#### 1995 CASUALTY LOSS RESERVE SEMINAR

# 7F: Reserving in Run-Off and Insolvent Situations

Moderator: Kim E. Piersol, Vice President & Actuary

**CNA Insurance Companies** 

Panel: W. Michael Flaharty, Principal

Coopers & Lybrand Paul A. Jardine, Partner Coopers & Lybrand

David C. Westerholm, Assistant Vice President

& Actuary

**CNA Insurance Companies** 

# Casualty Loss Reserve Seminar Chicago, September 1995

Reserving in Run-off and Insolvent
Situations
A Claims Perspective

Mike Flaharty
Coopers & Lybrand L.L.P.

# Comparison of Run-off to Insolvencies

- Run-off has ongoing balance sheet concerns versus court mandated resolution.
- While asset preservation is of primary concern, two different perspectivesexist.
- Timing and Final Resolution considerations differ.

# Key Challenges to Reserving Run-off

- Need to vallue portfolio promplty
- Desire to protect reinsurance markets
- Insureds cooperation is forthcoming
- Loss of institutional memory
- Need to stabilize claims staff

# Key Challenges to Reserving in Liquidation

- Focus is on marshalling assets
- Limited factual data and insured cooperation
- Court mandated time schedules clusters of activity
- Difficulties in maintaining adequate staff

#### **Short Term Considerations**

- In the short term, claim reserving is traditional
- Involves short-tail lines
- Good availability of industry statistics and factual data
- Clear coverage issues
- Limited litigation

# **Long-term Considerations**

- Damages and Claims slow to emerge and to be reported
- Lack of credible factual and historical data
- Complex legal coverage issues result in high level of litigation
- Nature of claims is difficult to reserve on pure case basis

# Differences In Case Reserving

Bulk of run-off claims have been reserved in a traditional mannner through life of the "live" program.

Run-off reserving is "anticipatory" in approach seeking out emerging claims trends.

Liquidation reserving runs the risk of focusing on maximizing asset recovery through reinsurance.

# Differences In Case Reserving

Liquidations are dealing with finite number of claims based upon estate cut-off dates. Beyond the liquidation there are no on-going business insurers. This may be a factor in dealing with reinsurers.

Run-off reserving is check-and-balance with bottom line balance sheet issues providing a business approach to both the reserving and reinsurance recovery process.

# Casualty Loss Reserve Seminar Chicago, September 1995

**Session 7F** 

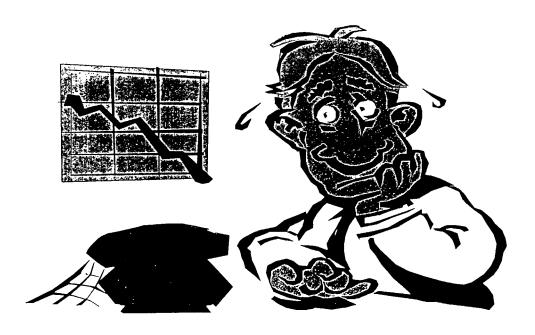
## Reserving in Run-off and Insolvent Situations

**A London Perspective** 

Paul Jardine, FIA Coopers & Lybrand, London

# Reserving in Run-off and Insolvent Situations

#### **A London Perspective**



## What happens to a company in run-off?

- Is a run-off just a latent insolvency?
- Change in circumstances: is it a going concern?
- No margins in balance sheet provisions
- Reinsurance programme performance and collectability
- Insurance/reinsurance litigation the Bear's view
- Cashflow deterioration
- The undoubted optimism of management



## **London - The painful facts**

Company	Ceased U/W	Declared Insolvency	Months in Solvent Run-off
Fremont (UK)	March 1991	October 1992	19
Chancellor	January 1992	December 1992	11
MGI	April 1992	March 1994	23
Scan Re	April 1992	March 1993	11
Orion	October 1992	October 1994	24
English & American	November 1992	March 1993	4



Solutions for Business

### Why do companies become insolvent?

- The balance sheet test
- Sudden or gradual?
- Assets or liabilities?
- Assets:
  - ► free assets
  - ► reinsurance
  - ► margins in either assets or liabilities
- Quality of information



### What happens next?

- Skilled underwriting staff leave
- Claims staff leave
- Data entry and maintenance deteriorates
- Brokers reduce their communication with the company
- Funds are withheld by reinsurers and brokers
- LOC's drawn down
- Business ceded to run-off managers?



