The business of run-off

CAS Annual meeting – November 7, 2011

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Panel members - “The Business of Run-Off“

Dr. Klaus Endres

- Executive Vice President of AXA LM (based at headquarter in Paris), Managing Director of AXA LM Investments, Board member of Hochrhein Internationale Rückversicherung AG
- In charge of external business development including company and portfolio acquisitions
- Previous experience in strategy consultancy (Insurance Practice of McKinsey & Company, Germany) and M&A

Steven Herman

- Principal, Asset Discovery Associates LLC
- In charge of identifying hidden assets for clients in reinsurance contracts, commutations and insurance business before sale.
- Previous experience in run-off management, commutation pricing and reserving (CNA, Continental Insurance and The Home Insurance Company)

Stuart Wrenn

- Senior Vice President, Armour Group Holdings (based in Philadelphia currently), Managing Director of Armour Risk Management Ltd (UK).
- In charge of all analytical functions of the group including actuarial pricing and reserving, and acquisition assessment.
- Previous experience in insurance and reinsurance underwriting and reserving (Imagine, XL, Zurich ..)

Contents

Most (re-)insurers have run-off books – for a broad range of reasons

REASONS FOR EXISTENCE OF RUN-OFF BOOKS

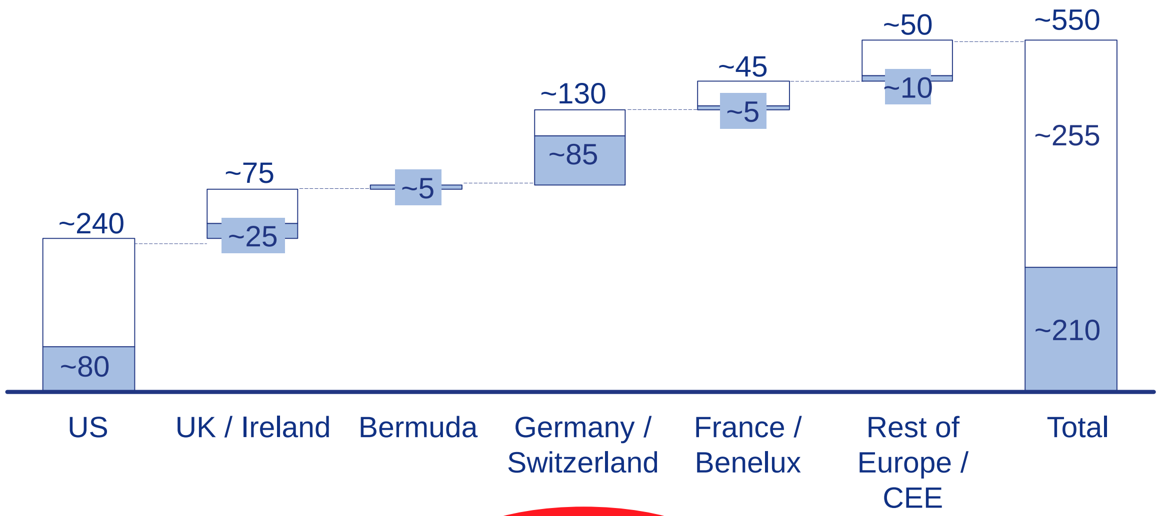
Strategic portfolio management	■ Focus on core business segments ■ Exit of business segments with low profitability and/or low growth
By-product of M&A	■ Acquisition of run-off portfolio as part of broader transaction ■ Discontinuation of strategically unattractive part of acquisition
Adjustment to regulatory / rating environment	■ Focus on business segments with favorable treatment by regulators and rating agencies, e.g. relatively light capital requirements in Solvency II
Business difficulties	■ Need to focus available capital resources on growth of most promising segments ■ Insolvencies

Run-off business includes all former (re-)insurance policies with remaining liabilities but without new underwriting, it is sometimes also called “discontinued business” or “legacy”

