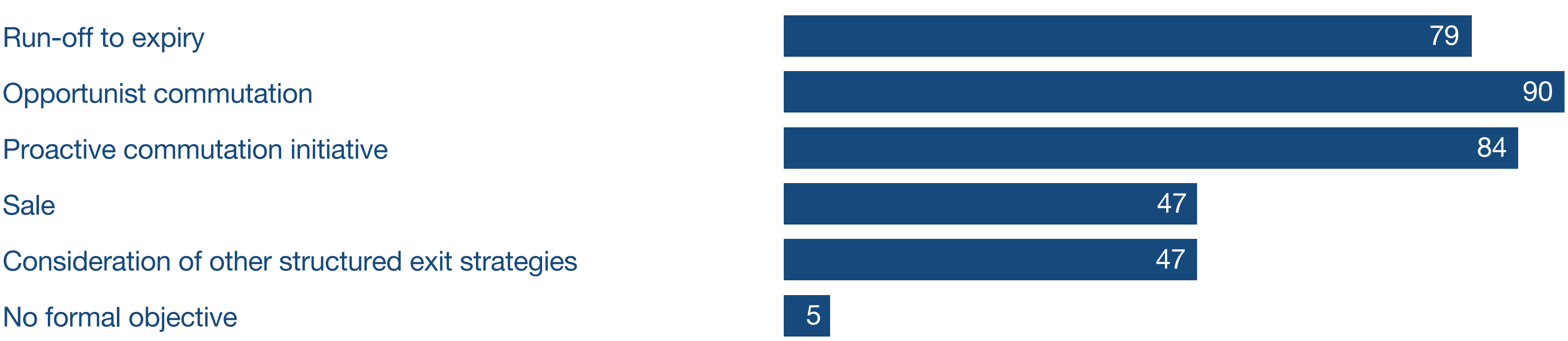
Do you have a written strategic plan for the management of your run-off operation?

If the answer above is "yes," does it include a financial model projecting your future run-off strategy?

Figure 4

Regardless of whether you have a written strategic plan, do you have a strategy in place to bring closure to the run-off liabilities?

By what means to you intend to bring closure to run-off liabilities? (%) [1]



1 Total numbers exceed 100 percent. Respondents were asked to check all that apply.

Key risks to the run-off

The following key factors represent risks to the successful attainment of strategic goals:

- Affect of adverse claims development
- Ability to retain key staff in the enterprise
- Loss of the company's reinsurance asset
- Ability to effectively manage operating expenses
- Ability to manage staff culture and approach to run-off management

The survey participants were asked additional questions relating to each of these areas. The responses to questions concerning cost reduction and staff retention are set out below, while claims and reinsurance issues are examined in more detail later in this report.

Cost reduction

Cost reduction was seen as a key goal in effective run-off management. This is consistent with the 2004 UK survey results; however, different methodologies are used to achieve cost reduction. The 2004 survey respondents predominantly favored the use of finality mechanisms as a tool to achieve cost reduction. The respondents to this survey applied a variety of tools, including:

- Proactive claims management
- Internal process re-engineering
- Assumed commutation initiatives

One explanation for the differing approach could be the lack of a tested, structured finality mechanism available to the US run-off market.

Staff retention and motivation

Staff retention was quoted by respondents as one of the top five risk factors to achieving their run-off objectives.

Because insurance run-offs historically take a number of years to resolve, having a successful strategy to retain essential staff is key. The in-house knowledge of integral operational functions, such as books of business, contract information, and claims history, is often irreplaceable. The cost to re-establish such knowledge can be significant, and in some cases wholly impractical. It is therefore imperative for the insurer to attempt to retain its existing staff throughout the run-off operation. Despite this issue, some 50 percent of survey participants do not have a retention plan for staff employed in the run-off operation.

Respondents who reported that they proactively try to retain staff use a number of different methods, including:

- Financial retention payments
- Performance-based incentive programs
- Enhanced career development and training programs

In addition to the goal of retaining staff, another key issue for survey respondents was the need to ensure that employee efforts were properly aligned to the goals of the run-off. In this instance, more than half of survey respondents had performance-based incentive plans in place. In most cases, these plans tied the individual's reward package to both individual performance and company performance.

