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ASSOCIATION OF INSURANCE AND REINSURANCE RUN-OFF COMPANIES

# AIRROC Matters

A NEWSLETTER ABOUT RUN-OFF COMPANIES AND THEIR ISSUES

VOL. 2 NO. 1 WWW.AIRROC.ORG SPRING 2006

## Message from CEO and Executive Director

# The AIRROC Agenda Continues to Impress

Trish Getty

*By Trish Getty*

It has become increasingly apparent that "lackadaisical" will never be found in the AIRROC dictionary! Wherever one turns in AIRROC, there is excitement, energy, enthusiasm and progress.

During the February 15 AIRROC Board of Directors meeting, four new members were approved. We welcome Harper Insurance Ltd, International Indemnity Insurance Co. in Liquidation, Canada Life and The Brandywine Group to AIRROC, bringing our membership to forty-five.

*Ms. Getty is CEO and Executive Director of AIRROC. She can be reached at trishgetty@bellsouth.net.*

We enjoyed a social time on the evening of February 15 at a welcome reception hosted by Mound Cotton Wollan & Greengrass and Navigant Consulting. Nearly eighty attendees were present in Kansas City for the first 2006 AIRROC membership meeting at the GE Insurance Leadership Institute on February 16th. Ron Pressman, Chairman of GE Insurance Solutions, greeted the AIRROC delegates and applauded AIRROC's creation and growth in a relatively short period of time, reflecting the obvious need for a run-off association. As another AIRROC speaker pointed out, the specialized arena of run-off management facilitates the creative and intelligent movement of capital into and out of insurance and reinsurance operations. In turn, this heightens efficiency and adaptability in risk management,

*continued on page 12*

## Notes from the Editor

# Momentum… Do you feel it?

*By Peter Scarpato*

As we submit our third issue of ***AIRROC Matters***, absorb the progress AIRROC has made and new members we have garnered, and review our board's and committees' agendas, the feeling of momentum is real – what

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Notes from the Editor

## Momentum… Do you feel it?

continued from Page 1

Peter Scarpato

Trish Getty so aptly calls in her Message "excitement, energy, enthusiasm and progress." Thanks to you, AIRROC is making a difference and having a positive impact on the run-off community – and your newsletter is a powerful, meaningful voice in this endeavor.

In this issue, we tap into the diverse and experienced "voices" of our community to explore a range of topics impacting run-off specifically and the industry at large: In his piece **"Underlying Data," Bob Quigley** explores the need for actuaries and accountants to coordinate their respective duties beyond the expected analysis of loss and LAE into the worlds of premium, claims management and underwriting programs, especially in our SOX environment. Next, **Dan Sykes** provides an interesting comparison of the US' and UK's exposure estimates in his article **"Asbestos,"** asking whether the UK is behind the US in calculating and addressing the perennial asbestos problem. The answer may surprise you. From there, we fly to the Commonwealth Court of Pennsylvania aboard **Jonathan Bank's** and **Robin Choi's** submission **"Reinsurance Proceeds Fly the Unfriendly Skies,"** a thoughtful analysis of the court's *Koken v. Legion* decision and its impact on run-off companies' direct involvement in the claims handling process. Are you too close to the fire? Tired of fighting all of your battles in arbitration and wondering if a viable alternative exists? **Brad Barron** makes the case for mediating reinsurance disputes – yes, even between or involving run-off companies – in **"The Role of Mediation in Reinsurance,"** citing such benefits as time and cost savings, preserving relationships and having experienced professionals guide the parties to a meaningful resolution. To keep pace with the progress of our UK counterpart,

*continued on page 12*

*Mr. Scarpato is an arbitrator, mediator, run-off specialist, attorney-at-law and President of Conflict Resolved, LLC, based in Yardley, PA. He can be reached at peter@conflictresolved.com.*

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*AIRROC Matters* is published to provide insights and commentary on run-off business in the U.S. for the purpose of educating members and the public, stimulating discussion and fostering innovation that will advance the interests of the run-off industry.

Publishing and editorial decisions are based on the editor's judgment of the quality of the writing, its relevance to AIRROC members' interests and the timeliness of the article.

Certain articles may be controversial. Neither these nor any other article should be deemed to reflect the views of any member or AIRROC, unless expressly stated. No endorsement by AIRROC of any views expressed in articles should be inferred, unless expressly stated.

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**Think Tank**

# Underlying Data Revisited

*By Robert C. Quigley, CPA*

Robert Quigley

A few years ago I wrote a commentary, *"Underlying Data …The Actuary's Achilles' Heel,"* that identified the need for accountants and actuaries to better coordinate their respective professional duties. This article revisits some of the themes in that earlier commentary in light of subsequent events, including the *Sarbanes-Oxley Act of 2002* ("SOX").

Mention the term underlying data and most of us think of loss and loss adjustment expense data. With respect to insurance company examinations and audits, most financial examiners and CPAs view their responsibility to verify the accuracy and completeness of this data in terms of annual statement Schedule P displays. They design procedures to test the accuracy of Schedule P cells, including sampling across accident years for both paid and unpaid records. However, many financial examiners and CPAs limit this testing to only a small part of the database, frequently omitting completeness testing, such as testing for claim processing backlogs in weak control environments.

**In addition to verifying the integrity of underlying data, accountants should also disclose to the actuary all of the nuances of an insurer's major underwriting programs and claims management practices.**

However, underlying data cannot be limited solely to paid and incurred loss development triangles. The adequacy of premium rates and how premiums are recorded are too frequently ignored, especially when confronted with immature books of business that rely on adaptations of Bornhuetter-Ferguson actuarial methodologies. The competition for niche markets among insurers only heightens the specter of inadequate rates.

In addition to verifying the integrity of underlying data, accountants should also disclose to the actuary all of the nuances of an insurer's major underwriting programs and claims management practices. Armed with this knowledge, the actuary is better able to employ the appropriate actuarial methodologies on the different programs to extrapolate the best estimates of ultimate losses from the underlying data.

Some history is appropriate before examining what actuaries need to know about an insurer's underwriting, claims, and reinsurance programs in the context of recorded premium and loss transactions. In response to the insurance insolvencies ("failed promises") of the 1980s, and the threat of federal regulatory intervention, state insurance regulators, through the National Association of Insurance Commissioners ("NAIC"), enacted a series of measures to strengthen solvency regulation. These measures included requirements for annual actuarial opinions of loss reserves and CPA audits of insurers' statutory financial statements. In conjunction with these regulatory initiatives, in the early 1990s the Actuarial Standards Board of the American Academy of Actuaries ("AAA") and the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA") responded with new professional standards that among other things addressed data quality. These independent attest functions were intended to elevate the reliability of insurer financial reporting. However, where they have failed, actuaries and accountants must accept a share of the blame for not better exercising the professional skepticism demanded by attest engagements.

In August 2000, following an earlier request from the Securities and Exchange Commission ("SEC"), the accounting profession's Public Oversight Board's Panel on Audit Effectiveness issued its report. Not surprisingly, the report emphasizes the need for

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auditors to be more skeptical in carrying out their audit responsibilities. With respect to management fraud, an original concern of the SEC that prompted the study along with the issue of auditor independence, the Panel identified a need for some "forensic" audit procedures. With respect to loss reserves, and the susceptibility of these accounting estimates to management bias and fraud, actuaries and accountants have always been charged with a heightened sense of duty to understand the relevance of and test underlying data. In this most sensitive area of an insurer's operations, management assertions must always be challenged.