#### Lies, damn lies and statistics ....

The organisation of the data is critical to the management of the insolvency and the run-off in the future

- How large is the problem?
- What is the nature of the business/claims?
- Likelihood of commutations/cut-offs?
- How large and secure is the reinsurance asset pay as paid?



### Initial tasks for the actuary

- Assist with the organisation of the data
- Participate in the initial investigation surrounding the insolvency
- Assist with the discussions regarding the next steps
- How to replace representative reports once payments have ceased



### Cash is king!

How should you decide on a method for dealing with the insolvency?

- The chosen method should depend on:
  - ► nature of the underlying business
  - ► territorial scope
  - ► country of jurisdiction
  - ► the reason(s) for insolvency
  - ► the opinions of the major creditors (and debtors)
  - availability and suitability of data for the selected approach



#### What are the choices?

- Sit tight and hope for the best
- Solvent run-off (technically insolvent company)
- Pay as you go arrangement
- Commutation exercise
- Cut-off based on estimation
- Schemes of arrangement



Solutions for Business

#### **Cut-off schemes**

- Actuarial estimation exercise
- Quality of data
- Equity
- Allocation to contracts/creditors



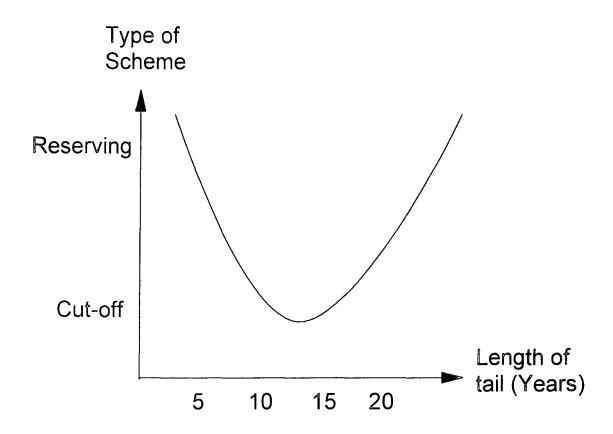
#### Reserving schemes

- Dividend protection
- Uncertainty
- Special margins
- Adequate data



Solutions for Business

#### The choice of scheme





Solutions for Business

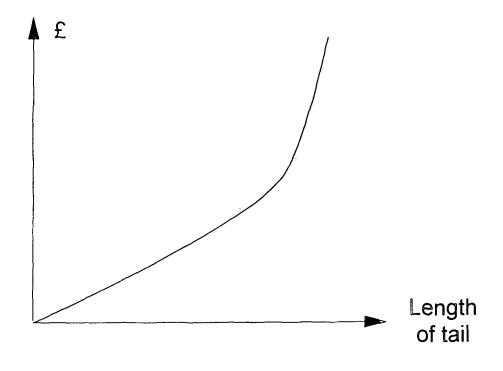
### Protection with the special margin

- Certainty vs uncertainty
- The liquidator's nightmare
- Long-tail vs short-tail creditors
- What it covers
- Calculation