As the run-off market continues to mature in the US, the appeal of managing run-off liabilities as a career should continue to grow, as it has in the UK. This should make it easier for the industry to attract and retain staff. However, it will likely be accompanied by increased competition, emphasizing the need to be proactive in retaining talent.

Regulatory relationships and reporting

Regulatory considerations within the US insurance market tend to be somewhat more complex than in the UK market. The US market is subject to regulation by state insurance commissioners, resulting in a variety of regulatory requirements across the country. The varying governing bodies, coupled with the less mature run-off market in the US, results in a regulatory framework that is not clearly defined. For this reason, we dedicated a number of questions to the topic of regulation in an attempt to examine the relationships between our respondents and their domiciliary regulators.

Almost half of respondents are required to report on their run-off operations in addition to their usual statutory reporting responsibilities (see figures 5, 6, and 7).

This significant percentage appears to demonstrate that US regulators view run-off administration as an activity that merits scrutiny.

While only 20 percent of respondents stated that the regulatory framework helps them greatly in meeting strategic objectives for the run-off, almost all respondents have a good relationship with their regulators. This suggests an opportunity for respondents to leverage those relationships to develop a regulatory framework conducive to meeting their strategic goals for run-off finality. Some 15 percent of respondents had an agreement with regulators relating to the extraction of capital from the run-off, while 30 percent said they had no such agreement.

Figure 5

Other than annual reporting, is the business under any obligation to report regularly in respect of its run-off liabilities?

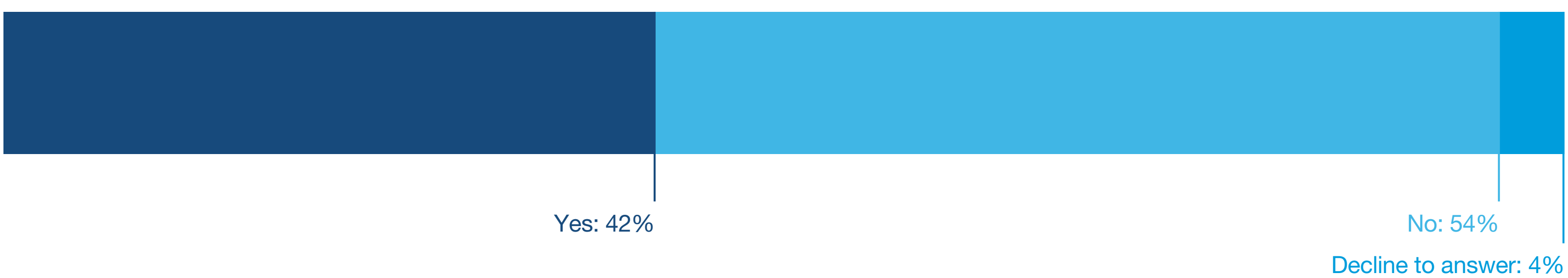


Figure 6

How often do you report orally? How often do you report in writing? (%)