More recently, the financial markets and public psyche have been shaken to the core by accounting scandals of major proportions. Enron, WorldCom, Adelphia, Tyco, and scores of lesser-known scandals created a crisis of confidence. While the scope of new accounting scandals were still emerging as headline news, Congress reacted by passing SOX, one of the most comprehensive public company oversight laws ever enacted. Shortly afterwards, the Auditing Standards Board issued Statement on Auditing Standards ("SAS") 99, *Consideration of Fraud in Financial Statements*, which relies heavily on a "red flag" approach as part of a new audit model that encourages forensic procedures and "brainstorming" among audit engagement team members. Auditors have traditionally been hesitant to ask probing questions of management for fear that doing so might offend the very people who have engaged them, and actuaries are no less immune to a reluctance of biting the hand that feeds them.

[T]he insurance industry has had its own accounting scandals, and many of these troubles have entwined accountants and actuaries together, especially the ongoing investigations involving the abusive use of finite reinsurance.

Closer to home, the insurance industry has had its own accounting scandals, and many of these troubles have entwined accountants and actuaries together, especially the ongoing investigations involving the abusive use of finite reinsurance. While the Enron scandal, with the aid of overzealous federal prosecutors, brought down an accounting profession icon – Arthur Anderson, the finite reinsurance scandal has brought down an insurance industry icon – Hank Greenberg. AIG is a case study of corporate governance gone awry.

Actuaries were already reeling from a Standard & Poor's report critical of the profession, *Insurance Actuaries: A Crisis of Credibility*, released in November 2003, before the finite reinsurance scandal made front-page news. The American Academy of Actuaries reacted promptly to its members being accused of "naiveté or knavery" for their "wildly inaccurate" actuarial estimates, but the response rang hollow.

Now let's focus attention on the problems associated with underlying data. Later, we can take a closer look at SOX and the reluctance of some insurers, particularly mutual companies, to being subject to a similar state insurance regulatory edict. There is middle ground in all controversies, and instead of strict rules and regulations, perhaps the solution lies in more thoughtful corporate governance policies that require independent company directors and audit committee members with more financial and industry expertise.

## Underwriting

In addition to a changing audit model that puts much greater emphasis on enterprise risk management and similar risk assessments, internal control documentation and annual monitoring under Section 404 of SOX has had a profound impact on accountants and actuaries alike. In the past, too many actuaries and accountants made little independent effort to understand major underwriting programs that went to the heart of their attest functions. Underwriting cannot be assessed in a vacuum, nor should it be accepted at face value. Equally as important as how a premium transaction is being recorded and earned are issues of risk selectivity and rate adequacy. The inevitable consequence of inadequate rates is higher loss ratios. Consequently, under no circumstances should industry loss data or other benchmark factors be used to assess loss reserve adequacy when a company is displaying growth outside the parameters of general market conditions. Instead, professional skepticism requires further investigation and documentation of the circumstances giving rise to the premium growth.

The production sources of premiums also need to be carefully screened. Is the underwriting controlled in-house

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Feature Article

# Asbestos

By Dan Sykes

Asbestos is ubiquitous worldwide. Its resistance to heat and friction made it a key raw material for major industries including auto manufacture, building and heavy engineering. Both the US and the UK were heavy users of asbestos in the twentieth century and both now face the economic consequences of asbestos use.

Since the 1980s, when the economic scale of the problem was first recognised, there have been numerous attempts to quantify US asbestos costs. Early estimates ranged between US$40 billion and US$60 billion and gradually increased up to 2000, when the post-Georgine surges in claim filings caused the major US actuarial consultancies to talk for the first time of figures in the hundreds, rather than the tens, of billions.

[T]he US has paid between a quarter and a third of predicted total costs, whereas the UK has paid less than one fifth.

On the other hand, the first credible study of the cost of asbestos related claims in the UK was only made in 2004, when the UK Institute of Actuaries published a working party paper on the asbestos problem ("UK Asbestos – The Definitive Guide"). The paper predicted a total cost between £5 billion and £11 billion with about £1 billion paid to the end of 2003.

How do US and UK estimates square up? And why is the UK apparently ten years behind the US in carrying out an analysis?

Two of the most widely quoted studies of the asbestos issue in the US have been published by the Rand Institute: "Asbestos Litigation Costs and Compensation: An Interim Report" (2002) and "Asbestos Litigation" (2005). The Rand Institute predicted in 2002 that the total cost of asbestos related claims in the US could total between $200 billion and $265 billion, with (as reported in 2005) about $70 billion paid to the end of 2002.

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Even allowing for the roughly 6:1 ratio between the two GDPs, the predicted US costs are far higher. Moreover, based on these estimates, the US has paid between a quarter and a third of predicted total costs, whereas the UK has paid less than one fifth. The figures therefore suggest that the UK is indeed some way behind the US in the recognition of the problem. To understand these differences it is necessary to look in more detail at the conditions caused by asbestos exposure.

There are four main categories of condition. In ascending order of severity these are pleural thickening and pleural plaques, asbestosis, lung cancer and mesothelioma, each with very different characteristics. There are no usable national statistics for pleural thickening, pleural plaques, nor for asbestosis. For lung cancer, although there are death statistics, the relationship with asbestos exposure can't yet be disentangled from the smoking risk and uncertainty over the scale of asbestos related lung cancer claims is at the centre of the huge variation in possible costs estimates put forward in the Bates White report.

Mesothelioma, a cancer of the chest lining, leads to death and is linked almost uniquely to asbestos. It alone provides a credible guide to national trends.

Death rates in the US have been stable for the last decade, whereas in the UK they are still climbing steeply. The natural implication is that rates have reached their peak in the US but not yet in the UK.

This supposition is borne out by medical studies that do indeed indicate mesothelioma deaths having already reached their peak, but that point to deaths in the UK climbing for another decade by which time the annual number of deaths in the two economies may be about the same despite the population of the US being five times larger. Analysis of worldwide asbestos trade shows that the UK scaled down its imports significantly later than the US and provides an explanation for these trends.

So the case is made for the US being further ahead. But the case is not yet made for the higher level of costs in the US: the UK actually has significantly *higher* death rates. So other factors must be at work.

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**Feature Article**

# Asbestos…

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Two factors contribute to the economic cost: the number of claims and their average cost.

First of all, the numbers. Rather fewer than half of mesothelioma deaths lead to claims in the UK and in the US so the numbers of mesothelioma claims are comparable. But when claims for other types of condition are brought into the picture, things change.

In the US, mesothelioma claims account for only about 5 percent of current settlements by number. While that ratio may, with mesothelioma's extremely long latency, increase over time, predictions of future claim numbers show non-malignant claims dominating. The UK Institute of Actuaries reports that UK mesothelioma claims on the other hand account for about a quarter of all asbestos-related claims by number. Moreover, the likelihood is that non-malignant claims in the UK may diminish in the future, as the Court of Appeal ruled earlier this year that pleural plaques do not constitute a compensatible injury, overturning the original High Court ruling. It is possible that the ruling will be further appealed to the House of Lords.

**[T]he UK is indeed ten years behind in the emergence of the disease and … should only now be starting to quantify its exposure.**

Part of the difference in numbers may be the significant proportion of uninjured claimants currently compensated under the US system. An August 2004 study in Academic Radiology, a US trade journal for the radiological profession, looked at a sample of x-rays submitted alongside asbestos claims. The readers employed to assess the x-rays reported a 95 percent injury rate. The independent assessors brought in by the journal reported that 95 percent of the x-rays showed *no* injury.

Unimpaired claims are one of the key issues addressed in the Fairness in Asbestos Injury Resolution ("FAIR") Act of 2005, under which claimants must meet strict medical criteria. But even under the criteria set out in the Act, non-malignant claims still dominate. A Congressional Budget Office ("CBO") cost estimate on the Act (2005) indicated the likely range of valid claims over the life of the fund set up under that bill would be between US $120 billion and US $150 billion, with non-malignant claims outnumbering malignant claims by more than ten to one.

