The Casualty Actuarial Society is committed to adhering strictly to the letter and spirit of the antitrust laws. Seminars conducted under the auspices of the CAS are designed solely to provide a forum for the expression of various points of view on topics described in the programs or agendas for such meetings.

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It is the responsibility of all seminar participants to be aware of antitrust regulations, to prevent any written or verbal discussions that appear to violate these laws, and to adhere in every respect to the CAS antitrust compliance policy.
Panel members - “The Business of Run-Off“

Dr. Klaus Endres
- Executive Vice President of AXA LM (based at headquarters 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

- Introduction to “run-off”
- Managing a run-off book (“owner’s” view)
- Acquiring a run-off book (“buyer’s” view)
- Q&A
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

<table>
<thead>
<tr>
<th>Region</th>
<th>Direct insurance</th>
<th>Reinsurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>~240</td>
<td>~255</td>
</tr>
<tr>
<td>UK / Ireland</td>
<td>~80</td>
<td>~210</td>
</tr>
<tr>
<td>Bermuda</td>
<td>~75</td>
<td>~45</td>
</tr>
<tr>
<td>Germany / Switzerland</td>
<td>~130</td>
<td>~50</td>
</tr>
<tr>
<td>France / Benelux</td>
<td>~45</td>
<td>~5</td>
</tr>
<tr>
<td>Rest of Europe / CEE</td>
<td>~50</td>
<td>~10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>~550</strong></td>
<td><strong>~255</strong></td>
</tr>
</tbody>
</table>

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

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

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

Source: KPMG, PWC, Bannister

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 reputational risks exist in most run-off portfolios

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

International presence

- 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

<table>
<thead>
<tr>
<th>Country</th>
<th>No. of people</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>~60</td>
</tr>
<tr>
<td>UK</td>
<td>~135</td>
</tr>
<tr>
<td>US</td>
<td>~70</td>
</tr>
<tr>
<td>Germany &amp; Switzerland</td>
<td>~65</td>
</tr>
<tr>
<td>Belgium</td>
<td>~10</td>
</tr>
</tbody>
</table>

London Ipswich Paris Cologne Zurich
New York
An active management of run-off portfolios requires more than administration and claims payments.

Passive run-off management:
- Administration (accounting, investments, HR, …)
- Claims payment

Active run-off management:
- Solvency capital management
- Specific asset-liability and risk management
- Tailored HR / people-approach
- Active claims and litigation management
- Commutations / schemes
- Retrocession / reinsurance collection

Holistic view of run-off portfolio, i.e., "Head of run-off management" or "Chief Liability Officer", and not just sub-group of claims department.

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-officeadmin 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**

- How to involve them?
- Not suitable for active run-off techniques or quality issues
- Suitable for active run-off techniques
- Ready to invest in specialized recruiting?
- Attractive recruiting value proposition?
- Motivation vs. headcount adjustments?
- Current run-off team
- Additional FTEs for proactive techniques
- Time
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?

Financial downside mostly protected
Feasible for all legal types and jurisdictions 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?

**Challenges of selling**
- One-off due diligence and structuring effort
- Identification of suitable counterparty
- Potential one-off P&L impact

**Advantages of selling**
- Immediate, true finality with full capital release
- No more volatilities or risk of future P&L losses
- No more management attention required
- Potential participation in upside through active run-off approach and scale effects

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 Frauenme, Cologne

Axa Liabilities Managers has won a liability contract in Germany. Axa is a partner in what is expected to become a rapidly growing market in the country.

The deal has been won from the state government of Bavaria and Brandenburg. According to market sources, the deal has a total value of BV 300m.

The company, which is based in Berlin, is said to have won the deal ahead of several other large run-off players. The deal was won from a list of around 12 companies.

Axa is the largest of the four largest European players in the run-off market. It has a strong presence in Germany, where it has over BV 750m of run-off business.

**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.

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

<table>
<thead>
<tr>
<th>Fulfilled</th>
<th>Not fulfilled</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full finality with quick capital release</td>
<td>Build up own team</td>
</tr>
<tr>
<td>Pure reinsurance solution (e.g. ADC)</td>
<td>Third-party administration</td>
</tr>
</tbody>
</table>

Portfolio sale (LPT or stock deal)

Not fulfilled | Fulfilled |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proactive approach without high management attention required</td>
<td></td>
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</tbody>
</table>
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)
People

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

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?
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
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

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
Introduction to “run-off”

Managing a run-off book ("owner’s" view)

Acquiring a run-off book ("buyer’s" view)

Q&A

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 - ACQUISITION 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
ATTRACTION RETURNS

- Mutually beneficial transaction
- Low volatility
- Limited competition

ATTRACTION RETURNS - SOURCES

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

### REQUIREMENTS FOR ACTIVE RUN-OFF MANAGEMENT

<table>
<thead>
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<th>Requirement</th>
<th>Description</th>
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</tbody>
</table>

### 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)
Fee income
- Management Expenses
- Consultancy areas
- Investment Management

Dividend
- Regulatory Approval
- Surplus Adequacy

Truncation
- Scheme/Commutation
- Part VII

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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