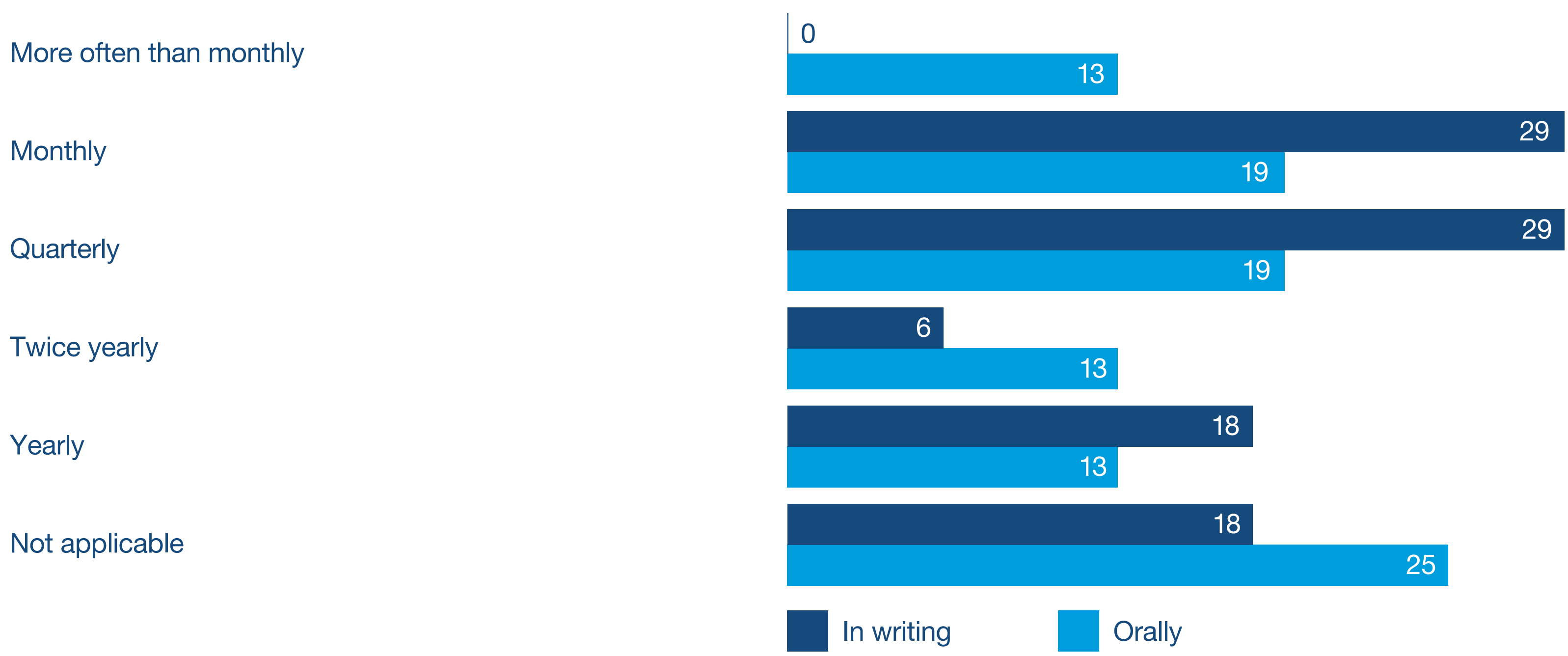


Figure 7

Are you required to file a run-off plan?

Claims management

While claims management is a key function of any insurance entity, managing claim liabilities is even more significant in the run-off environment. Among respondents to our survey, the prospect of adverse claims development throughout the term of the run-off was widely considered to be the greatest risk affecting a company's ability to achieve its strategic goals.

Survey respondents identified the following top three priorities in the claims area:

- Achieve finality to assumed exposures. This was by far the top priority, with almost 80 percent of respondents ranking this as either first or second priority.
- Remove volatility from the account.
- Minimize claims settlement amounts.

Despite the importance of managing claims costs, claims cost reduction was not considered a top priority. This is consistent with the results of PwC's 2004 run-off survey as well as PwC's 2003 London Insurance Market survey. This may indicate that respondents believe they have limited ability to influence claims costs or it may be recognition that claims cost reduction may adversely impact the ability to gain finality.

Survey participants were asked to identify the amount of loss adjustment expenses incurred in run-off operations. Figure 8 illustrates that there is a wide distribution in loss-adjustment expenses in proportion to claims costs. Although the survey was not designed to address this issue in detail, it may prove insightful to determine whether those entities spending a higher percentage of loss-adjustment expenses were achieving better indemnity results or were spending less on internal staffing.

The focus on finality was also mirrored when respondents were asked to state their greatest challenges over the short term. Gaining finality to assumed exposures was overwhelmingly seen as the greatest challenge, while staff retention and cost reduction were also considered to be key challenges, albeit to a lesser extent.

In analyzing claims performance, respondents considered reserve accuracy, claims inventory management, and individual claims closure target monitoring as the most important measures.

Figure 8

What were the 2005 allocated loss adjustment expenses expressed as a percentage of indemnity payments? (%) [1]

1 Provided as a best estimate.

Claims staffing and structure

Almost all survey respondents had a claims team dedicated to the management of run-off liabilities (see figure 9)—an encouraging sign that insurers view the handling of run-off claims as a discipline that requires a specialized skill set.

Claims handler caseload varied by line of business (see figure 10). Direct claims handlers have fewer caseloads than reinsurance claims handlers. This is consistent with the greater amount of day-to-day involvement required for direct cases.