A separate study by Bates White "Analysis of S. 852 Fairness in Asbestos Injury Resolution (FAIR) Act" has concluded that the fund would probably suffer major shortfalls. The issue identified in the Bates White report was that the medical criteria set out in the Act would attract significantly more claims, particularly for lung cancer, than are succeeding under current litigation. Under 'pessimistic' assumptions the report predicts future costs possibly exceeding the available funding *by a factor of four*. The Bates White report has been criticised in some quarters, although it probably contributed to the Act failing to reach the necessary majority in a US Senate procedural vote in February this year.

Average awards also show large differences. The Rand Institute reports that Court awards for asbestosis and for other cancers in the US average well over US $1 million, with average awards for mesothelioma exceeding US $3 million. In the UK however £1 million awards for mesothelioma are rare and for other disease types almost unheard of.

A key component of the difference is legal fees, which the Rand Institute reports as representing well over 50 percent of the US $70 billion of total US paid costs to 2002, but which constitute a much smaller proportion of UK costs. As with unimpaired claimants, legal fees are also addressed in the FAIR Act, with a cap of 5 percent of plaintiff awards being applied to fees.

Thus legal fees represent a fairly small share of the CBO predicted cost and explain why the Rand Institute estimates are so much higher. Indeed, after removing likely allowance for legal fees from both sets of estimates, the CBO figures start to look more pessimistic. The CBO itself reported that the FAIR Act's proposed funding structure would be unlikely to raise enough to meet claims over the first ten years of the fund's life.

What can we conclude? Direct comparisons can be made between US and UK experience of mesothelioma: these suggest that the UK is indeed ten years behind in the emergence of the disease and help to explain why the UK should only now be starting to quantify its exposure.

It would be natural to assume then that we can use US experience as a guide for the UK. But there are wide

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## Smooth sailing

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**Feature Article**

# Reinsurance Proceeds Fly the Unfriendly Skies

Jonathan Bank

Robin Choi

*By Jonathan Bank, Esq. and Robin Choi, Esq.*

American Airlines, one of a number of policyholders, was recently successful in collecting reinsurance proceeds directly from the reinsurers of the insolvent Legion Insurance Company. *See Koken v. Legion*, 831 A.2d 1196 (Pa. Commw. Ct. 2003). This case is of particular interest for companies in run-off, as they generally pay more attention to, and get more involved in, the handling of claims. While this conduct is not to be discouraged, *Koken v. Legion* (and its predecessors) highlights the risks attendant to getting too involved in the claims handling process.

A reinsurance agreement is a contract between a reinsurer and a ceding insurer. Accordingly, since generally no privity of contract exists between a reinsurer and a policyholder, a reinsurer is not directly liable to policyholders. A "cut-through" provision,* however, allows assertion of rights against a reinsurer by a party not otherwise in privity with the reinsurer, subject to certain specific conditions enumerated within the cut-through. A cut-through may be in the form of a clause within a reinsurance agreement or an endorsement appended to the insuring agreement (the policy). Both cut-through clauses and endorsements are contractual obligations of the reinsurer, generally triggered by the ceding insurer's insolvency or default in payment.

As noted above, absent a cut through provision, a reinsurer owes no contractual duty to policyholders, but if the reinsurer conducts itself as a direct insurer, *e.g.*, involves itself in underwriting, claims handling, etc., it may create a direct liability to the policyholders where one did not otherwise exist.

> **[I]f the reinsurer conducts itself as a direct insurer, e.g., involves itself in underwriting, claims handling, etc., it may create a direct liability to the policyholders where one did not otherwise exist.**

Typically, reinsurers have legally distanced themselves from original policyholders, and as a result, have been fairly successful in avoiding direct contractual liability to them. Reinsurers have even added clauses to reinsurance agreements stating that they shall have no legal liability to any third persons. This may be sufficient to avoid contractual liability (assuming no cut-through provisions), but will not be effective if the reinsurer conducts itself in a manner inconsistent with a true reinsurance relationship. There have been a number of cases holding that the original policyholder may bring a direct action against a reinsurer in such specific instances.

As illustrated further below, the opinions in most of these cases were based, not on any particular contractual terms in the reinsurance agreement, but on

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**Note:**

*Cut-through provisions found their origin in property risks, where a lender (mortgagee) required the borrower-owner (mortgagor) to procure insurance with an "acceptable" insurer. In those instances where the insurer failed to meet the lender's requirements, a reinsurer (with stronger financials than that of the insurer) of the risk may be asked to issue a cut-through directly to the lender. It could be for only the reinsurer's share of the risk, or in some cases, 100% of the risk. Although having their origins in property risks, cut-through provisions have been used (arguably misused) to guaranty liability exposures as well.

the reinsurer's conduct, which resulted in policyholders' having a direct right of action against the reinsurer. For example, in *Venetsanos v. Zucker, Facher & Zucker*, 638 A.2d 1333, (N.J. Super. Ct. App. Div., 1994), the court held that a reinsurer, who assumed 100% of the risks of the ceding insurer, made initial underwriting decisions and handled claims, used the ceding insurer as a mere "front" and, thus should be "regarded as though it had the obligations of a primary insurer." In so deciding, the court considered the "role of [the reinsurer], its officers and affiliates, in the entire insuring process ranging from initial acceptance of [a] risk and its nominal allocation to [the ceding insurer], to its assumption of insuring responsibility for 100 percent of the risk and absolute control of the final claim adjustment," and concluded that the foregoing key factors subjected the reinsurer to direct suit by the insured when the ceding insurer became insolvent. Similarly, in *O'Hare v. Pursell*, 329 S.W.2d 614 (Mo. 1959), the court held that policyholder of an insolvent insurer had the right to maintain a direct action against a reinsurer that assumed 100% of all policy liability written in Missouri, collected premiums and directly handled the insureds' claims. The court stated that where the reinsurer's liability was "based upon the same terms and condition as those of the policies of the ceding company" under the reinsurance agreement and where the "reinsurer actually took over and serviced [the ceding insurer]'s outstanding policies" by collecting premiums and paying and settling claims, "[f]or all practical purposes [the reinsurer] became and was substituted for [the ceding insurer] insofar as the insureds were concerned." *See also First Nat'l Bank of Kansas City v. Higgins*, 357 S.W.2d 139 (Mo. 1962).

**There have been a number of cases holding that the original policyholder may bring a direct action against a reinsurer in [certain] specific instances.**

More recently, in *Koken v. Legion*, the presiding judge, Mary Hannah Leavitt, ruled that four of Legion's large corporate policyholders – American Airlines, Inc., Rural/Metro Corporation, Pulte Homes, Inc., and the Psychiatrists' Purchasing Group, Inc. (collectively, the "Policyholder Intervenors") – should have direct access to Legion's reinsurance covering the policies at issue. In July 2005, in a *per curiam* order, the Pennsylvania Supreme Court affirmed, for reasons set forth in Judge Leavitt's opinion. In the lower court's opinion, Legion was repeatedly described as a mere "fronting" insurer that bore no actual underwriting risk, played no role in the handling of claims, and performed very few functions, if any, as a typical direct insurer. In its factual findings, the court stated that in some instances, the Policyholder Intervenors negotiated for coverage directly with the reinsurers, and that Legion was added as a front simply to allow the Policyholder Intervenors to satisfy financial responsibility laws by having coverage from a licensed insurance company.

Judge Leavitt's legal analysis rightly noted that, as a general matter, an insolvent insurer's reinsurance proceeds become assets of the insurer's estate, and as such, insureds have no rights vis-à-vis the reinsurers. The court, however, then observed:

> The usual occasion for reinsurance has no application to Legion. [The Policyholder] Intervenors, not Legion, placed the reinsurance; Legion neither adjusted nor funded claims; and Legion did not seek to expand its underwriting capacity through reinsurance. Indeed, it sought to avoid any underwriting because its business plan called for generation of fees not underwriting profits.