There are ~$550 billion run-off non-life reserves – of which ~45% in the US

ESTIMATED NON-LIFE RUN-OFF RESERVES
$ bn, 2009

Direct insurance
Reinsurance

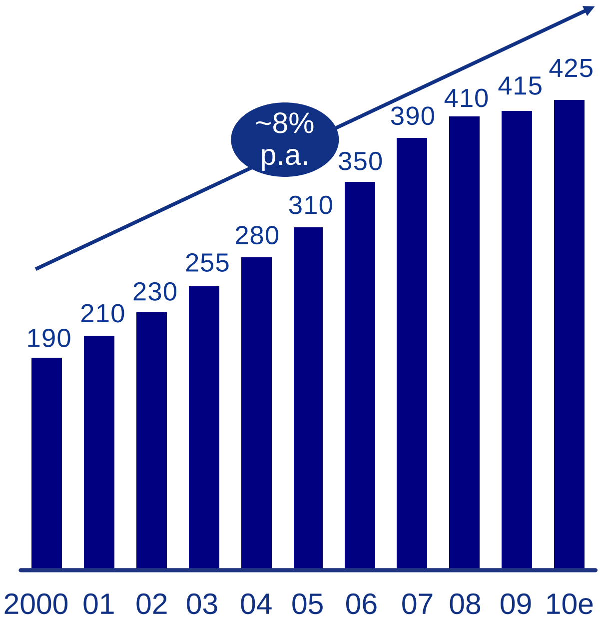


In addition
~ $300 bn life run-off business

Source: KPMG, PWC

The non-life run-off market is still developing and is expected to grow further

Estimated historic growth of key markets
Non-life run-off reserves € bn



Source: KPMG, PWC, Bannister

Drivers for market dynamics & future growth

- Discontinuations in current **financial crisis**
- **Regulatory requirements** lead to stricter capital requirements
- More **sophisticated** value and risk based portfolio management techniques, leading to **quicker discontinuations** for non-strategic lines of business
- **Emerging markets** have potential to generate run-off business (e.g. BRIC)
- **Large claims events** creating new run-off business, e.g. large natural catastrophes

- **Shortening** of the overall run-off business market tail
- **More professional** run-off management and commutation activities will accelerate overall market decrease

AXA created AXA Liabilities Managers to proactively handle its run-off portfolios …

Substantial non-life run-off portfolios

- By-products of wave of AXA Group M&A's
- Strategic decision to exit active reinsurance in 2006 (AXA RE)

+ Strategic decision for active run-off approach

- Respecting commitments made by AXA
- Value creation potential

= Creation of AXA Liabilities Managers in 2001

- Pioneer in centralized run-off management for a large group
- Leading globally in non-life run-off experience and expertise

… and has also experienced many of the challenges of run-off business

Volatile and risky liabilities (and retro assets)

- US asbestos and liability exposures
- Fraudulent claims, arbitrations, litigations, …
- Counterparties insolvent or performing solvent schemes of arrangements (UK)

Organizational challenges

- Large number of legal entities and portfolios
- Multitude of run-off IT systems
- Limited data quality, incl. missing files
- Active business to be put into run-off

Some special cases …

- Reinsurance and cash recoveries in Nigeria, North Korea, Madagascar, …
- UK legal issues, e.g. "waive your right"
- Threats by criminal organizations, …

Examples of challenges for AXA in managing run-off business; similar financial and reputa-tional risks exist in most run-off portfolios

