ASSOCIATION OF INSURANCE AND REINSURANCE RUN-OFF COMPANIES

AIRROC® MATTERS

A NEWSLETTER ABOUT RUN-OFF COMPANIES AND THEIR ISSUES

Vol. 4 No. 3 www.airroc.org Winter 2008/2009

Message from CEO and Executive Director

Rocking into 2009

Trish Getty

By Trish Getty

The past four years since AIRROC was incorporated on December 14, 2004 have been incredible, particularly for me. I have watched this association grow legs in such a meaningful way. Our foundation remains solid as we continue to move forward in the run-off market's ever-changing world. A multitude of industry people have established face-to-face relationships through our membership and commutation event meetings, commutations have been accomplished, disputes have been resolved, associated run-off issues have been addressed through the AIRROC educational sessions, and "run-off" is no longer something to be ignored. Virtually all healthy ongoing writers will eventually have discontinued lines that go into "run-off."

On behalf of AIRROC, our thank you goes to the entire Publications Committee, particularly to Chair Ali Rifai and Editor-in-Chief Peter Scarpato. Over the last few months I have participated in their monthly conference calls which are not only informative but remind me of how much time committee members devote to "AIRROC Matters." Our newsletter has received numerous compliments regarding its timely articles and appearance. Along with our website and marketing

continued on page 17

AIRROC — "There is no Business like Run-Off Business"

By Kari Paukku

Introduction

Doom and Gloom is often related to the moment when a company ceases to actively write new business and moves to the twilight world of run-off. The reasons for this may vary, but the challenges are the same.

In this article we will highlight some of the issues that are of importance when aiming to run a successful run-off operation. Proactively designed run-off will pay back the investments made in management, staff and IT.

An example of this is a real-life case study included at the end of the article.

continued on page 7

Was it such a Payne?

By Mike S. Walker and James Bolton

The advisers behind the EW Payne Pool Scheme were recently presented with the Market Initiative of the Year award by the Association of Run-Off Companies at their annual legacy awards ceremony. The managers are Reinsurance Solutions Limited, with KPMG and Edwards Angell Palmer & Dodge as the advisers.

On presenting the award, the chairman of ARC referred to this scheme as addressing "one of the key imperatives of the legacy management sector – to achieve finality and release for all stakeholders in a transparent, consistent and economic way." The scheme also potentially provides a template for dealing with the longstanding problem of London market underwriting pools.

> *The scheme also potentially provides a template for dealing with the longstanding problem of London market underwriting pools.*

Just like live insurance and reinsurance, run-off is also a business and needs to be treated that way. However, the point is that the business environment has changed.

Many such pools were established in the 1960s and 1970s. A large number were broker driven with an underwriting

continued on page 10

Notes from the Editor

The Best is Yet to Come…


Peter Scarpato

By Peter Scarpato

Hopeful words amidst the global economic crisis, but particularly apt to the Publications Committee's goals for your newsletter. And to achieve that goal, we are pleased to announce the formation of our Advanced Planning Committee, comprised of Michael Walsh, Maryann Taylor and Nicole Hicks-Pharr of Boundas, Skarzynski, Walsh & Black and Larry Zelle of Zelle Hofmann Voelbel & Mason. Working with me, Trish Getty and our Design/Production team, the APC wants to hear from you if *(a)* you have ideas or suggestions for future articles, roundtable interviews or themes for Special Editions *(b)* you wish to submit an article, sit for an interview or contribute as a Special Editor, or *(c)* you have contributions for our Present Value page which updates members on events and people in the run-off news. You may share your thoughts direct with all members of the APC by using a convenient email hyperlink – **Advance Planning Committee**.