After noting that an insured's "direct access" to its insurer's reinsurance is established on a "case-by-case basis," the court held that the Policyholder Intervenors enjoyed "third-party beneficiary" status under Legion's reinsurance contracts.

With one exception, Legion's reinsurers were non-parties to the judicial proceedings before Judge Leavitt. Despite the reinsurers' absence from the proceedings, the court granted the Policyholder Intervenors' request for "direct access" to Legion's reinsurance contracts. The court also ordered the Rehabilitator of the Legion estate to establish a procedure whereby other Legion insureds may demonstrate "third-party beneficiary rights" under one of Legion's other reinsurance contracts, and thus gain direct access to such reinsurance.

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Feature Article

# Unfriendly Skies…

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The *Legion* decision is consistent with prior case law where the reinsurer undertook activities that are traditionally carried out by the direct insurer. As such, this decision is not surprising. The only open question is, after this long trip through the portals of justice with American Airlines, are the reinsurers at least entitled to AAdvantage miles? ■

Message from CEO and Executive Director

# AIRROC Agenda…

continued from Page 1

which is so critical to national and global economies. AIRROC serves an important role in this process.

There was a bustle of activity throughout the morning of the 16th as all committees met. The newly formed A & H/Life Committee met for the first time to identify the issues relevant to the accident, health and disability run-off business. After enjoying lunch together, the afternoon was dedicated to an education session, "U.S. Insolvencies," which was videotaped (sponsored by Edwards Angell Palmer & Dodge LLP) to be made available to AIRROC members for in-house training. We are grateful for the eminent industry speakers including Doug Hartz and Hal Horwich of Bingham McCutchen as well as Larry Schiffer of LeBoeuf, Lamb, Greene & MacRae.

***Wherever one turns in AIRROC, there is excitement, energy, enthusiasm and progress.***

We thank GE Insurance Solutions for providing us with a marvelous training facility for our meetings and for a delicious breakfast, lunch and snacks.

It was my honor to speak on the panel, "Casting the Runes — What Are the Influences Shaping the Run-off Sector?" on March 8th at the ARC Congress in London. The forum was an excellent opportunity to talk about the creation of AIRROC and some of its goals, to interact with others in the run-off industry and socialize at the end of the day.

The AIRROC Education Committee will finalize its agenda for another education session during the next membership meeting on May 18, 2006 in Hartford, CT. Going forward, the meeting agenda will be posted in a timely manner on our website www.airroc.org under "Training, Education and Materials." Some but not all committees will meet again during the afternoon of May 17.

While attending the ARC Congress, I heard positive comments about the second AIRROC/Cavell Commutation & Networking Event scheduled for October 16-18, 2006, again at the Sheraton Meadowlands, New Jersey. As reflected in the brochure (access www.airroc.org or www.communtations-rendezvous.com), start spreading the news! To miss this event would be to miss a brilliant opportunity for networking, negotiating and commuting. We urge you to register as soon as possible to assure a spot and to let others know that you will attend. The event will kick off on the evening of October 16th with a reception followed by a gala dinner. Who will be this year's run-off person of the year? Join other prominent people in the run-off industry worldwide to hear it first! ■

Notes from the Editor

# Momentum… Do you feel it?

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The Association of Runoff Companies (ARC) and trends in the London market, **Nigel Curtis** summarizes the proceedings of ARC's recent 6th Annual Congress in **"ARC Congress, London March 7-8, 2006,"** including the presentation of our own Executive Director. And of course, no issue of ***AIRROC Matters*** would be complete without **"Trish Getty's Message from the CEO and Executive Director"** and **KPMG's "Policyholder Support Update."**

Yes, the many voices of our insurance community provide unique, thought-provoking commentary on diverse aspects of the reinsurance and run-off business. What are your views? Have they hit or missed the mark? Are there other more pressing issues warranting discussion and debate? ***AIRROC*** *Matters* can only be the true voice of its members if its members decide to speak. Get the word out, engender debate, explore issues important to you and your colleagues. Let us hear from you. ■

Feature Article

# Role of Mediation in Reinsurance

By Brad Barron, Esq.

Brad Barron

## Introduction

Reinsurance has long been a gentlemanly business where parties are expected to meet their obligations with civility and minimal resistance when compared to other business sectors. With increasingly contentious disputes, reinsurance companies may want to look for alternative ways to amicably settle their disputes. Mediation offers a viable and valuable solution as it often allows reinsurance companies to minimize hostilities, preserve their business relationships, save money and avoid the hazards of a third party's decision. Even though the concept of mediation in reinsurance is relatively new, that does not mean that reinsurance companies should slowly adapt to the use of mediation. Rather, reinsurance companies should seriously consider using mediation at the outset of all disputes.

**Mediation offers a viable and valuable solution as it often allows reinsurance companies to minimize hostilities, preserve their business relationships, save money and avoid the hazards of a third party's decision.**

Reinsurance contracts often involve companies from around the world. This globalization of the industry hinders the normal enforcement of contracts through a specific country's judicial system because of the associated costs as well as the difficulty of ascertaining a proper jurisdiction and enforcing a judgment. In order to avoid this problem with traditional judicial enforcement, the reinsurance industry includes arbitration provisions in almost all contracts. These arbitration provisions were intended to serve multiple purposes. First, the provisions were intended to resolve disputes civilly, allowing the companies to avoid litigation which could jeopardize their business relationship. Second, the use of arbitration provisions could drastically reduce the cost of dispute resolution by avoiding high fees associated with lengthy litigation. Third, by going to arbitration, companies could reduce the amount of time spent resolving the dispute. Finally, arbitration would lend itself to speedier and more economical business results because the arbitration panel would be made up of reinsurance professionals who would better understand the industry-specific language and practices.

With the increasing emphasis on profitability by reinsurance companies, the distinction between arbitration and litigation is becoming increasingly blurred. By focusing on getting the most out of every dispute, companies appear to be moving towards an increasingly adversarial relationship with the opposing party. To maximize the likelihood of prevailing, companies are spending more time and money on their representation in arbitration. Further, arbitration proceedings now involve lengthy discovery and the actual proceeding can take many days. As such, arbitration is turning into exactly what it was intended to avoid: full blown hostile litigation.[a] This increasing hostility erodes any goodwill between the companies and they no longer focus on a mutually beneficial relationship, but rather the result of the dispute. This is particularly prevalent where the companies no longer maintain a business relationship. In addition to the loss of goodwill, companies lose increasing amounts of income on arbitrations due to expenses such as the time spent by employees preparing for and participating in the arbitration and the costs of locating and duplicating records. Finally, even with a positive arbitration award, companies often find it difficult to enforce these awards in foreign countries against a now hostile business partner. Thus, reinsurance companies may want to consider moving away from contentious and costly arbitrations and seriously consider mediation.

## Mediation's Advantages

Mediation offers many advantages over arbitration. First, mediation reduces costs for all companies involved.[b] Currently, reinsurance companies must not

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**Feature Article**

## Mediation…

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only have employees present to support the company's case, but the companies must also pay for the arbitrators as well as the cost of locating and analyzing loss and account details, which require extensive duplication and employees' time.[c] At the very least, mediation reduces the cost of dispute resolution by drastically cutting down the time spent by employees in arbitration due to the average duration of mediation being significantly shorter than the average duration of an arbitration hearing.[d] While some may also consider reducing attorney's fees by wholly or partially removing them from mediation, this is only a short term savings. While mediation itself does not involve a binding resolution, the parties may enter into a binding contract as a result of the mediation. This binding agreement not only ends any dispute, but it also carries with it long term consequences for both parties. As such, it is important during the process of dispute resolution to fully understand the legal ramifications of all agreements. Additionally, an experienced reinsurance attorney can provide invaluable advice about possible pitfalls and benefits by calling on his or her vast wealth of knowledge. By including an attorney in the process and informing them of the company's mediation goals, a company can obtain valuable legal advice, which will positively affect the company's long-term prospects.[e]

At the very least, mediation reduces the cost of dispute resolution by drastically cutting down the time spent by employees in arbitration…

Second, mediation offers a return to civility for the reinsurance industry. Dispute resolution in reinsurance has become more and more acrimonious, especially in the past decade. This is due to the increasing financial liability at stake from litigation involving such items as asbestos and environmental pollution, among others. With this significantly increased financial exposure, companies realize that their own solvency and survivability is in the balance, and they are therefore often willing to do whatever it takes to "win" a dispute. Mediation encourages companies to become more focused on maintaining good diplomacy rather than ensuring the company is victorious on every possible issue. In reinsurance, goodwill is extremely important because of the small size of the industry which virtually ensures that the companies will meet again whether it is to conduct new business or windup old business.[f] Thus, by focusing on maintaining and cultivating a good relationship, the parties are more likely to leave the dispute with increased bonds of goodwill rather than a frayed relationship.