Figure 9

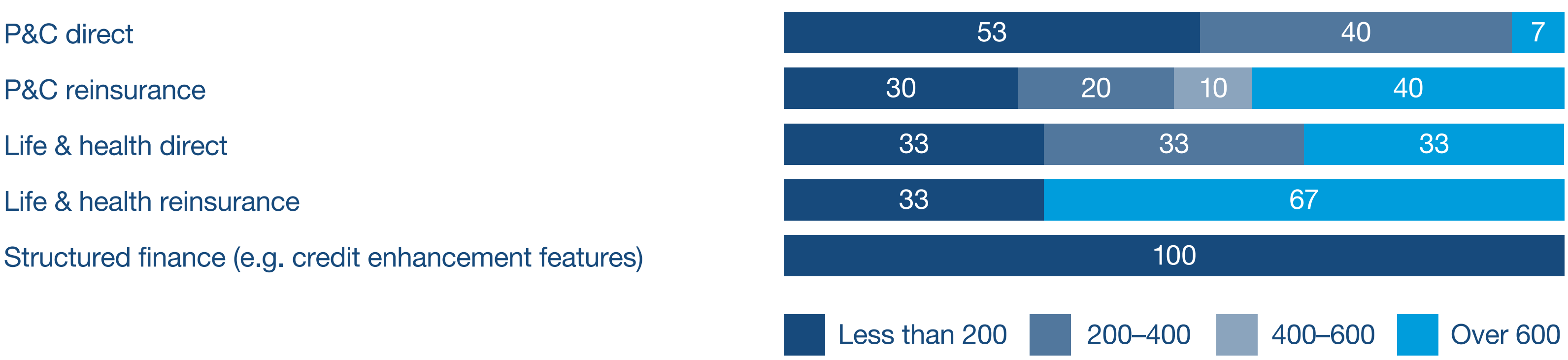
Do you have a team dedicated solely to managing your run-off claims?

How many staff in this dedicated team work on claims? [1]

1 Responses stated as full-time equivalents.

Figure 10

What is the average caseload for a claims handler at any given point, in each line of business? (%)



Checks and balances

When examining claims operations, we asked whether respondents were operating their claims departments in line with a formal claims protocol (see figure 11).

The relatively low number of respondents using a formal claims protocol came as a surprise. From our experience, the absence of clear working practices and guidelines aligned to the company strategy negatively affects the company's ability to achieve run-off goals. This is of particular importance during the transition to run-off, as claims handlers are likely to be operating under older working practices established to support live underwriting objectives that may no longer be valid.

The survey also measured whether formal signed agreements were in place with those service providers that had delegated claims-settlement authority, and identified the percentage of those that they had audited within the year (see figure 12).

Surprisingly, more than one-third of respondents did not have a signed agreement or an established protocol with any of their service providers. A further 20 percent had agreements with some service providers, but not all. We also measured the extent to which service provider audits had been performed. Fifty-five percent of respondents had audited most, if not all, of their service providers, while the remaining 20 percent had audited few or none.

The lack of formal agreements with service providers points to the need for increased risk-management vigilance when claims-paying authority is outsourced.

Figure 11

Do you have a dedicated run-off claims protocol? (%)