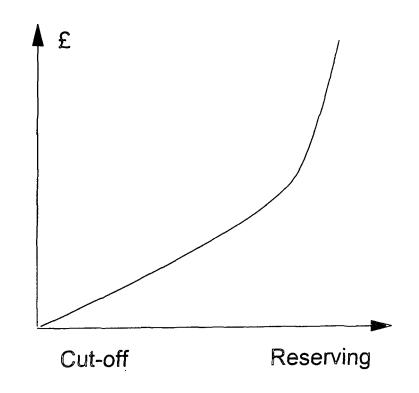


## Size of special margin

By type of business



By type of scheme



Coopers &Lybrand Solutions for Business

# Reserving in Run-off and Insolvent Situations



# Casualty Loss Reserve Seminar Chicago, September 1995

Reserving in Run-off and Insolvent Situations

Paul Jardine Coopers & Lybrand, London

# Casualty Loss Reserve Seminar Chicago, September 1995

#### Reserving in Run-off and Insolvent Situations

- Perhaps the title of this session makes too much of a presumption regarding the financial state of the fictitious company I shall be using an example today. The payment of dividends marks the culmination of a lengthy and detailed process which starts at the point a company becomes insolvent. Indeed, in many cases, particularly with regard to London Market insolvencies, the payment of even an initial dividend appears to be a long way off.
- The role of the actuarial adviser to the liquidators or provisional liquidators of a company in financial difficulties is a complex one. The actuary is usually required to provide a wide range of advice under what are quite difficult and abnormal circumstances for the organisation concerned. Further, the issues which the actuary has to consider within the context of an insolvent insurance company go beyond those which are usually considered within an actuarial reserving exercise.
- My task today is to provide you with some insight into the actuary's perspective, the type of role and responsibilities you should expect from an actuary, typical problems which occur and some of the practical decisions which the insolvency practitioners, the company and its advisors are likely to have to make once the actuarial exercises, where appropriate, are complete.
- All of my comments are made within the context of non-life insurance although some of the points made are equally relevant to those life assurance companies with an impaired financial position. I have tried as far as possible to deal with the practical considerations based on my own experience. However please forgive me if I occasionally slip into some of the theoretical issues which surround the actuary's role; at times the beckoning of the ivory tower is difficult to overcome!

#### Why Actuaries?

Non-life actuaries are relatively rare in the United Kingdom; of approximately 3,500 qualified actuaries in the UK, under 10% are actively involved in the non-life market. I suppose this begs the question "Since the majority of general insurance companies in the UK do not employ actuaries or have specific actuarial studies prepared, does this mean that actuaries have nothing to contribute to these organisations?". In fact the situation in the UK general insurance industry has been changing, albeit slowly. Many of the large companies have established in-house actuarial departments, and many actuaries have become increasingly involved in all aspects of general insurance business not least with the Government Actuaries Department which supports the DTI. However, there is always a potential danger of the actuary retreating into arcane actuarial alchemy as described in a recent newspaper article referring to any colleagues in the Life and Pensions area.

#### Is the Company insolvent?

- One of the key features of the initial actuarial assessment of the Company's financial position will be to identify whether the organisation is, in fact, insolvent. In this context, insolvency is measured in its basic form of the balance sheet test as defined under the Insolvency Act 1986, that is, assets less liabilities. For an insurance company, this test may be far from simple. The Company may carry margins, whether implicit or explicit, within its balance sheet provisions for outstanding claims. Perhaps the most obvious of these margins is the fact that most UK non-life insurance companies establish undiscounted reserves, that is, they take no account of the future investment income which will be earned on the claims reserves from the balance sheet date to the date of claims settlement.
- For a Company writing longer-tail lines of business, the value of the embedded investment income may be significant simply discounting the outstanding claims provisions may turn an apparent insolvent company into a solvent one. Indeed, the

value of the assets may be significantly below the assessed value of the liabilities and there could still be scope for returning to solvency by discounting.

- 8 However, the ability to improve the Company's apparent financial position through the use of discounted claims provisions may be limited by the existence of certain types of assets. For example, if significant amounts of financial reinsurance have been purchased, particularly Time & Distance, the ability to further discount is limited.
- It may also be possible to further utilise the Company's assets in order to improve the financial position. In simple terms, little can be done on the liability side to hedge the asset side of the equation, other than of course ceasing to pay claims, thereby protecting cashflow. On the asset side, however, it may be possible to hedge the liabilities through the more efficient and effective use of the available assets. The fact that such manoeuvres may result in problems as far as DTI Asset Admissibility regulations are concerned, is, in my opinion, of little consequence since we are seeking to affect absolute rather than regulatory solvency.
- I am not for one minute suggesting that the Company's management should take the available assets and place them on the 2.30pm at Sandown Park nor, for that matter, entrust their portfolio to a single derivatives trader in a former outpost of the Empire, but rather than certain products may provide scope for enhancing the balance sheet equation. For example, securitisation is frequently used in the mortgage-lending market to offload liabilities by receiving a consideration up front. In the same way it may be possible to package an insurance company's liabilities in order to sell forward the future earnings stream. Combining this with gross roll-up, offshore, may provide the enhanced investment return to fundamentally alter the balance sheet position.