Third, mediation places control back into the hands of the parties. Court adjudications and arbitrations only allow the parties to present their case and the final result is in the control of the third party decision maker whether that is a judge or an arbitration panel.[g] In reinsurance, this is problematic because of the difficulty in calculating a proper award and the complexity of the business. Long term solvency is important for all companies in the reinsurance field, even the party initiating the action, because it is likely that the parties will have contracted additional business with each other through indirect channels which will likely require a future payment. Thus, while a third party neutral may come up with an arbitral award, it may not take into account the payor's long term solvency and could force the company into insolvency. Mediation would address this problem by allowing the payee company to come up with a solution that not only satisfies its adversary, but also that allows it some form of long term security and solvency. The size of the award is not the only concern involving third party neutrals as they may never fully understand all the aspects of a reinsurance dispute. Even a third party neutral who has experience in the reinsurance field may have difficulty fully digesting all the claims detail because of their constraint on time and the complex nature of many reinsurance claims. Mediation allows the individuals with the most intimate knowledge of the claim to craft a resolution, rather than trying to fully inform a third party neutral on a complex and time consuming issue. While an arbitration panel may attempt to fully understand all the issues, documents and arguments, it will be very difficult for the panel to understand the issues as clearly and with as much precision as the parties themselves. By using mediation, the parties increase the likelihood that all nuances are fully explored, understood and taken into account when a resolution is reached.

Fourth, mediation increases the approval and participation of the agreed upon resolution. In

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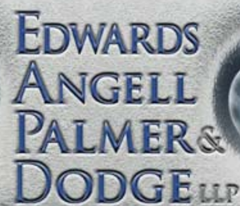


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# ARC Congress
## London, March 7-8, 2006

*By Nigel Curtis*

The Association of Runoff Companies (ARC), the UK run-off industry's representative body, held its sixth annual Congress at Merchant Taylor's Hall in London in March. The two-day event consisted of seminar and panel sessions on the first day covering such subjects as "Finality; who is driving?" "Regulating run-off" and "Toujours asbestos – will we ever be free of it?" The second day was a commutation and networking day with booth and table holders holding court.

**[Only] 54% of the roughly 200 member companies are risk carriers and 73% of those risk carriers have outsourced their portfolios to service providers.**

In existence since 1998, ARC took the opportunity to hold an open forum for its membership to discuss where the organization is headed. Among the membership's stated objectives were raising the profile of ARC's members and the awareness of run-off. Peter Abbott, ARC's Vice Chairman, added that one of ARC's primary roles was to "bring run-off practitioners and the live market together to form a robust and informed sector of the industry."

## The UK Runoff Scene

It was noted that only 54% of the roughly 200 member companies are risk carriers and 73% of those risk carriers have outsourced their portfolios to service providers. Mike Palmer of ARC's Executive Committee views the high concentration of service providers within the organization as proof that the "outsourcing model was beginning to prevail."

Asked whether run-off was a diminishing market in the UK, Philip Grant, ARC's Chairman, stated that run-off was now perceived as "part of the lifecycle of the insurance industry, not a temporary phenomenon." The amount of finalized liabilities in the UK was thought to be around GBP 100m, a small fraction of the overall liabilities in run-off. Concentration within the risk bearing sector and the merger activity of recent years was also seen as a prelude to larger entities and portfolios entering the run-off arena through choice (e.g., discontinuance of underwriting) as opposed to being forced (e.g., due to insolvency).

*Mr. Curtis is an Executive Vice President at Citadel Risk Management, Inc. and can be reached at nigel.curtis@citadelriskmanagement.com.*

Among ARC's initiatives is the establishment of an insurance academy. Bill Bower outlined a series of educational courses designed specifically for run-off practitioners to complement existing educational programs offered by the Chartered Insurance Institute. These include one to three-day courses on Schemes of Arrangement, Outsourcing, Understanding the Actuarial Process and Run-Off Skills. ARC is also seeking to build stronger links with overseas groups sharing the same objectives, such as AIRROC and SEGS (Syndicat Europeen de Gestion des Sinistres – the French runoff industry association).

There was a stimulating panel discussion on run-off mergers and acquisitions, broker replacement, the future for service providers and run-off market comparisons between the UK, U.S. and France.

## Runoff Mergers & Acquisitions

Charles Thresh of Tawa described three main components for a successful runoff merger and acquisition (M&A) from a buyers perspective: 1) a robust personality on the sellers side to champion the deal; 2) a sense of urgency and realism on the part of the seller; and 3) structural flexibility in terms of financing. Mr. Thresh characterized the large-scale runoff M&A sector as expensive and time-consuming with a high failure rate. In his view, unless there was a sea change in the costs of exit and wide-scale under-reserving, there was unlikely to be a vibrant runoff M&A sector.

Access to finance is no longer an issue; the panelists thought that there was probably more available capital than available run-off portfolios for sale. Mr. Thresh added that two other major obstacles to a thriving run-off M&A sector were management inertia due to the desire for long-term job security and the current debate within large organizations as to how much of their business was non-core and therefore available for sale.

Peter Taylor from Lovells took a more positive view of the run-off M&A sector indicating that in his view there were many small pockets of relatively low value, low profile portfolios available. He was also of

the opinion that European subsidiaries were likely to be better reserved than their London counterparts. Mr.

> [T]wo major obstacles to a thriving run-off M&A sector were management inertia … and the current debate within large organizations as to how much of their business was non-core...

Taylor added that one often overlooked advantage to a run-off M&A was the release of capital tied up in the business to meet regulatory requirements.

## Run-Off Market Comparisons

Trish Getty, CEO and Executive Director of AIRROC, stated the objectives of some of the AIRROC committees, as well as the background of AIRROC's formation. She expressed the desire on the part of the membership to bring market players together, principal to principal, to address issues of mutual concern, identify/implement solutions, resolve their own mutual issues, further their commutations efforts, and monitor the Federal and State regulatory environment. She further emphasized the importance of establishing personal relationships thereby allowing each other the opportunity to speak frankly about issues, principal to principal.

Resistance to solvent schemes by policyholders was perceived as a problem faced on both sides of the Atlantic, partly due to a lack of understanding as to what schemes are about and partly for fear of diluting existing security. Promotion of a better understanding of solvent schemes was seen a potential solution.

Jean-Michel Ragot of SEGS provided yet another perspective from France. Eight founding members with the objective of outsourcing live and run-off business, connecting with overseas organizations and raising technical proficiency, formed SEGS a year ago. Mr. Ragot saw that the reason the French insurance market was a latecomer to the run-off scene was due to the strength of the regulatory authorities and the desire on the part of insurance companies to sweep their run-off under the carpet for fear that it may negatively impact their ongoing business.

## London Market Trends

The Panel felt that the London insurance market, as a broker-driven market, had concluded that the way to improve broker performance in run-off was to elect for broker replacement or to deal direct (principal to principal), despite the contractual duty on the part of the original broker who placed the business to continue to retain the same service levels.