On to our current offering. From systems to commutations, audits to schemes, and acquirers to providers, this edition covers the veritable gamut of all things run-off. We begin with Kari Paukku's *There is no Business like Run-Off Business,* addressing the strategic, operational and systems' challenges faced in making your run-off a "business." In *Was it such a Payne?* Mike S. Walker and James Bolton provide a fascinating postscript to the EW Payne scheme of arrangement, offering background to the Pool, reasons why finality was desirable and a review of the stakeholders' major challenges. Addressing a core theme of AIRROC, *The Power of Commutations,* Chris Reichow and Neil Martin begin with the basic reasons behind commutations' global predominance and launch to current stimuli, including the subprime crisis, for their continued popularity. With our Chair Ali Rifai, I had the pleasure of conducting a revealing roundtable with Kathy Barker, Ian Marshall and Richard Hershman, to delve into the many facets of *A Comparative View of Run-Off Providers in the US vs. UK and EU.* In their pair of articles on another cornerstone in the run-off model *Reinsurance Auditing for the 21st Century* and *After the Reinsurance Audit,* Donald Wustrow, John Kelly, Richard Hughes and Bart Frazzitta outline the benefits of data mining and phases of the audit process. And, Mark Shepherd helps us look ahead in *Trends in the Acquisition of Insurance Companies in Run-Off,* a careful analysis addressing the reasons for rising prices and popularity of the asset class, and offering optimism beyond our current credit nightmare.

And of course, Trish Getty's *Rocking into 2009* extols the continued success of this fine organization, Nigel Curtis' *Present Value* gives the low down on current events and KPMG keeps us up to date in *KPMG Policyholder Support Update.*

So enjoy our new edition, contact our APC, look favorably ahead and, since we are your voice in the run-off world: Let us hear from you. ■

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.

AIRROC® Matters– In this Issue

Vol. 4 No. 3 • Winter 2008/2009

Copyright Notice

AIRROC® Board of Directors

AIRROC — "There is no Business like Run-Off Business" *continued from page 1*

Kari Paukku

Make your discontinued business a business

Just like live insurance and reinsurance, run-off is also a business and needs to be treated that way. However, the point is that the business environment has changed. Active business is premium driven whereas in run-off management focus will turn to claims. Change requires different talents. The key question is how to make your discontinued business a business?

The challenges can be divided into three groups: strategy, operational and system. We will address, briefly, the first two issues before moving onto the IT requirements, as these make the background for everything else.

1. Strategy - *"Where there is a will there is a way."*

The GOAL - what do you want to achieve?

To be in run-off there is either an internal or an external reason - but there is a reason. When this initial hurdle has been overcome the next step is to make the best of a bad situation. This requires you to recognise the benefits of run-off as well as identifying the interests of the different stakeholders, up-front. It's important to define, in advance, what you consider a successful run-off to be.

Among the options are:

- Run-off to natural expiry (Passively).

  The traditional approach still widely used, especially outside the UK.

  Pros: Few or none.
  Cons: Liabilities remain on the balance sheet, long term commitment and costs.

- Run-off to natural expiry (Pro-actively).

  This is common in the UK often with the implementation of an effective commutation program.

Kari Paukku designs and implements IT systems to serve the needs of the insurance industry and has been involved in insurance, reinsurance and run-off since 1987. He can be reached at kari.paukku@re-sys.co.uk.

SYSTEM		
Migration	Daily operations	Commutations / Schemes

OPERATIONAL		
Change management	Risk management	Finality management

STRATEGY		
Planning	Outsourcing	Exit

Pros: Faster resolution of liabilities and reduced costs.
Cons: Liabilities still remain on the balance sheet, still has a long term commitment and costs, while reduced, are still high.

- Run-off to Finality (Pro-actively with Finality solution).

  If a sale or portfolio transfer is not possible, schemes of arrangement can provide the finality the company is looking for.

  Pros: Achieves finality, flexible, short term commitment, greatly reduced costs.
  Cons: Requires "sufficient connection" with England, not available for all books of business.

2. Operational - *"It's all about the people."*

Once the run-off strategy is decided the focal issue is to find the right management team and employ qualified staff, in house or outsourced, to be able to execute the strategy.

3. System- *"Tomorrow is a busy day ."*

The system that manages the run-off should support the strategy. The requirements of a run-off are both process and knowledge based, thereby putting pressure on the system's performance and reporting.

The more disparate systems the company has, the more it must rely upon Excel spreadsheets and Access databases just to get the job done. This highlights the need for a single system that can incorporate all of the data. Moreover the single system must provide the required processing

continued on next page

AIRROC – "There is No Buisness like Run-Off Business" *continued from Page 7*

and reporting solutions to enable the company to achieve its goals.

Companies that try to find workarounds to overcome the inadequacies of their systems by e.g. developing a separate data warehouse solution are just hiding the real issues.