#### How can an actuary assist an insolvent company?

- Assuming that, despite the various activities some desperate, that may be taken, insolvency is unavoidable, how can the actuary assist an insolvent company?
- To answer this question we need to consider why companies go into run-off or become insolvent, and what happens in the immediate aftermath of this event. The companies become insolvent because assets become insufficient to support their liabilities. Assets in this context include any implicit margins held in the reserves as well as the company's outwards reinsurance protections. Insolvency could arise from cash flow problems where poor investment decisions have been made, or could be technical when the company is no longer able to meet its DTI obligations. In a number of cases parent companies have withdrawn support from subsidiaries with the same result.
- Whilst insolvency can occur suddenly, for example to a writer of catastrophe excess of loss contracts facing an unprecedented level of losses, progress towards insolvency can normally be identified in advance. In my experience, many of the problems can be traced to poor management information on the portfolio of business underwritten. The immediate aftermath of the closure to new business normally means that underwriters and senior claims staff leave for pastures new. The fund may be placed in the hands of run-off managers who are just acquiring an entirely new portfolio which may in some cases only be boxes of claims files. In short, experience usually haemorrhages away rapidly. It is in this situation that actuaries can make a valuable contribution.
- Any actuarial projection is only as good as the data on which it has been based. Actuaries therefore spend the vast majority of their time analysing data and putting it into a semblance of order. The organisation of data is critical to the management of the company in the future. Without a sound database, the insolvency practitioner will have difficulty in understanding the problem. The run-off manager would have

difficulty in understanding the contracts written and the implications for future reinsurance recoveries. The actuary will also have problems on advising on the extent of insolvency or on any other issue such as commutations or cut-offs. It is essential that as far as possible the actuary is involved in the initial specification of data requirements and in the investigations which should be performed into some of the reasons underlying the run-off or insolvency in order to ensure that the problem is understood.

- An example should make this clearer. We were recently involved with a company which went into provisional liquidation with a number of very large creditors. Data at the company level was poor, however we had investigated a number of the company's major involvements previously during the course of our work. We were therefore able to assess the liabilities with a reasonable amount of certainty, and to assist with devising a commutation program which was acceptable to creditors. It is often said "First understand the problem, then you can solve it". For insolvencies, the golden rule is "First understand the data, then you can understand the problem". Working in conjunction with the run-off manager and the remaining claims and underwriting staff actuaries can assist with those crucial first steps.
- In the case of a company writing long term business the actuary's role is recognised in statute Sections 12(2) and 17(5) of the Policyholders Protection Act 1975. The actuary is required to produce a report to the PPB which amongst other matters should opine on whether the benefits of any class of contract are excessive and should be reduced. The actuary must consider in such a report:-
  - the availability of appropriate investments;
  - the level of expenses;
  - the financial strength of the company when the contract was issued;
  - the framework within which the contract was written.

#### What other roles can the actuary play?

Once an initial assessment is complete, decisions have to be made regarding how the portfolio should be run off. This choice is not a standard off the peg solution. Each company is different and its specific circumstances must be taken into account. A solution which will meet the requirements of a direct company with many individual policy holders and potential PPB involvement is not necessarily appropriate for a direct company writing commercial business, and is unlikely to be suitable for a pure reinsurer. Different parts of the portfolio may be long or short tailed and may require separate solutions. Some of the portfolio could possibly be sold at a profit for the benefit of the remaining body of policyholders. The optimal solution is usually not mitially clear for the majority of insolvent insurance or reinsurance companies. Therefore the insolvency practitioner or management of the company needs to have experience of the options available and a proper understanding of all of the issues involved before a choice is made.

I believe that the method chosen to extinguish the liabilities should depend at least on the nature of the underlying business, its territorial scope, the reason(s) for insolvency, the opinions of major creditors and debtors and the availability and suitability of the data to implement the strategy selected. Once again, the actuary can assist with advice on the feasibility of any of the range of alternatives which could be used.

#### What are some of the alternatives?

The first alternative is to do nothing and to settle claims as they arise. This choice is attractive and can be adopted for solvent companies or organisations where a parent or other company is willing to support the run-off. I believe in these circumstances the parent company concerned should commission an actuarial study to attempt to independently assess how much they could be expected to contribute

over the future. In many cases, they will be surprised at the size of the financial commitment they have made.