Opportunities for service providers were seen as arising primarily from prospective changes at Lloyd's where the exit routes available for syndicates wishing to leave the market are currently limited. There was speculation that the Corporation of Lloyd's would authorize solvent schemes and Part VII transfers (novations) – tools that are regularly used in the company market. One reason for such speculation is that total liabilities for 1993 and subsequent underwriting years now exceed those of Equitas (handling Lloyd's 1992 and prior year liabilities).

Asked what lessons the ongoing market could learn from the run-off market, the Panel focused on the science of claims management. Run-off companies, it was thought, with more finite resources, could usually demonstrate more sophisticated control and cost effective claims management. They were usually better at staff motivation, principal-to-principal accounting and commutation pricing and made more effective use of audits and inspections.

This year's ARC Congress was attended by in excess of 450 discontinued-business professionals and it appears that in the six years since ARC has been around, the run-off market in London has matured considerably in terms of sophistication and technical proficiency. Moreover, the ARC Congress has established itself as one of the most important events in the UK run-off calendar. Further details about ARC may be found on their website at www.arcrunoff.com. ■

If you are interested in having commutation discussions with Converium Reinsurance (North America) Inc. please contact:

Raymond Dowling at (212) 898-5040
Email: ray.dowling@converium.com

# Policyholder Support Update — Alert No. 12 (March 2006)

*Submitted by KPMG LLP (UK)'s Corporate Recovery Insurance Solutions team.*

*This e-alert, kindly provided by KPMG, acts as a reminder of forthcoming bar dates and scheme creditor meetings. Our online database of solvent and insolvent cut-off Schemes of Arrangement, providing a source of up to date information, can be accessed through our website.*

## Solvent Schemes Upcoming Key Dates

1) LION CITY RUN-OFF PRIVATE LIMITED

   The proposed solvent Scheme of Arrangement was approved by the requisite majority of scheme creditors at the meeting held on 23 February 2006. The proposed Scheme was sanctioned by the High Court of Justice of England and Wales on 23 March 2006. The sanction hearing by the High Court of the Republic of Singapore will be heard on 30 March 2006. Further information can be obtained by e-Mailing Andrew Campbell at LionCityRunOff@omniwhittington.com.

2) PENDER MUTUAL INSURANCE COMPANY LIMITED

   By Order of the High Court of Justice of England and Wales and by Order of the High Court of Justice of the Isle of Man, a Meeting of Scheme Creditors for the above company is to be convened for the purpose of considering and, if thought fit, approving a Scheme of Arrangement. The Meeting of Creditors will be held on 19 May 2006 at the Shangri-La Hotel, 22 Orange Grove Road, Singapore 258350. Further details are available at www.freshfields.com/soa-pender-mutual.

3) NRC REINSURANCE COMPANY LIMITED (BERMUDA)

   The Meetings of Creditors for the above company was held on 22 March 2006. The outcome of this meeting has yet to be announced. Further information is available via email at stephen.a.ward@us.pwc.com.

4) DUTCH AVIATION POOL

   Schemes for the 18 Scheme Companies which participated in the Dutch Aviation Pool, were approved at their respective Meetings of Creditors on 15 September 2005 and were subsequently sanctioned by the Court. The Schemes became effective on 30 September 2005 and the bar date has been set as 30 March 2006. Further information is available by contacting the Scheme Manager: DAP Holding N.V., Hoogoorddreef 54E, PO Box 23320, 1100 DVAmsterdam Z.O., The Netherlands. e-Mail: dapscheme@assurpools.nl.

5) SRO RUN-OFF LIMITED

   By Order of the Supreme Court of Bermuda Meetings of Scheme Creditors for the above company are to be convened for the purpose of considering and, if thought fit, approving a Scheme of Arrangement. The Meetings of Creditors will be held on 17 April 2006 at the offices of Conyers Dill & Pearman, 2nd Floor, Richmond House, Hamilton HM 08, Bermuda. Further details are available at http://www.cambridgeworldwide.com/ftp/sro-soa (Username: SRO; Password gw84x).

6) GORDIAN RUN-OFF (UK) LIMITED (FORMERLY GIO (UK) LIMITED)

   The proposed Scheme was approved by the requisite majority of scheme creditors at the meeting held on 3 March 2005. The 22 July 2005 hearing scheduled to sanction the Scheme has been adjourned until 25 April 2006. Further details are available at www.gordianuk.co.uk.

7) GLOBAL GENERAL AND REINSURANCE COMPANY LIMITED

   The above company's Scheme was approved at the Meetings of Creditors on 17 January 2006 and was subsequently sanctioned by the Court. The Scheme became effective on 8 February 2006 and the bar date has been set as 8 August 2006. Further information is available on http://www.globalre.com/ggre-uk/scheme.

8) PAN FINANCIAL INSURANCE COMPANY LIMITED

   The above company's Scheme sanctioned on 14 December 2004 has been finally implemented. Further information is available from Philip Grant, Clay Chimneys House, Albury Road, Furneux Pelham, Buntingford, Hertfordshire, SG5 0LP, UK or from miriam.bartlett@rpc.co.uk.

## Other Recent Developments

9) RELIANCE NATIONAL INSURANCE COMPANY (EUROPE) LIMITED

   The Meeting of Creditors for the above company was held on 2 February 2006. The outcome of that meeting has yet to be announced. Further details are available at www.omniwhittington.com.

10) WILLIS FABER (UNDERWRITING MANAGEMENT) WFUM POOLS

    The 9 March 2006 hearing for permission to convene Meetings of Creditors for the 16 Scheme Companies which participated in the WFUM Pools has been adjourned to the 27 and 28 April 2006. Further details are available at www.wfumpools.com.

11) QBE REINSURANCE (UK) LIMITED (FORMERLY ALLSTATE REINSURANCE CO. LIMITED)

The above company's Scheme was approved at the Meeting of Creditors on 6 February 2006. The 27 February 2006 hearing scheduled to sanction the Scheme has been adjourned until 27 March 2006. Further details are available at www.zuginsurancescheme.co.uk.

12) NRG VICTORY

The above company was due to be heard in the High Court of Justice of England and Wales on 23 March 2006 in order to obtain leave to convene a Creditors' Meeting. This hearing was adjourned to a date yet to be announced. Further information is available at: www.nrg-solventscheme.co.uk.

13) CAVELL INSURANCE COMPANY LIMITED
The proposed solvent Scheme of Arrangement was approved by the requisite majority of scheme creditors at the reconvened meeting held on 25 April 2005. The Company has postponed their application to the High Court of Justice of England and Wales for the Scheme to be sanctioned whilst they await the outcome of an appeal to be heard in the Canadian Court. Further information is available at http://www.cavell.biz/schemes.

14) THE SCOTTISH EAGLE INSURANCE COMPANY LIMITED

The 1 March 2006 bar date for the above company's Scheme has now passed. Further information is available at www.scottisheaglesolventscheme.co.uk.

15) LA MUTUELLE DU MANS ASSURANCES IARD

The 1 March 2006 bar date for the above company's Scheme has now passed. Further information is available at http://mmaukbranchsolventscheme.co.uk.

16) RIVERSTONE INSURANCE (UK) LIMITED; MITSUI SUMITOMO INSURANCE COMPANY (EUROPE) LIMITED; SIRIUS INTERNATIONAL INSURANCE CORPORATION (PUBL) (IN RESPECT OF THE ORION POOL BUSINESS)

The above companies expect to apply to the High Court of Justice of England and Wales in mid-2006 for permission to convene a Meeting of Creditors. Further information is available from OrionPoolScheme@rsml.co.uk.