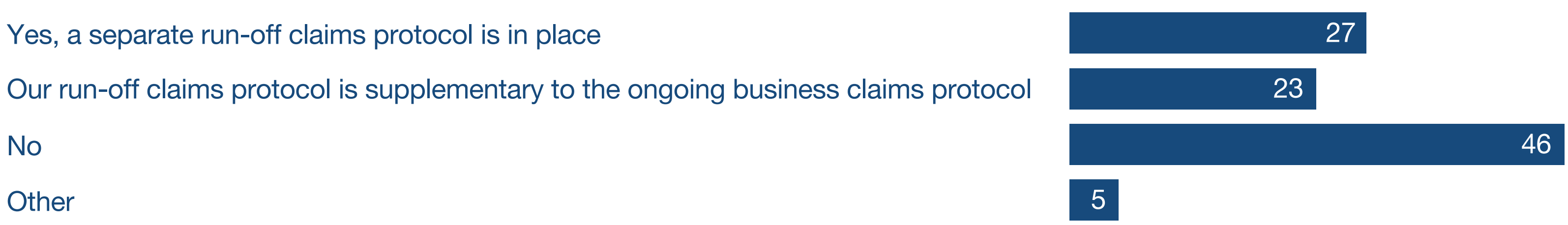
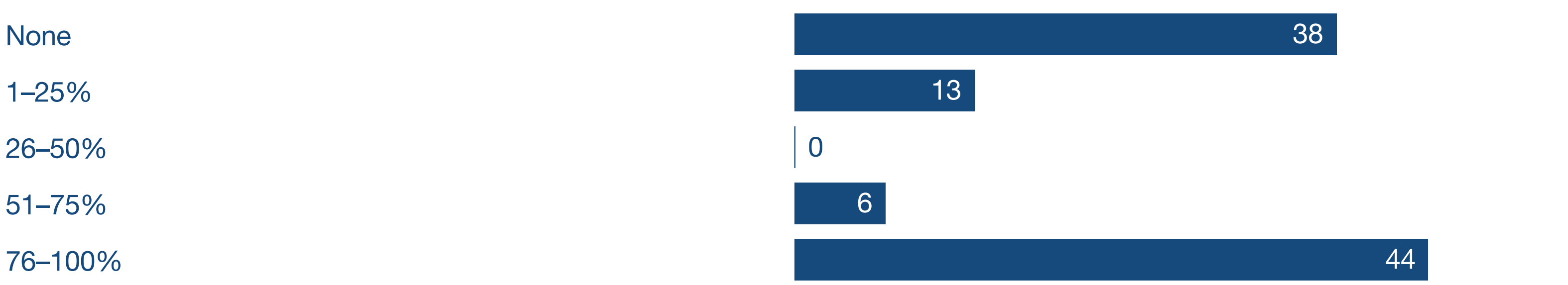
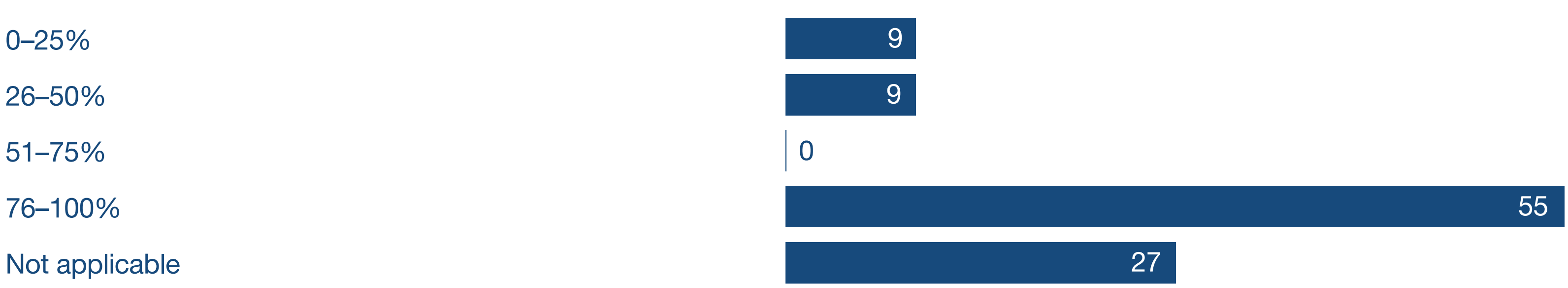


Figure 12

What is the approximate percentage of third parties with delegated claim authority who have a signed agreement in place for the current year? (%)



What percentage of third parties with delegated claims-handling authority have been audited or reviewed in the last year? (%)



1 Responses stated as full-time equivalents.

Assumed commutations initiatives

Given the lack of a tested structured finality mechanism within the US run-off market, assumed commutations play a key role in the pursuit of respondents' stated goals to achieve finality and remove volatility from their portfolios. Assumed commutations were also identified by many respondents as a key tool used to lower operating expenses. Given their importance, it is not surprising that nearly 75 percent of respondents had a dedicated protocol that set out working practices and guidelines for their assumed commutation initiatives.

Removal of volatility was the most commonly stated objective for pursuing commutations, along with expense reduction and the opportunity to deliver savings against booked reserves. An interesting question is whether the objective of delivering savings against booked reserves can be achieved alongside the goals of removing volatility and gaining finality. In the case of particularly volatile books of business, it is not uncommon for a cedant to seek a premium in return for providing a release from all future liability.