- If the company is insolvent and in provisional or actual liquidation, the insolvency practitioner is charged with ensuring that all creditors are treated equitably. This creates problems. How should the practitioner cope with a creditor who appears in 30 years time and requests that its claim is settled on the same basis on which you have settled claims in the next year? This situation is not as far fetched as it sounds; for example, in a number of cases we are seeing new claim filings on policies written in the 1930s and 1940s. Latent claims remain a problem for the industry. In my opinion, it would be excessively optimistic to assume that no new latent claim events are likely to emerge in the future.
- Where we are the actuarial advisers involved, we have generally recommended that if amounts are to be paid on claims, a margin in excess of the central or median estimates which we recommend should be maintained to ensure that as far as possible future claims could be settled on the same basis as past claims. This margin is akin to the capital of the company supporting fluctuations in claim levels. Whilst we cannot guarantee that any margin in any specific case will be sufficient to ensure that all claims could be settled equitably, we can ensure that a very high degree of certainty can be achieved and the responsible liquidator is protected from the nightmare scenario of paying too much too early.
- The approach described above has been adopted for the KWELM companies where we have advised that the margin should be substantial because of the extremely high casualty content of the portfolio underwritten. Margins are also likely to be held in a number of other cases where some form of immediate payment is intended.
- The second alternative is a commutation based approach. The company would commute the liabilities of all its major creditors and then attempt to deal with any remaining creditors on the basis of the assets available once the commutation process

is complete. The usual intention of a commutation based approach is to attempt to regain solvency by commuting the portfolio on attractive terms. This type of approach works because creditors are usually prepared to accept some money now instead of no money at all. In these circumstances the role of the actuary is to advise on acceptable commutation values and the sensitivity of the results to the success or failure of the exercise.

- A commutation is a commercial negotiation between a buyer and a seller of a portfolio of business. In this context, the seller of the portfolio is relieving itself of the uncertainty associated with setting claims, and therefore could be expected to pay an "insurance" premium to the buyer for this. This premium is clearly negative in the case of a company with impaired solvency which may not pay at all. In the case of outwards commutations the reverse is true and a premium should be sought from the Company's own reinsurers in any commutation deal. The actuary can advise on the size of that premium and assist with the determination of an acceptable value. However it is still the duty of the negotiator to obtain the best possible price for each portfolio sold and the maximum income from each outwards reinsurance contract commuted.
- The third alternative is a cut-off of the liabilities of the company. Under this method the projected reserves including IBNR are estimated and allocated to each contract. Assets are then distributed in proportion to the liabilities allocated to each contract. Allocation in this context can be performed on a policy basis using empirical methodologies, ad-hoc methodologies, or alternatively using statistical methodologies.
- Cut-offs are often necessary because of the time it takes insurance and reinsurance claims, in particular claims on casualty business, to develop and settle. In the normal course of events there will remain a rump of policies where late claims development can occur. Further, once all outwards reinsurance has been collected or exhausted there remains little point in retaining the assets of the company from all policyholders whilst waiting on claims from a few policies to finally emerge. Cut-offs

are also useful when there is a desire to return the monies to the market as speedily as possible.

- In all cut-off arrangements the actuary should be heavily involved in defining the data and the methodology to be used to determine the global liabilities and to allocate them equitably between creditors. Any allocation method adopted involves a form of rough justice. The aim therefore should be to determine the liabilities fairly and to allocate them to the contract level in a manner which could be supported by the outwards reinsurers, in order to maximise collections where these are still possible. Such an approach is being adopted in the case of RMCA Re and ICS Re where a statistical methodology is being used to allocate liabilities, and St Helens where the age of the portfolio requires an empirical approach to the cut-off process.
- We have generally adopted approaches based on credibility theory where we have applied statistical techniques. Other modelling approaches are possible, and it is the role of the actuary to consider the data available and the most suitable approach to the problems at hand. Where old claims are involved, or development has largely ceased, a simple approach using market related benchmarks can be applied. Clearly an extensive market database is required to ensure that the results in these cases are reasonable and equitable.
- In my opinion, the actuary should be involved in all aspects of the design and structure of the arrangement being established to extinguish the liabilities. The actuary's role should be to assist the run-off manager and insolvency practitioner in determining which arrangements will be optimal. The actuary would then apply his or her expertise in trying to ensure that the application of the methodology meets the legal standard of equity and equal treatment of all creditors, as well as being acceptable to the company's outwards reinsurers.
- The choice of the type of arrangement or mechanism to employ in a particular situation will depend vitally on the level and detail of the available information and

on the perceived length of tail of the business concerned. For shorter-tail portfolios, cut-off schemes will be more appropriate given that actuarial valuations can be conducted, given adequate data, with a greater degree of certainty. However, for extremely short-tailed portfolios it is likely to be more efficient and cost effective to simply allow the claims to mature within a reserving scheme. There is little to be gained with respect to the timing of payments to creditors by imposing an estimation of liabilities rather than allowing claims to be agreed directly with creditors.