## Insolvent Estates

17) HIH CASUALTY AND GENERAL INSURANCE LIMITED, WORLD MARINE & GENERAL INSURANCE PTY LIMITED, FAI GENERAL INSURANCE COMPANY LIMITED, FAI INSURANCES LIMITED, CIC INSURANCE LIMITED, FAI TRADERS INSURANCE COMPANY PTY LIMITED, FAI REINSURANCES PTY LIMITED, HIH UNDERWRITING AND INSURANCE (AUSTRALIA) PTY LIMITED

By Order of the High Court of Justice of England and Wales and the Supreme Court of New South Wales, meetings of scheme creditors for the above companies are to be convened for the purpose of considering and, if thought fit, approving Schemes of Arrangement. The Meetings of Creditors will be held on 29 March 2006 at the Wesley Conference Centre, 220 Pitt Street, Sydney, NSW, Australia. Further details are available at www.hih.com.au and www.kpmg.co.uk/insurancesolutions.

18) WILLIS FABER (UNDERWRITING MANAGEMENT) WFUM POOLS (INSOLVENT PARTICIPANT)

See Solvent Schemes.

19) BELVEDERE INSURANCE COMPANY LIMITED
The 20 February 2006 bar date for the above company's Scheme has now passed. Further information is available at www.belvedere-liquidation.com or at Belvedere-liquidation@kpmg.bm.

20) OCEANUS MUTUAL UNDERWRITING ASSOCIATION (BERMUDA) LTD The 16 March 2006 bar date for the above company's Scheme has now passed. Further details are available at www.deloitte.com/uk/oceanus.

21) NEW CAP REINSURANCE CORPORATION (BERMUDA) LIMITED

The above company's Scheme was approved at the meeting of creditors on 9 February 2006 and was subsequently sanctioned by the Court. The Scheme became effective on 23 February 2006 and the bar date has been set as 31 May 2006. Further information is available from John C. McKenna, Ernst & Young LLP, Reid Hall, 3 Reid Street, Hamilton HM 12, Bermuda or on john.mckenna@bm.ey.com.

22) AA MUTUAL INTERNATIONAL INSURANCE COMPANY LIMITED

By Order of the High Court of Justice of England and Wales Meetings of Scheme Creditors for the above company are to be convened for the purpose of considering and, if thought fit, approving a Scheme of Arrangement. The Meetings of Creditors will be held on 26 April 2006 at the offices of PricewaterhouseCoopers LLP, Plumtree Court, London, EC4A 4HT. Further details are available at www.pwc.com/uk/aamii.

*If you wish to subscribe to the KPMG regular email alerts, please contact Mike Walker on mike.s.waler@kpmg.co.uk.*

**Think Tank**

## Underlying Data Revisited…

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or delegated to managing general agents ("MGAs")? MGAs have a tendency to generate production for the sake of their commissions rather than underwriting profitability, and worry less about the aftermath of losses. Consequently, underwriting standards and rate adequacy are at greater risk when MGAs have binding authority.

The different lines of business an insurer underwrites can also impose significant burdens on the actuarial function. Ordinarily, a direct property book of business is not subject to the same volatility as a reinsured casualty program where the experience is being reported by different cedents, the underwriting risks are very diverse, and reporting often not timely.

**Actuaries and accountants must be keenly aware of changes in an insurer's claim investigation, reserving, and settlement practices.**

Generally accepted auditing standards ("GAAS") have always required accountants to have a basic understanding of these underwriting issues as a prerequisite to assessing audit risk and designing audit procedures. However, too often in the past accountants followed form over substance and failed to step back and take a businessman's perspective of a company's operations. The requirements of SOX and more rigorous professional standards that SOX has fostered are changing the attitudes of both accountants and actuaries concerning the relevance of such issues.

## Claims

Just as every insurer underwrites its business differently than its competitors, every insurer investigates, reserves and settles claims differently than other insurers. Consequently, there is an equal burden on actuaries and accountants to understand and test management representations and assertions with respect to a company's claim management philosophy. In this most troublesome area of an insurer's operations requiring significant accounting estimates, SOX has the potential for bringing about significant cooperation among an insurer's different business disciplines.

Actuaries and accountants must be keenly aware of changes in an insurer's claim investigation, reserving, and settlement practices. These can arise from rapid growth in business volumes, changes in management personnel or staffing, implementation of new computer systems, centralization or decentralization of certain functions, or external factors that can give rise to higher claim values and changes in settlement patterns. For instance, there has been a dramatic shift in automobile claim costs in the last twenty years as automobile accident rates have steadily decreased while people involved in accidents have become more inclined to file injury claims. Consequently, bodily injury claims have grown exponentially compared to property damage claims. The actuary must recognize and give weight to such changing patterns.

In the past, it was common for many insurers to finance growth at the expense of adequate loss reserves. Today, managers of insurers subject to SOX can face severe penalties and criminal prosecution for taking such liberties with the public trust. While there is still the potential for a great deal of subjectivity in the setting of loss reserves, actuaries and accountants must be keenly aware to challenge management biases. To turn a blind eye to management biases illustrates a degree of intentional recklessness akin to fraud. Gone are the days when an insurer can use a simple loss ratio method to set IBNR reserves and expect its actuary and accountants to develop a point estimate or range of reasonableness in close proximity without sufficient competent evidential matter.

Given the specific dynamics of an insurer's operations, it is advisable to conduct a claims audit periodically. It is important that in addition to an audit of large losses, that a random sample of smaller claims be included in the audit.

**A company experiencing rapid growth is of particular concern because a claims audit will reveal how effective the claim diary system is working and the level of skills of the claim adjusters.**

Reinsurers frequently conduct claim audits and actuaries and accountants should routinely request copies of their audit findings from their clients. A good audit usually will indicate whether the individual case reserves realistically reflect the facts in each file and whether there have been changes in reserving guidelines or settlement practices.

A company experiencing rapid growth is of particular concern because a claims audit will reveal how effective the claim diary system is working and the level of skills of the claim adjusters. How losses develop is a measure of the competence and experience of the claim adjusters – something that the actuary must know to select and weigh appropriate actuarial methodologies and assumptions. Here again, the use of industry loss data by an actuary is no substitute for verifying the integrity of underlying data

*continued on next page*

in any loss reserve study. At a minimum, actuaries must first assure themselves that company underwriting, claims, and reinsurance practices comply with industry standards before applying industry factors to underlying data, whether it is premium or loss data.

## Reinsurance

Setting aside assumed reinsurance for the moment, an insurer's ceded reinsurance program has significant influence on the actuary's assessment of net loss reserves. Ceded reinsurance can serve many uses from providing financial capacity and stabilizing operating results to reducing exposure on particular risks or classes of risks and protecting against catastrophes. There are also many types of reinsurance from proportional pro rata to excess of loss and facultative.

Excess of loss and facultative contracts are the most challenging for an actuary and require good loss histories for the actuary to properly assess issues of claim frequency and severity in projecting patterns of reinsurance recovery in the future. If such patterns are very volatile, or the book of business is immature, it is common for an insurer and its reinsurers to agree to profit contingents and/or retrospectively rated premium adjustments on contracts. It is important for the actuary to have a basic understanding of the significant terms of the insurer's major reinsurance protections to insure that bona fide transfers of risk exist. It is also important for the actuary to be cognizant of surplus relief provisions outside of industry norms that can distort operating results and cause company data to be incomparable with industry experience.

Actuaries must explicitly comment on reinsurance and its collectibility in their actuarial opinions filed with insurers' annual statements. Any disputes with reinsurers, whether they have deteriorated to formal arbitrations or not, should also be sufficiently investigated by actuaries and accountants alike. Occasionally, reinsurance contracts include retroactive protection of loss events that occurred in the past. Subject to specific terms and other considerations, these contracts may be subject to deposit accounting rules.

Aside from basic timing differences with cedents' records, assumed reinsurance also raises some unique and challenging accounting issues for both actuaries and accountants.