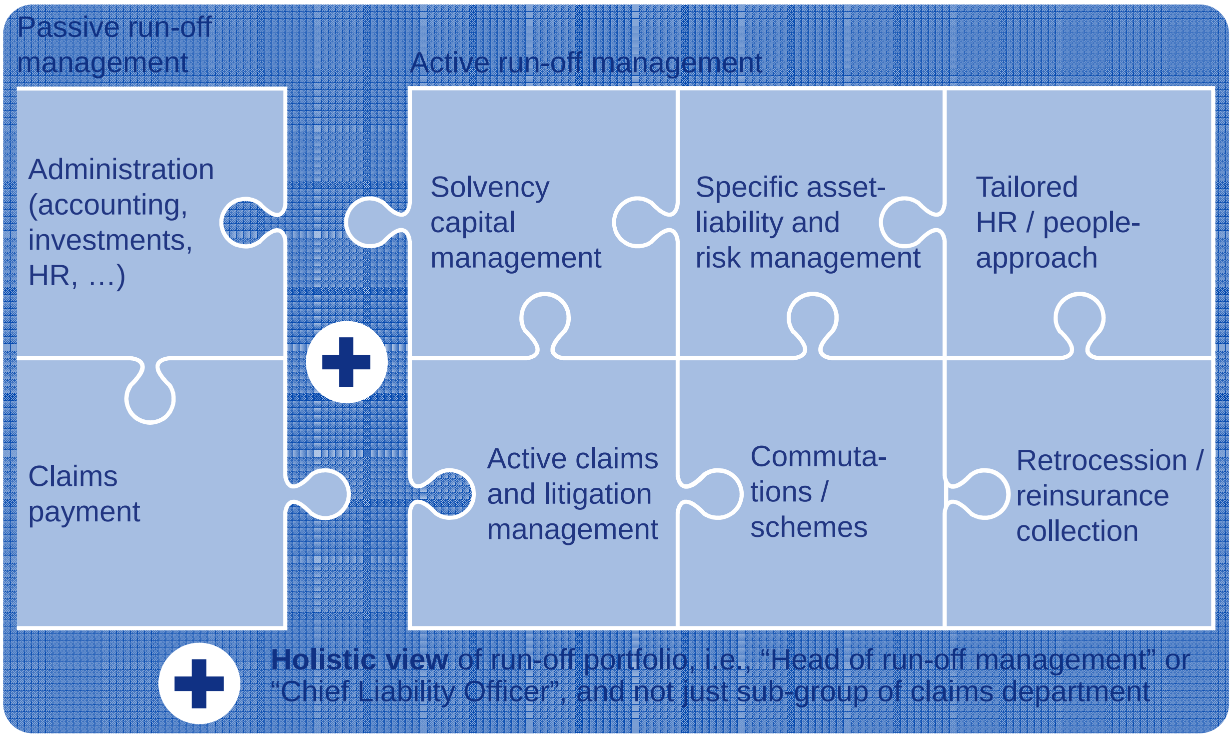
AXA LM manages run-off portfolios on an international platform in key markets

International presence

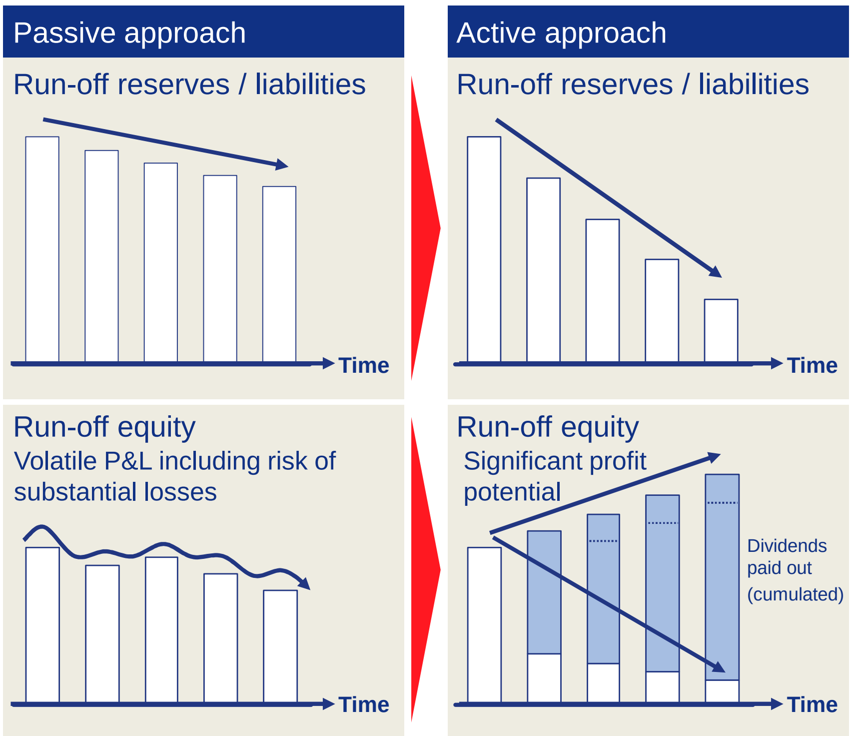
	No. of people
France	~60
UK	~135
US	~70
Germany & Switzerland	~65
Belgium	~10

- Transnational organization in the field of claims management, reinsurance collection, audits and commutations
- Critical files from all entities are transferred where they are best managed

An active management of run-off portfolios requires more than administration and claims payments



An active approach can create substantial upside compared with passive run-off administration



Key advantages

- Quick reduction of reserves through commutations and active claims management
- Significant risk reduction very quickly

- Quick capital release through active management and reserve reduction
- Additional profit through active reserve management and reinsurance bad debt recovery