- At the other extreme, the very long-tailed and uncertain portfolios, particularly those with a predominance of occurrence-based US Casualty coverages, a cut-off scheme would be entirely inappropriate and impractical. In these circumstances, and KWELM is a good example, a reserving scheme may be the only viable solution.
- In the middle ground between the two extremes highlighted above, the decision becomes more difficult. Again the quality of the data will be of paramount importance. Poor quality information will probably mean that a reserving scheme may be more appropriate since it will not be possible to allow for the distinct features of the Company's business. However, where detailed comprehensive policy and claims information is available a cut-off scheme can be considered. Exactly this situation prevails in the case of Fremont with which I am personally involved.
- 33 The type of scheme adopted will also impact the need or otherwise for a special margin to be added to the reserves. A cut-off scheme by its very nature does not require such a margin given that the intention is to accelerate cash distribution to creditors.

#### **Summary**

So what is the answer to our initial question, what is or should be the role of the actuary? I am sure you will appreciate that some of the tasks which I have outlined above are extremely complex. I believe that actuaries specialising in this area of work have an important role in applying their skills and techniques to solve some of the problems faced in the run-off of a company. They need to work with all parties involved in the process and not in competition against any of the advisers. Each of the major parties involved is important and has a role to play to ensure the success of the plan. In my experience success or failure in the management of an insolvent run-off is strongly dependent on an effective partnership involving the insolvency practitioner, the actuary, the run-off manager, major creditors and outwards reinsurers.

Paul Jardine

### Casualty Loss Reserve Seminar

Chicago, September 1995

# Reserving in Run-off and Insolvent Situations A Company Actuary's Perspective

Dave Westerholm

CNA Insurance

During my portion of the presentation, I will discuss some of the special considerations or requirements that must be addressed when performing an actuarial reserve analysis on a book of business that has been discontinued or is in runoff. I will discuss these considerations from the perspective of a company reserving actuary and will try to note differences in their application to direct, assumed, and ceded books of business.

The first, and arguably the most important piece of information that the reservist must obtain is a clear understanding of senior management's strategy for disposing of the given book(s) of business. Is the strategy to --

- 1. Let it die a natural death;
- 2. Kill it off as quickly as possible using all available means (Damn the cash flow!); or
- 3. Sustain its life as long as possible (Cash flow is king!).

Once the runoff strategy has been identified, the reservist should be able to reasonably ascertain both the tools used and the manner in which they will be applied to the given discontinued or runoff book of business. Armed with this knowledge, the reservist should be able to make -- <u>subjective qualitative adjustments</u> at a minimum, <u>precise quantitative adjustments</u> at a maximum -- to the historical loss developments of a once proud ongoing book of business to reflect its sad fall into runoff status.

The reservist must periodically check to see that the initially identified claims handling strategy is continuing to be followed and that it has not degenerated, or is the process of degenerating, into some other runoff strategy or combination of such. The runoff claims handling strategy that is implemented is the back drop against which the reservist should be making all the required qualitative and quantitative adjustments to the historical reserving data elements being used to estimate the ultimate remaining liability.

2

Once a book of business is discontinued and goes into runoff status, new exposures, losses, claim counts, etc. are no longer being added to the reserve data base -- i.e., the average age of the outstanding claim population gets older and older; the average calendar year closed claim payment shows a marked increase over historical levels; most historical calendar year measures, ratios, reserving rules of thumb, etc. no longer apply.

In general, the comfort often afforded reservists by the 'Law of Large Numbers' quickly begins to disappear as the inventory of open claims begins its monotonic march toward zero. What this means to the reservist is that future reserve analyses will soon have to start taking place at finer and finer levels of detail (definition of soon will vary by LOB / size of open claims inventory / average duration of open claim). As the older accident years run off, you will quickly find that the estimated margins of redundancy/deficiency in a given accident year's reserve level can no longer automatically be expected to be offset by comparable margins in other accident years.

The aggregate accident year paid and incurred loss developments that were routinely used in prior reserve analyses may no longer suffice. Losses at the individual claim, cedant, treaty, loss layer, etc. level of detail -- once the exception to the norm of standard reserve analysis data requirements -- may soon have to become the norm. Reserve analyses at this level of detail generally require significantly more time to complete -- analysis time as well as data acquisition time. Such data which was generally obtained only by special request in the past, may now be required on a routine basis. In some instances you will find that the level of detail you now require in your reserving data is not available at any cost.