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With respect to assumed reinsurance, the actuary must first ascertain whether the underlying risks are homogeneous or not and should identify the major production sources for possible additional inquiry. Assumed business can represent fronting arrangements given an insurer's licensing limitations, or it could be part of an intercompany pooling arrangement or strategic alliance with another insurer(s) with mutual interests. On the other hand, the insurer could have a "professional" book of property and/or liability reinsurance assumptions of like or disparate risks. The actuary needs to know the "profile" of the assumed book of business.

Given that a professional reinsurance program assumes business from numerous cedents – primary insurers and/or retrocessional reinsurers, there can be significant differences in how each cedent accounts for its production. Generally, reinsurance accounting is controlled by requirements applicable to primary insurance accounting that do not recognize the potential peculiarities of assumed reinsurance, some emanating from overseas. When the Financial Accounting Standards Board ("FASB") issued FAS 113 – *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, some wanted FASB to specify the accounting by assuming reinsurers and require symmetrical accounting by both parties to a reinsurance contract. FASB wisely declined to go into those uncharted waters. However, the actuary must be cognizant of how the insurer accounts for its assumed production. In addition to the inherent problems with timely reporting, different policy/contract year and calendar/accident year accounting treatments between cedent and reinsurer often preclude symmetrical accounting. In such situations, adequate disclosure is the appropriate course of action.

## Sarbanes-Oxley Act of 2002

The opinions of most people familiar with the requirements of SOX differ depending on what side of the fence they find themselves. Corporate managers complain about the exorbitant cost of Section 404 controls implementation and annual monitoring. And, in a bit of irony, the very accountants who gave rise to SOX because of the accounting profession's failed audit model are reaping huge financial rewards that CEOs and CFOs complain about. In some respects, SOX, and related rules and regulations promulgated by the SEC, are overly burdensome and typically bureaucratic through the one-size fits all approach.

What SOX has revealed is that the large accounting firms do not always have the industry talent and expertise to do the job at hand and this has not gone unnoticed by CEOs and CFOs. However, cost considerations aside,

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**Think Tank**

## Underlying Data Revisited…

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SOX or similar insurance regulatory provisions offer a unique opportunity for accountants and actuaries to work together in comprehensive assessments of insurers' control environments across all business disciplines, including underwriting, claims and reinsurance.

The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") recently released for public comment an exposure draft for smaller public companies reporting on internal control over financial reporting to comply with Section 404 of SOX. The draft articulates ways that effective internal control can be achieved in a more cost-efficient and practical manner by applying COSO principles that best fit each company's circumstances. One aspect that is discussed is broadening the pool of audit committee members. Last year I issued a forensic review report on a public malpractice insurer that was placed into rehabilitation in 2004. The audit committee was composed exclusively of medical doctors first associated with the insurer when it was a reciprocal before it was reorganized and went public. In addition to serious corporate governance issues, a finite reinsurance program was in place that by its design was intended to be risk free and one which allowed the company to grow recklessly. Although a side agreement did not exist, there were reinsurer relief provisions built into the contract that for all practical purposes made it impossible for any actuary to do "10-10" risk transfer modeling. More financially astute audit committee members could have changed the course of the company long before it got itself into its current predicament.

> What SOX has revealed is that the large accounting firms do not always have the industry talent and expertise to do the job at hand and this has not gone unnoticed by CEOs and CFOs.

### Summary

Much of what has been outlined here are reasonable expectations of knowledge that an actuary should possess as a basis for opining on the adequacy of an insurer's loss reserves. Unfortunately, despite continuing efforts by the NAIC for more actuary accountability, the caveats contained in actuarial opinions still shift the responsibility for much of that knowledge to others – company managers who may be motivated to be less than forthright in their disclosures and accountants who frequently are torn between their duty of independence and placating in order to retain their clients. However, SOX-inspired insurance regulations offer hope that more independent corporate governance and financial transparency disclosures will encourage actuaries, who are increasingly at risk of being swept up in failed promises, to be more skeptical. The representations of others may no longer protect them. ■

**Feature Article**

## Asbestos…

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variations in numbers of non-malignant claims and in average claim costs. Both economies are now moving towards targeting money on compensation for impairment so that differences due to unimpaired claimants and legal fees could largely disappear. Even after removing these elements though, large differences remain.

Asbestos was used worldwide and the problems it has caused are common across the world. However, the way that each economy responds to these problems is unique. There are some pointers to be gained from comparisons between US and UK experience, but overall the differences outweigh the similarities and future UK predictions will need to be built on UK experience. ■

Source data: Rand Institute Asbestos Litigation Costs and Compensation, An Interim Report (2002); Rand Institute Asbestos Litigation (2005) & UK Institute of Actuaries Working Party UK Asbestos – The Definitive Guide (2004).

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Feature Article

## Mediation…

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reinsurance, an arbitral or court award is no guarantee of success when it comes time to collect on the award. In reinsurance, companies are spread out throughout the world and some are protected by inconvenient, expensive and time consuming legal systems which often discourage and sometimes prohibit the enforcement of awards by foreign companies. Rather than risk the expense of gaining an award that is difficult to enforce, mediation fosters cooperation and participation in the settlement. By giving all parties a chance to shape the result and getting the approval of all parties, mediation increases the likelihood that a company will stand by its agreement and not merely retreat behind its domestic legal system.

Finally, mediation offers the parties a chance to address all issues. In arbitration and especially within the judicial system, the only issue that is addressed and resolved is the underlying legal dispute. Any outlying issues are left for another day. In reinsurance, this approach can be problematic because of the complex nature of the industry. However, in mediation, the parties can address not only the legally based dispute, but also any other issues they desire.[h] This not only prevents spending time and money in the future on addressing a problem, but it also promotes good relationships as both parties discuss their concerns and hopefully find an acceptable solution.

## Conclusion

In reinsurance, mediation is a viable and valuable alternative to traditional third party neutral resolutions, such as arbitration and judicial proceedings. While mediation may not involve formal legal proceedings, reinsurance companies would be well served to include experienced reinsurance lawyers in all their mediation sessions. Even with counsel, mediation provides not only economic advantages, but also maintains goodwill and preserves relationships in an industry in which parties will encounter each other frequently. While mediation may not always lead to an amicable result, it should be seriously considered as a starting point. ■

### Endnotes

a *See* Pollux, *Me Judice1*, 15-22 Mealey's Litig. Rep. Reinsurance 10 (Mar. 17, 2005) (commenting on general view that arbitration used to take three to six months, but now lasts one to two years).

b *See id.* (commenting on relative cost of mediation and arbitration).

c *See* Pollux, *Me Judice1*, 15-22 Mealey's Litig. Rep. Reinsurance 10 (Mar. 17, 2005) (noting "arbitrator billing constitute runaway expense").

d *Compare* Massuci, Deborah, *Securities Arbitration – A Success Story: What Does the Future Hold?*, 31 Wake Forest L. Rev. 183, 188 (1996), *and* Dembeck, Louise, *Book Review International Mediation - The Art of Business Diplomacy, by Eileen Carroll and Karl Mackie*, 10 Am. Rev. Int'l Arb. 265, 269 (1999). *See also* Twidgen, Simon, *If It's Broke, Fix It!*, 14-18 Mealey's Litig. Rep. Reinsurance 13 ( January 22, 2004) (stating most mediations last only one day).

e *See* Pollux, *infra* at 1 (stating best form of mediation involves not only business employees and skilled mediator, but also skilled lawyer to advise and support).

f Obviously, this does not apply to companies in run off, liquidation or rehabilitation.

g *See id.* ("Consider that the mediation process seeks to facilitate a settlement whereas the arbitration process seeks to adjudicate an issue.").

h *See id.* (commenting on mediation's ability to bring previously unrecognized nuances to forefront, and mediator's ability to reinforce and resolve issues arising out of these nuances).

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