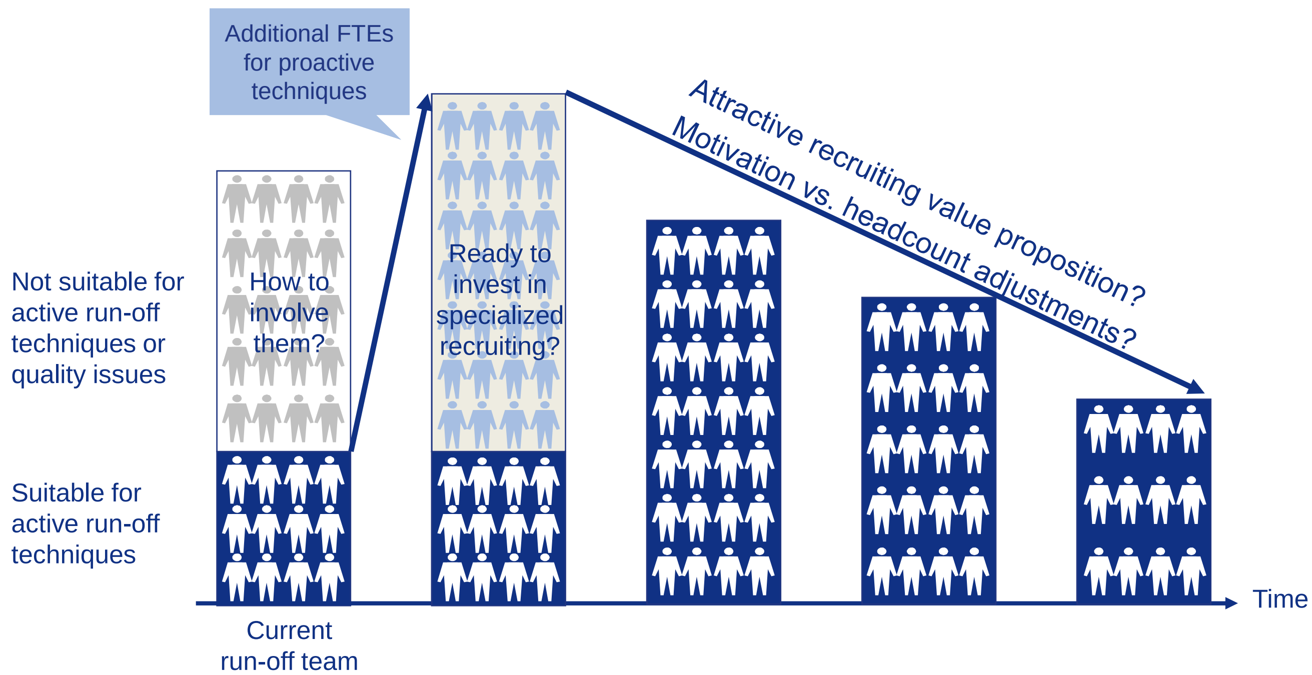
However, a truly active approach needs several specific ingredients

REQUIREMENTS FOR ACTIVE RUN-OFF MANAGEMENT

Portfolio strategy	Clear mid-term action plan on how to actively manage portfolio, e.g. prioritization of key litigations, commutations, …
Experienced specialists	Employees with experience in specific active run-off techniques, e.g. commutations, litigation, specific actuarial expertise
Active run-off mindset	Proactive, financial management approach on run-off portfolio, not passive, follow-the-fortune back-office admin attitude
Skills in key risks	Specific expertise in key long-tail risks, e.g. asbestos, D&O, and general liability teams including former underwriter from original time period
Presence in key locations	Commutations and claims teams with specific market and language skills in key locations, e.g. London market
Management attention	Senior management with independence from active business and significant time focused on active run-off techniques, e.g. commutation negotiations or regulator interactions

Is it worth building up these resources internally, given the expected development of reserves?

NUMBER OF FTEs IN RUN-OFF MANAGEMENT



Are third party administrators the solution to active run-off management – as they provide experienced teams?