Most survey respondents had a clear focus on their commutation initiatives (see figure 13).

Figure 13

What is the primary focus of your company's commutation efforts?

1 Responses stated as full-time equivalents.

The results detailed in figure 13 suggest that companies are focusing on concluding cedant-specific commutations in an effort to gain finality with entire entities. It is likely that the relatively small number of respondents targeting group-level commutations is due to the complexity of trying to resolve relationships among a number of entities simultaneously.

The key challenges respondents face when attempting to conclude assumed commutations are:

- Disinterest of counterparty
- Production of IBNR at contract or cedant level
- Financial strength of the assuming party

Each of these challenges, while very real, can be overcome through proper targeting and communication, early preparation for each commutation being proposed, and the provision of appropriate incentives.

Reinsurance collections

The ability to collect reinsurance is a key component of managing a successful run-off. However, when a company enters run-off (and particularly when the entire company discontinues its operations), long-established commercial relationships come to an end. This results in the potential loss of goodwill and an inability to collect on reinsurance balances from both brokers and reinsurers.

This difficulty, and sometimes inability, to collect upon reinsurance debt was cited by a large number of respondents as a key risk to effective run-off management.

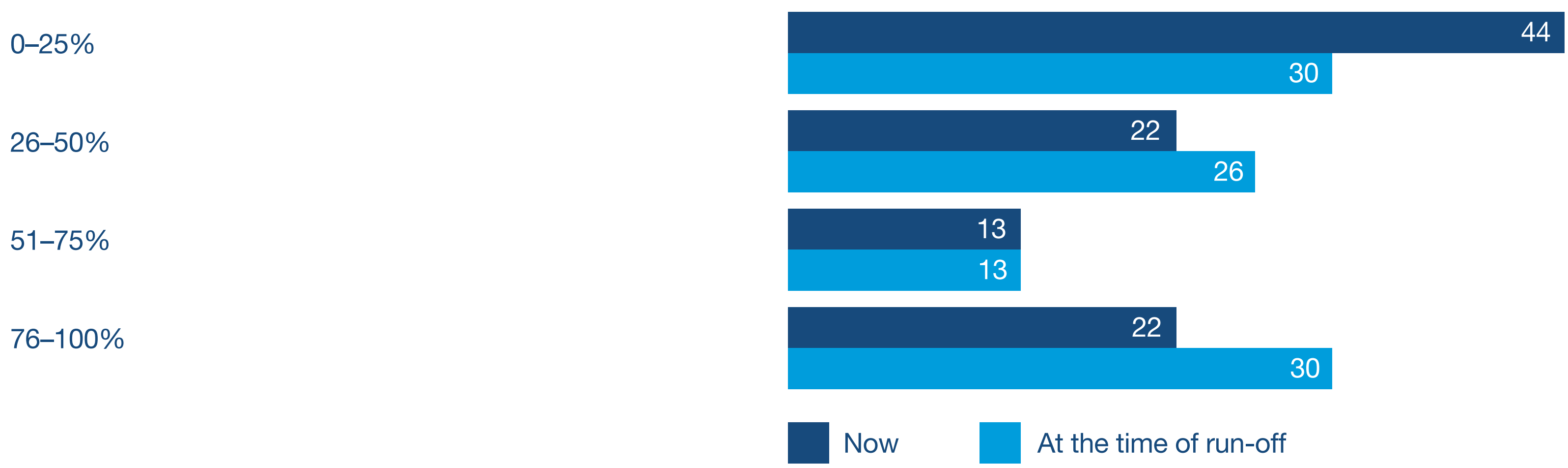
Collection effectiveness

Survey participants were questioned as to the financial security of their reinsurance coverage (see figure 14).

It is encouraging that the largest percentage of respondents have 75 percent or greater of their reinsurance security rated at “A” or higher. However, the results still show a large proportion of reinsurers with less than ideal security. This may ultimately manifest itself as difficulty or inability to collect reinsurance balances. The inability to collect reinsurance balances has a direct impact on a company’s financial health because of imposed Schedule F penalties on overdue reinsurance balances. This is a problem that run-off companies must address in their strategic and operational planning.