The effects of this are then reflected in all the relevant areas of run-off, e.g.

- Knowledge of financial and contractual relationships.
- Processing of every-day transaction.
- Commutation work, from set up to processing and policy closure.
- Haphazard and disjointed reporting.

System issues should be addressed as early as possible in the run-off in order to get the best results. We all know that "tomorrow is a busy day".

The IT solution should be approached from two angles:

- Processing : By having well defined processes in place the performance is enhanced.
- Reporting: A single source to provide the required reporting on time, consistent and accurate.

All of the above is clear, common sense. So why is that run-off operations often continue to be managed using the same systems they used while "live"? Surely this cannot be optimal. An IT system designed for "live", premium driven business, cannot be "fit for purpose" for run-off, where the premium is rare and the focus is on claims and liabilities as well as finding out the financial and contractual relationships that exist between the various parties.

Common arguments given for doing nothing

A common mantra when arguing against any IT investment in run-off is "garbage in - garbage out".

Here the argument is that if the data is bad in the old system(s) any system upgrade will not make it any better.

This is simply not true. A good system will provide the ability to improve the data. It's all part of the run-off process.

In a proper system errors in data, or even missing data, can be corrected. In older systems it is not that uncommon that even the simplest of corrections is impossible. Having several systems in place doesn't help matters as everything becomes unnecessarily complicated. All this prevents the company in run-off from performing to its' potential.

With a dedicated run-off system, garbage in can become quality data. The resulting knowledge, based on good data, improves competitiveness and allows the company to better define and execute its strategy.

A common mantra when arguing against any IT investment in run-off is "garbage in - garbage out".

Today, consolidation of systems can and must be done in a timely fashion, with a fixed cost and without any fear of losing data. This can be done in a way that it doesn't disturb existing systems and the "switch-over" can be tested and implemented when it's assured that everything works as planned.

Other excuses for delaying action, such as below, are usually just that - excuses!

- Conversion is difficult, takes too long and is costly
- Demand a fixed cost and fixed time conversion.
- We are almost there – there is no point at this late stage to do anything.
- True and false. Yes, if you are very close to the end of run-off it may be that there is no point to start this kind of exercise. Experience has shown, however, that things usually take far longer than expected. This needs to be considered very carefully with perhaps the initial view that yes, we should just do it.
- It's too risky – our operation would be put in jeopardy.

For example with the new virtualization techniques all work can be done in a way that the current operation is not at risk at any point. The new system can be taken into operation after it has been ensured that it has the required functionality and that the overall results match the expectations. There would, at all times, be the option to fall back to the existing, old systems should any issues need to be resolved.

In Conclusion

A proper system supporting the discontinued business operation will result in enhanced performance of the run-off. This results in better operational results and adds value for all stakeholders.

continued on next page

Efficiency pays back! – A case study

continued from previous page

Introduction

This case study presents a real-life example of how a live insurance company having several books of discontinued business solved the "liability issue" that the run-off presented. The simplified case also shows how the receiving company approached the run-off and what steps it involved.

1. The original company had several books of business placed in run-off. Eventually these were transferred to a separate company owned by the parent.
2. The new run-off company managed the run-off using the old systems. It can be argued that these systems where not "fit-for-purpose". The run-off focused on a commutation drive using a manual approach. Processing of a mid-sized commutation could take months and involve several employees.
3. Eventually - in search of finality - the run-off company was sold to a third party.

While the original run-off company had five different systems to manage the data the buyer had a clear vision of converting the data to one purpose-built system.

The five original different systems were:

- One proprietary system for inwards business (Mainframe).
- One proprietary system for outwards business (Mainframe).
- One proprietary system for losses and claims (Windows server).
- One "solution" for IBNR (actuary specified, proprietary, implemented using different tools, Excel etc).
- One Microsoft Access system to manage two separate, smaller portfolios.

As can be imagined, the above structure had its share of problems!