Run-off business owner

- Flexibly requires people with a specific experience profile e.g. type of risk, markets, languages
- Financial objective is to quickly release capital and reach finality with additional profit generation if possible

Third party administrator

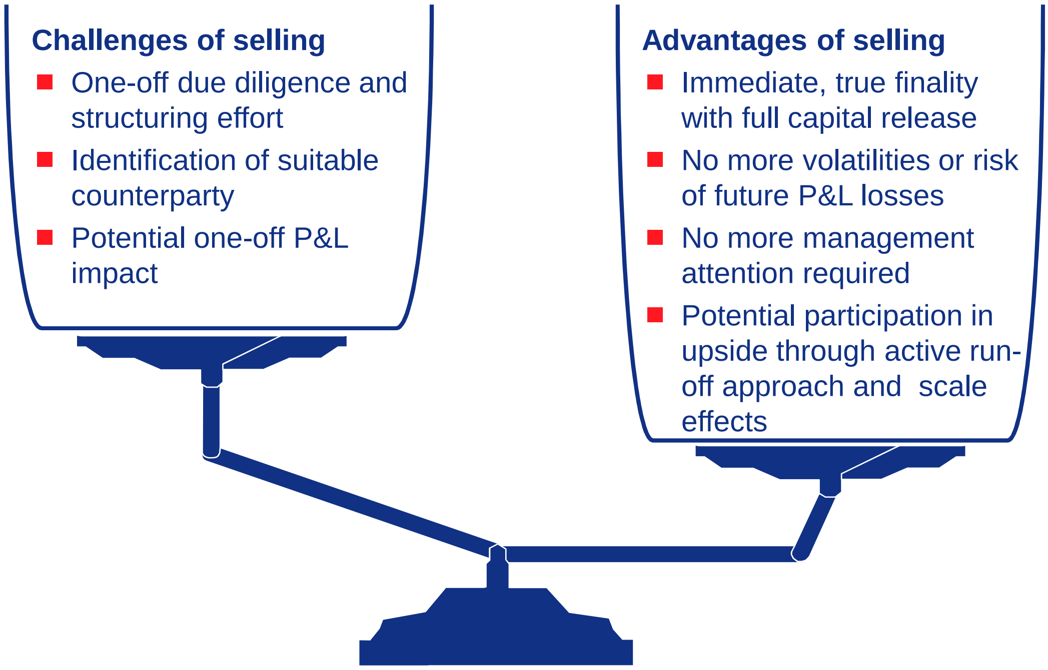
- Needs to utilize its current workforce with their existing experience profile
- Financial objective is to generate a high and long-term fee income

Will a pure reinsurance coverage for the remaining run-off risks provide you with finality?

Potential consequences of reinsurance solution

- ✓ Financial downside mostly protected
- ✓ Feasible for all legal types and juris-dictions without publicity or approvals
- ? Remaining credit risk prevents full solvency capital release
- ? Financial risk if solvency / rating of reinsurer declines in the future
- ? Substantial resource and management involvement remaining
- ? No change to more active, value-creating run-off management approach
- ? Participation in value creation upside?

Could selling a run-off portfolio be a solution to participate in the advantages of active management?



There are various other reasons why (re-)insurers have decided to sell their run-off portfolios …

Typical reasons why (re-)insurers divest their run-off portfolios

- No internal team with sufficient scale and/or specific skill for active run-off management
- Unsatisfied with offer or performance of third party administrators
- Remove management attention and admin hassle for run-off issues
- Unlock trapped equity capital and avoid additional capital under Solvency II
- Remove volatile and risky liabilities for a one-off fixed price
- Avoid negative view and questions by rating agencies and regulators
- Ensure that run-off issues are no deal breaker for M&A-plans
- Unlock equalization reserves and “convert them into equity”
- …

… and the 2 run-off acquirers in this panel are happy to share some experiences from recent cases

Axa Liabilities Managers wins BF Re run-off deal

Herbert Fromme, Cologne

AXA LIABILITIES MANAGERS has won a fiercely contested run-off deal in Germany, a landmark in what is expected to become a rapidly growing market in the country.

The subsidiary of Paris-based Axa acquired the reinsurer BF Rückversicherung (BF Re) in Berlin from the state governments of Berlin and Brandenburg. According to market sources, the purchase price is €18m ($26.7m).

Klaus Endres, deputy chief executive of Axa Liabilities Managers, confirmed the deal, which was signed on Friday. The two states will convert BF Re from its present legal form as a public-law company into a joint-stock company. "We will then acquire 100% of the new company," Endres said. He refused to comment on the price.

There were around 10 bidders, which shows the growing interest in run-offs. Among them were Swiss Re, Randall & Quilter and former east German state reinsurer Darag.

BF Re has its roots in the 1990s, when the management of private-law general insurer Feuersozietät Berlin thought its local market was too small. It diversified into active reinsurance in London and the US and got badly burned. When Versicherungskammer Bayern acquired the primary business of Feuersozietät in 2004, it left the reinsurance contracts with the governments, which has finally got rid of them.