Figure 14

What percentage of your business (a) was subject to reinsurance protection at the time your business entered run-off, and (b) is now subject to reinsurance protection? (%)



The companies surveyed were also asked about the length of time between sending reinsurance recoveries to market and receiving cash (see figure 15).

The responses suggest a significant amount of time is required to collect reinsurance balances, with the added difficulties of resulting Schedule F penalties. Stand-alone companies indicated that it takes between 7 and 12 months, on average, to collect revenues. This is verification that the collection process slows dramatically once companies cease live business operations.

Figure 15

What is the average time between sending reinsurance recoveries to the market and receiving cash (i.e. typical aging of balances)? (%) [1]

1 Provided as a best estimate.

When questioned about collection methods, 87 percent of respondents indicated that they still rely on brokers under the terms of their original contracts (see figure 16).

This is in stark contrast to the practice in the UK, where insurers have begun to turn to broker incentives or broker replacements. Because reinsurance is often the only real asset of a run-off, a slowdown in the collection process can present a danger to long-term solvency. Based on these results, we anticipate that US companies may become more innovative in how they manage their reinsurance asset, including looking at broker incentives, broker consolidation, alternative debt financing, and debt sale.

When asked what has the greatest impact on their ability to collect, respondents noted that the attitude of reinsurers is at the top of the list. Reinsurers often treat run-off cedants with suspicion. This results in increased audit activity and less emphasis on adherence to contractual payment terms, a practice that can add significantly to collection times for the cedant. When this happens, the relationship between the insurer and reinsurer breaks down, and arbitration or litigation may be necessary to prevent the collection process from grinding to a standstill. Respondents cited reinsurance impairment as the second most significant impediment in the collection process, and specific legal/technical disputes as a third impacting factor.

Figure 16

In the event that your reinsurance was placed through a broker, which of the following describes your process for presenting reinsurance recoveries to your reinsurers? (%) [1]

1 Total numbers exceed 100 percent. Respondents were asked to check all that apply.

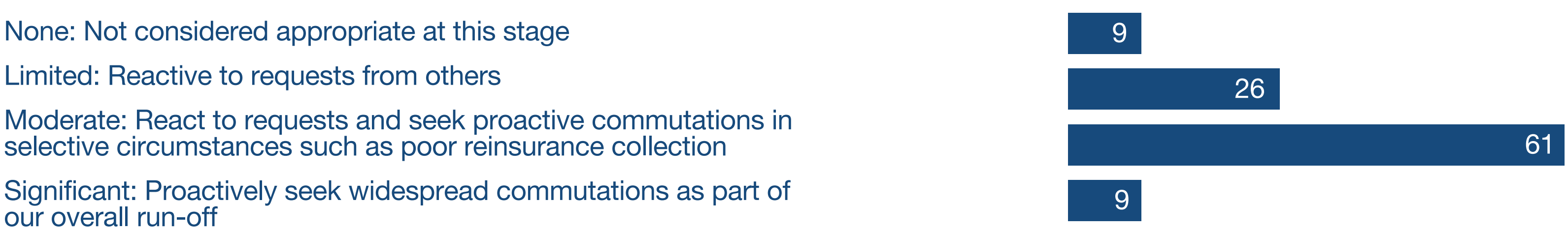
Ceded commutations

Despite the above-noted collection concerns, there appears to be limited motivation to commute business with reinsurers as part of the overall run-off strategy (see figure 17).

The majority of respondents fell into the moderate category, indicating that commutations are only arranged on an ad hoc basis or where there is concern over reinsurer impairment. This appears inconsistent with the apparent desire to achieve finality on the assumed book insofar as the overall goal of achieving finality is enhanced if ceded reinsurance protections are commuted as part of the overall run-off strategy.