Another series of events that often accompanies the discontinuation of a book of business and it going into runoff status is the following. These events can have a material impact on the ability of the reservist to perform accurate and timely reserve analyses. Their impact can also vary significantly when viewed from a company vs company acquisition perspective.

1.	Claims staff leaves or takes on additional claims handling duties.
2.	Underwriting staff leaves or is assigned to other ongoing books of business.
3.	Actuarial (pricing and reserving) staff leaves or is assigned other LOB responsibilities.
4.	Systems staff leaves or is reassigned to new systems.
5.	Data quality and timeliness of data entry deteriorates.
	Communication (frequency and level of detail) between company and brokers deteriorates.
7.	Funds (premiums and recoverables) are withheld by reinsurers and brokers.

I have touched on the basic strategies for dealing with discontinued and runoff operations, and have highlighted the associated additional levels of analysis and considerations that the reservist has to deal with when performing reserve analyses for these operations. I would like to spend the remainder of the time briefly going through some of the tools/procedures/methodologies used in running off a book of discontinued business and how their use can impact the underlying loss data used by the reservist.

Some of the more common tools or procedures used to manage the runoff of a discontinued book of business are:

- 1. <u>Commutations</u>: Estimation, payment, and complete discharge of all <u>current</u> (reported) and <u>future</u> (IBNR) liabilities between the parties for reinsurance losses incurred.
- 2. <u>Cut-off's:</u> Termination of reinsurance contract whereby the reinsurer is not be liable for losses occurring after the date of the termination. UPR @ cut-off date is generally returned.

- 3. <u>Schemes of Arrangement</u>: Negotiated settlement for a 'structured' payout (generally partial) of an insolvent company's assets to its creditors. Generally used as an alternative to liquidation.
- 4. <u>Buy-Outs:</u> Direct commutations -- commuting direct written business; often at the individual policy level of detail.
- 5. Hire a TPA or other professional claims handling organization to runoff the claims ASAP.
- 6. Establish a dedicated internal claims handling unit if a significantly large or complex block of the company's direct written business is discontinued, or if a discontinued block of business was obtained via a company acquisition.
- 7. Status quo if only a relatively small piece of the company's business has been discontinued.
- 8. Protect cash flow at all costs -- Delay! Delay! Delay!

The result of implementing any of the above procedures will almost certainly result in a payout of future losses which is markedly different (in both timing and amount) from that implied by historical developments. This is generally the desired result however -- especially with respect to the timing of the future payment. In several instances, incurred loss developments will also be impacted.

For a company that has discontinued a book of business that it used directly: commutations, cut-off's, write to and schemes of arrangement are generally not effective runoff alternatives. Hiring a TPA whose marching orders are to dispose of this business as quickly and efficiently as possible (with the emphasis on quick) will undoubtedly produce a speed up in payout pattern. Depending on the characteristics of the business being run off (personal v commercial v professional), I don't think you can generalize as to whether the total amount of Loss & ALAE paid out at the end of the day will be more or less under this runoff scenario than if the same group of claims were handled under a "business as usual" environment.

I have found however, that for most cases following this runoff scenario, the ratio of paid ALAE to paid loss for the claims being runoff is significantly different from historical ratio indications. How the TPA is being paid for their services can also influence this result but, in general, I have found that the ratio of paid ALAE to paid loss under this scenario will often be <u>lower</u> than would have been predicted from historical ratios -- the average loss payment is <u>higher</u> while the average ALAE payment is lower.

If the situation is one where the company is on the brink of insolvency and cash flow is critical, you may find exactly the opposite to be the case. Total loss & ALAE payments will slow (as almost all claim payment requests are now contested), but the ratio of paid ALAE to paid loss under this scenario will often be <a href="higher">higher</a> than would have been predicted from historical ratios -- the average loss payment is <a href="lower">lower</a> while the average ALAE payment is <a href="higher">higher</a>. Again, I don't think it is intuitively obvious whether the total loss & ALAE paid at the end of the day under this runoff scenario will be more or less than under a "business as usual" environment.

What these examples are intended to demonstrate however, is that if you reserved on a loss & ALAE combined basis in the past, you now may have to analyze each separately, and that blindly using "unadjusted" LDF's based on historical data will almost assuredly result in a materially understated or overstated ultimate.