When it started in 2004, BF Re had some 1,800 contracts, of which it commutated around 600. Existing loss reserves stand at €70m.

Axa Liabilities Managers was set up in 2001, in order to organise the runoff of many portfolios of companies merged into the Axa group. "Our gross reserves stand at €4bn," Endres said. The company employs some 410 people, of them 160 in France, 90 in the UK, 80 in the US and Bermudas, 70 in Germany and Switzerland and 10 in Belgium.

Axa Liabilities Managers estimates the non-life legacy reserves in North America and Europe amount to €350bn, €120bn of that reinsurance and €230bn primary business. North America accounts for €205bn, 25% of that reinsurance, while Europe comes to €145bn, of which 45% is reinsurance. Of the European part, Germany has €85bn, most likely €55bn of that reinsurance, France €30bn (€5bn reinsurance) and the rest of Europe another €30bn (€5bn reinsurance).

Klaus Endres: the deputy chief executive of Axa Liabilities Managers confirmed the deal, which will see the Axa subsidiary acquire the reinsurer BF Re

Source: Insurance Day, Dec 08 2009, p. 4

ARMOUR RE ACQUIRES PMA CAPITAL RUN-OFF

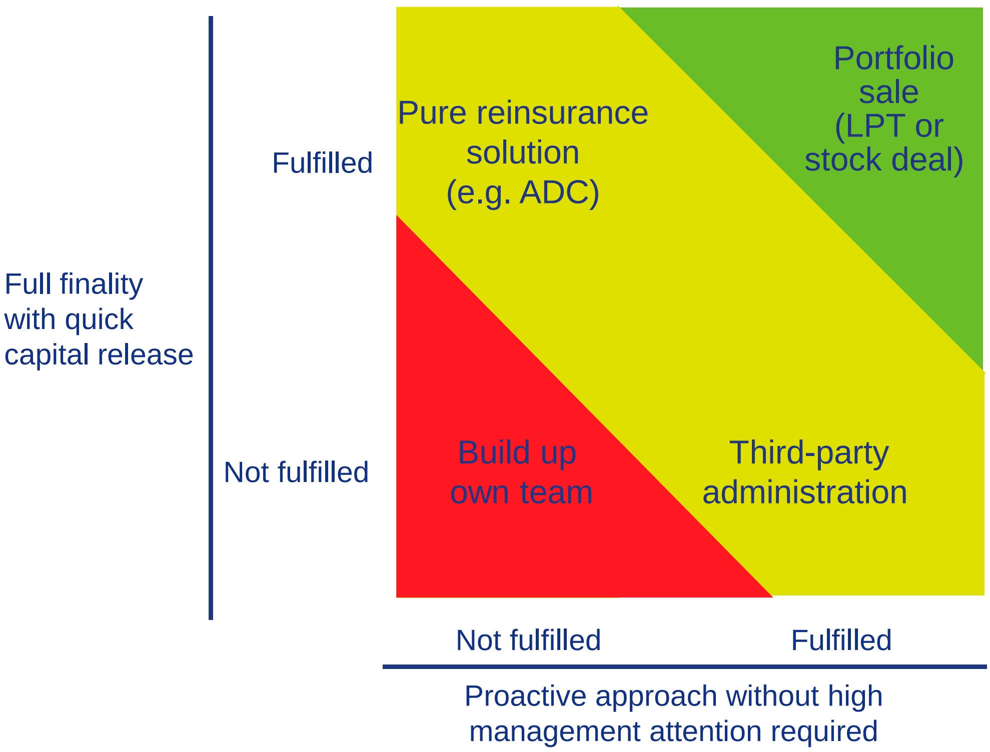
5 January 2010

Bermuda based Armour Reinsurance Group has completed its acquisition of PMA Capital Insurance Co and two related affiliates. The acquisition was completed on 24 December 2009 following receipt of all necessary regulatory approvals, including those of the Pennsylvania Insurance Department and the Cayman Islands Monetary Authority. The purchased entities were formerly the run-off operations of PMA Capital Corp. As part of the transaction PMA Capital Insurance Co is being renamed Excalibur Reinsurance Corp.

Armour Re has also announced the appointment of Steve Ryland as senior vice resident of the Group. Ryland was previously executive director of PRO Insurance Solutions where he had responsibility for global business development and was a member of strategy, executive committee and management boards. He has many years of experience in the areas of insurance run-off and the provision of services to discontinued insurance and reinsurance entities.