Figure 17

To what extent do communications with reinsurers form part of your run-off strategy? (%) [1]

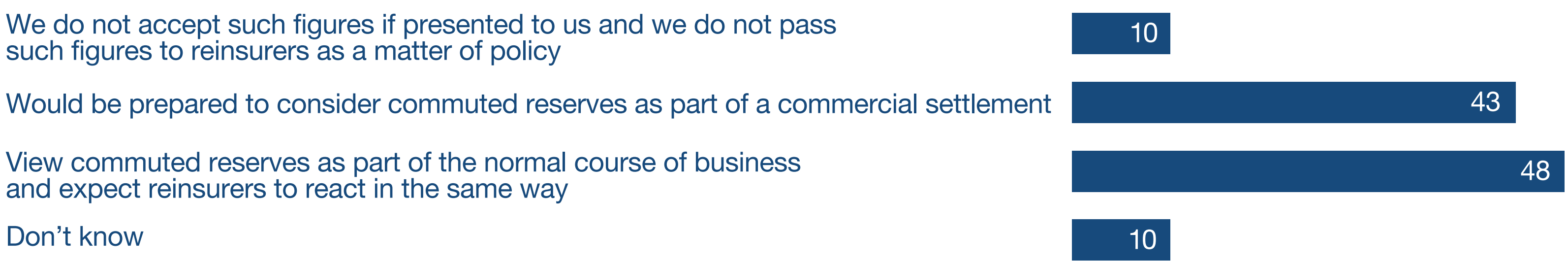


1 Total numbers exceed 100 percent. Respondents were asked to check all that apply.

Regarding the attitude of insurers toward collecting commuted reserves from an insurance program, most respondents view commuted insurance as part of the normal course of business, and they expect reinsurers to have a similar view (see figure 18). Forty-three percent of survey respondents said they would be willing to consider commuted insurance as part of a settlement with reinsurers. This provides some optimism for the ability of the US run-off market to become more proactive in terms of commutation of assumed and ceded liabilities. Based on this, it would appear critical that US cedants proceed with reinsurer commutations on a transparent and consensual basis in order to keep reinsurers fully involved in the process.

Figure 18

What is your policy towards the collectibility of commuted reserves from a reinsurance program? (%) [1]



1 Total numbers exceed 100 percent. Respondents were asked to check all that apply.

IT systems

We asked participants several questions related to IT systems and how these systems impact the ability to achieve run-off goals and objectives. Given respondents' overall view of cost reduction as a critical run-off goal, it is not surprising that 60 percent of respondent companies had legacy systems in place to support the needs of the run-off. A further 24 percent stated that legacy systems had been significantly developed, while 16 percent said that new systems had been purchased or developed in-house to support the run-off.

A fundamental IT question focused on whether respondents used a principal-level-based ledger system. About 55 percent answered "no," which came as a surprise considering that US companies are required to provide principal-level detail for Schedule F reporting.

The survey revealed that the following systems and data issues have the greatest impact on business:

- Lack of quality of historical data
- Poorly documented systems that are understood by only a small number of staff
- Inability to get a complete view of a company's position because data is held across multiple sources (which may also explain the limited number of respondents using principal-based ledgers)
- Inability to get timely information out of systems
- Lack of control over IT systems and their future direction

IT appears to be a sensitive area in the run-off context. The need for timely and accurate information appears to be high on companies' agendas, but the survey indicated that these requirements may be compromised over cost issues.

Conclusion

Run-off is clearly a major industry in its own right. Recent developments have further indicated the maturation of this industry, such as the establishment of the Association of Insurance & Reinsurance Run-Off Companies (AIRROC) as a dedicated industry organization and the enactment of Chapter 27 of the Rhode Island Insurance Code, which allows for the voluntary restructuring of run-off insurers.

The survey results indicate that the industry is dealing with some aspects of run-off management fairly well—including the establishment of run-off plans and the development of financial models against which operational results are being measured. In other respects, the industry is having difficulty meeting its objectives. Insurers are struggling to bring closure to their assumed exposures. They are also struggling to gain the support of reinsurers to meet their goals of early closure. Based on the survey feedback, it would appear that greater flexibility and transparency in the states' regulatory framework will help the industry achieve its desired goals.

Methodology

The PricewaterhouseCoopers' 2006 *US Discontinued Insurance Business Survey* is based on data gathered from 27 predominantly property and casualty insurance and reinsurance companies in the United States. The research was conducted from August 2006 through November 2006 by PricewaterhouseCoopers' International Survey Unit, and analysis was provided by PricewaterhouseCoopers' Philadelphia-based Insurance Restructuring Group.

If you would like further information on PwC's Insurance Restructuring Group and how they can assist with the development and implementation of strategic and operational plans for your discontinued business, please contact:

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