If your company is running off a book of reinsurance assumed and/or reinsurance ceded business -- either its own or a discontinued book it has acquired via a company acquisition, you will find some of the more common runoff tools to be commutations, cut-offs, and schemes of arrangement. These tools often come in to play when one or more of the following conditions exist (or appear to exist):

- 1. Cedant needs cash (take back o/s liability for its discounted P.V.).
- 2. Cedant views assuming company as a potential insolvency.
- 3. Reinsurer and cedant no longer have an ongoing relationship.

- 4. Cedant views the "discontinued" or "runoff" status of the business it has ceded as a potentially expensive and long term administrative quagmire (runoff business neglected; treated as 2nd class citizen). Take pre-emptive action and commute.
- 5. Reinsurer perceives a material deficiency in the loss & ALAE reserves it has assumed -- commute before "true" value is realized.

From a practical / cost effective standpoint, these tools are relatively ineffective if the book of business you are trying to run off is made up entirely of individual facultative certificates which cannot somehow be bundled and dealt with in much larger groups. These runoff tools are much more effective when dealing with large treaties.

In the majority of commutations, cut-off's, and schemes of arrangement, the cedant does not receive 100 cents on the "nominal" dollar for taking back its o/s liability. Thus, on a statutory basis, the impact of the above actions is generally a statutory profit on the

assuming company's financials, and a statutory loss on the cedant's on a discounted present value basis, it should generally be a break even proposition for each.

In the reinsurer's case, paid loss development is accelerated while incurred loss development is depressed. Exactly the opposite is occurring for the cedant.

In summary, we have highlighted the basic runoff strategies and associated operational changes which often accompany a discontinued book of business when its status changes from ongoing to runoff. We then discussed the primary tools used to manage the runoff of a discontinued book of business and their potential impact on the reservist's underlying loss & ALAE data.

Once a book of business has been discontinued and goes into runoff, the pre vs post runoff loss developments may, depending on the runoff strategy employed, be as different as auto physical damage vs auto liability. As the company reservist, it is incumbent on you to

develop and maintain new reserving methods and procedures, or adjust existing ones as needed, so that you can continue to provide timely and accurate qualitative and quantitative reserve assessments. Failure to do so could have material financial consequences -- either from failing to identify and correct adversely developing reserves until it is too late, or from failing to identify and take advantage of opportunities to produce reserve savings.

ŝ

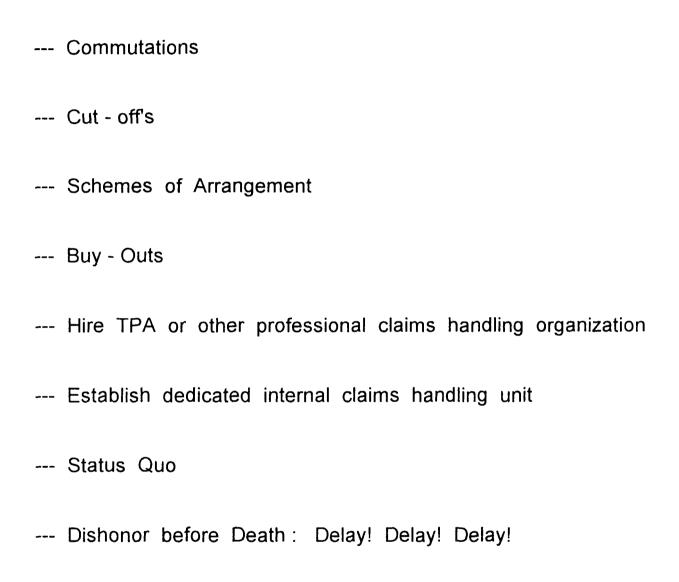
#### **Basic Run-off Strategies**

- --- Let it die a natural death
- --- Kill it off as quickly as possible
- --- Sustain its life as long as possible

#### Run-off Fallout

- --- Impact on Key Personnel
  - -- Claims Staff
  - -- Underwriting Staff
  - -- Actuarial Staff
  - -- Systems Staff
- --- Data quality and timeliness of data entry
- --- Communication between company and brokers
- --- Funds are withheld by reinsurers and brokers

#### Run-off Methodologies and Procedures



#### **Commutation Incentives**

- --- Cedant needs cash
- --- Cedant views assuming company as a potential insolvency
- --- Reinsurer and cedant no longer have ongoing relationship
- --- Avoid administrative red tape and extra expenses associated with a runoff book of business
- --- Capitalize on perceived "additional knowledge" regarding reinsurance transaction

)