Source: Http://runoffandrestructuring.com/news.php?id=433

Portfolio sale most attractive option for true finality of small to medium run-off portfolios



Contents

Managing run-off (“owner’s” view) – Initial Decisions

- Single or multiple segments of business
- Immediate Decisions
  - Sale of renewals
  - Inclusion of non-run-off claims
  - Managing run-off assets and liabilities
    - ⇨ Hidden (out of sight – out of mind)
    - ⇨ Focused
    - ⇨ Third Party Administration
    - ⇨ Sale

Managing run-off ("owner's" view) – Decisions and more Decisions

- Complex Decisions Needed
  - Systems
  - People
  - Management Processes
  - Overall Return

Managing run-off ("owner's" view) - Systems

- Different systems
  - Major Problems
    - ⇨ resource drain on staff
    - ⇨ cost
  - Solution
    - ⇨ find one system
    - ⇨ convert all other systems
  - Result
    - ⇨ 15 parts of 20 initially converted - remaining parts commuted (3), sold (1) or converted later (1)

Managing run-off (“owner’s” view) - People

- People
  - Identifying Proper Management
  - Remaining Staff – Manage expectations
    - ⇨ Staff Retention
    - ⇨ Cost of Reduction In Force

Managing run-off (“owner’s” view) – Metrics and More Metrics

- Management Processes – Metric Driven Goals = Overall Return
  - Financial
    - ⇨ Net Operating Income
    - ⇨ Expense Management
    - ⇨ Reserve Position
    - ⇨ Cash Management – Cash Inflow
    - ⇨ Cash Management – Cash Outflow
  - Operational
    - ⇨ Claim Activity
    - ⇨ Commutations
    - ⇨ Arbitrations and Disputes
    - ⇨ Audits

Managing run-off ("owner's" view) - NOI

- Net Operating Income (NOI)
  - Premium
    - Audit
    - Retro
    - Reinstatement
    - Swing-rated
    - Adjustments to M&D
    - Multiple Year
  - Commission
    - Profit
    - Impacts on commission due to premium changes

Managing run-off ("owner's" view) – Expense Management

- Expense Management
  - Understand drivers of change from prior and plan
  - Forecast future
  - Focus on headcount and reallocations of staff
  - Currency issues with UK staff
  - Severance cost factor on plan
  - Impacts of internal programs
  - What is ULAE and what is general expense?

Managing run-off ("owner's" view) - Reserves

- Reserve Position
  - Peer review of reserve analysis process
  - Critical communication on all other areas as to impact on reserve analysis
    - ⇨ Large loss reports
    - ⇨ Commutations
    - ⇨ Audits
    - ⇨ Arbitrations and disputes
    - ⇨ Premium developments
  - Assist on all retrocessional impacts

Managing run-off ("owner's" view) – Cash is King - Inflows

- Cash Management – Cash Inflow
  - Premiums
  - Refunds on prior paid in error by either party
  - Ceded Recoveries
    - ⇨ Identify over-dues and assist in reducing same
    - ⇨ Help set target goals
    - ⇨ Ensure commutation adjustments are reflected

- Cash Management – Cash Outflow
  - Assist Corporate Actuarial in estimation of loss payouts
  - Identify drivers of significant loss activity in comparing actual results to projections with focus on:
    - ⇨ large losses,
    - ⇨ unconfirmed to confirmed movements,
    - ⇨ dispute or arbitration resolutions,
    - ⇨ commutations and
    - ⇨ foreign exchange

- Claim Activity
  - Review all large loss reports
  - Understand unconfirmed activity
  - Review paid and incurred activity and understand drivers including:
    - ⇨ large losses,
    - ⇨ unconfirmed to confirmed movements,
    - ⇨ dispute or arbitration resolutions,
    - ⇨ commutations and
    - ⇨ foreign exchange timing
  - Identify cedant patterns supporting audits and/or commutations

Managing run-off ("owner's" view) - Commutations

- **Commutations**
  - Identify targets
  - Price targeted treaties
  - Have corporate actuaries identify carried reserves
  - Work with audit team to identify potential issues on targets to evaluate impacts to price
  - Identify retrocessional issues of assumed commutation
  - Provide support needed to deal with discounting issues
    - ⇨ Timing of payment
    - ⇨ Discount rate

Managing run-off ("owner's" view) – Arbitrations and Disputes

- **Arbitrations and Disputes**
  - Run-off has more arbitrations and disputes than ongoing
  - Provide actuarial input on significant ones
  - Understand issues fully - communicate with Corporate actuaries
  - Problem solve where possible
  - Estimate potential values of disputes to assist management decisions

Managing run-off (“owner’s” view) - Audits

- Audits
  - Identification of
    - ⇨ Cedant targets
    - ⇨ Treaties
    - ⇨ Claims
    - ⇨ Premiums
  - Results of audits written up and fully reviewed
  - Real impacts are reflected with clear identification
  - Communicate with corporate actuaries on realized and potential impacts

Managing run-off (“owner’s” view) – Review Decision

- Review Decisions as Size Decreases
  - Managing run-off assets and liabilities
    - ⇨ Continue Focused Approach
    - ⇨ Third Party Administration
    - ⇨ Sale

Contents

BUYERS VIEW

- Why invest in run-off
  - Market
  - Diversification
  - Returns
- Valuation Process

WHY INVEST IN RUN-OFF

- Large Potential Market:
  - $150bn-200bn liabilities in US
  - $500bn worldwide
- Diversified Investment Class:
  - No market correlation
  - Little economic correlation
- Attractive returns?
  - “Easy” transaction, win/win?
  - Low volatility?
  - Limited competition?

MARKET – POTENTIAL AQUIRERS

- Groups
  - AXA Liabilities Managers
  - Berkshire Hathaway
  - Fairfax
  - Swiss Re
- Specialists
  - Armour
  - Catalina
  - Enstar
  - Randall & Quilter
  - Tawa
  - White Mountains

MARKET - AQUISTION METHODS

- Equity purchase
- Reinsurance
- Loss Portfolio Transfer
- Hybrid

DIVERSIFIED RETURNS

- Not correlated with:
  - Equity returns
  - Bond returns
  - Economic factors (interest rates?)
- Can be:
  - Targeted or multi jurisdictions
  - Single or multiple currency
  - Tailored duration

ATTRACTIVE RETURNS

- Mutually beneficial transaction
- Low volatility
- Limited competition

ATTRACTIVE RETURNS - SOURCES

- Discount to book value
- Investment return gearing
- Effective claim management
- Expense efficiencies
- Future sale

COMPETITIVE ADVANTAGE

REQUIREMENTS FOR ACTIVE RUN-OFF MANAGEMENT

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VALUATION - Valuation Approach

- Balance Sheet

- Assets
- Reserves
- Expenses

VALUATION - Balance Sheet Adjustment

- Gross up any discounting
- Allow for known changes
- Make any restructuring changes
- Standardise format

- Reserves are undiscounted for time value
- Expenses seldom fully reserved for

VALUATION - Assets

- Mostly Cash and Investable Assets (Treasuries)
  - Mark to market
- Reinsurance Recoveries
  - Part of reserves
- Intercompany Balances
  - Require cash
- Funds Withheld Assets
- Other
  - Usually Intangible, write off

VALUATION - Reserves 1

- Biggest Item
- Largest volatility
- Most analysis
- Drives most of other factors
- Generally not discounted

VALUATION - Reserves 2

- 2 Parts – Claims Reserves, IBNR
- Client Internal Analysis
- External Actuaries Report
- Acquirer Analysis
  - Internal analysis
  - External assistance
  - Specific claim features
  - Structure constraints

VALUATION - Expenses

- Need to project to Ultimate
- Payment pattern relevant
- Current cost necessary starting point
- Alternative provider costs
- Redundancy/termination costs
- Lease and other contractual commitments
- May vary with settlement approach

VALUATION - Cashflow Projection

- Project future Balance Sheet and Profit and Loss account (15 years max)

VALUATION - Capital Extraction

- Fee income
  - Management Expenses
  - Consultancy areas
  - Investment Management
- Dividend
  - Regulatory Approval
  - Surplus Adequacy
- Truncation
  - Scheme/Commutation
  - Part VII

VALUATION - Metrics

- Mean term
- Embedded value
- IRR
- NPV
- Probability of loss to capital
- Probability of loss of all capital

MARKET - TRENDS

- Growing competition?
- Negative correlation with other business/market issues?
- Increasing pressure to resolve?
- Increase in regulatory routes to finality?
- Lower investment returns reduce attractiveness?

Contents

- Introduction to “run-off”
- Managing a run-off book
- Divesting and acquiring a run-off book
- Q&A

Your questions and comments

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