The problems

- The data was in separate systems and the same data appeared in several places, quite often not matching between the separate systems.
- Personnel with knowledge of the proprietary systems were disappearing.
- The mainframe systems were expensive to maintain.
- The systems were not "fit-for-purpose" – i.e. not designed for run-off.
- Reporting was largely manual. The process involved collecting the required data from the different systems and transferring it to a common "spreadsheet", then modifying the data and finally producing the required report. The process was both time consuming and error prone.
- Commutation related issues:
  - It was difficult to find all the relevant parties and policies to make up the commutation schedule.
  - The balance, outstanding loss and IBNR figures needed to be collected from several different systems several times and was out of date by the time it was produced.
  - Processing of commutations was delayed as the result needed to be manually entered into several systems.

While the original run-off company had five different systems to manage the data the buyer had a clear vision of converting the data to one purpose-built system.

The solution

- All data was converted and consolidated into one, purpose built, system consisting of:
  - Inwards and outwards policies.
  - Loss and claim information.
  - Outstanding losses/case reserves.
  - Loss and premium deposits.
  - IBNR-data and calculations.
  - Letter of Credit information.
  - Pools, etc.

This resulted in

- All data in one place and only one copy of each.
- An online principal to principal ledger.
- The possibility to enhance the data, such as:
  - add and change policy participants
  - add and change policy information
  - create policies, claims and losses
  - move claims to correct contracts
  - split pools as required
  - split outwards policies at principal level.
- Support of the entire commutation procedure including automated processing of the settlement (in multiple currencies if necessary).
- A flexible reporting solution whether for management, back-office or bookkeeping personnel.

The end-result was a solution that allowed the run-off to be managed in a pro-active, successful and profitable way.

The end result

The end-result was a solution that allowed the run-off to be managed in a pro-active, successful and profitable way.

This was achieved in a relatively short time (a few months) and at a cost that had a payback time of less than 12 months.

Additionally, the management now had a clear view of the overall situation, enabling it to set the goals and see the tasks ahead. Having a system in place that supports the run-off process at every step helps both individuals and the company as a whole to perform well to the benefit of all stakeholders. ■

Feature Article

Was it such a Payne? *continued from page 1*


Mike S. Walker


James Bolton

agency writing business often on behalf of a vast number of companies (participants). They were often complex as there were many different stamp combinations, fronting by certain participants and common reinsurance programmes.

The EW Payne Pools were collectively one of these complex London Market underwriting pools. The sanctioning of schemes of arrangement for 82 participants of the EW Payne Pools in July 2008 demonstrates that true finality can be brought to these complicated structures. This article provides a background to the Pool itself and the reasons why finality was so desirable; a review of the major challenges faced by the stakeholders of the Pool in trying to find a unified solution and a summary of the innovative Scheme features designed to simplify the method of achieving finality.

The Pool

The EW Payne Pool underwrote London Market excess of loss business from 1960 until going into run-off at the end of 1985, when in common with the rest of the market, the Pool began to experience an explosion in asbestos and pollution claims, particularly originating from the US. Over the next 20 years the Pool experienced many of the difficulties common to other London Market Pools:

- Payments to policyholders slowed down as participants exercised credit control practices typical of a run-off environment;
- Huge volumes of small transactions to be processed put a significant strain on the outdated legacy systems which struggled to cope with the information requirements of Pool participants and the fact that some payments were not being made;
- Most participations were small and participants had little in-house knowledge of the Pool and their participations which meant they rarely updated the Pool managers for events which affected their exposures;
- Increasingly onerous and costly administration as a result of insolvencies, mergers, commutations and Part VII transfers; and
- Deteriorating claims experience.

The Pool participants potentially faced a further 20-30 years before the Pool was likely to be run-off in the normal course. The Pool stakeholders were keen to bring accelerated finality to the Pool and it was our view that the inherent flexibility of the scheme of arrangement process could bring their association with the Pool to an early closure. No one associated with the Pool, however, underestimated the challenges that the stakeholders would face in trying to find a unified solution.

The Pool stakeholders were keen to bring accelerated finality to the Pool and it was our view that the inherent flexibility of the scheme of arrangement process could bring their association with the Pool to an early closure.

The Challenge

Conflicts in underwriting pools are easy to find and difficult to manage. Focusing the energies of the various stakeholders of the Pool on a unified exit solution was crucial to its success. This could only be achieved by building support for the Scheme from a critical mass of key stakeholders, maintaining that support over the course of the Scheme's development and consolidating that support by focusing on bringing as many other stakeholders as possible into the process.

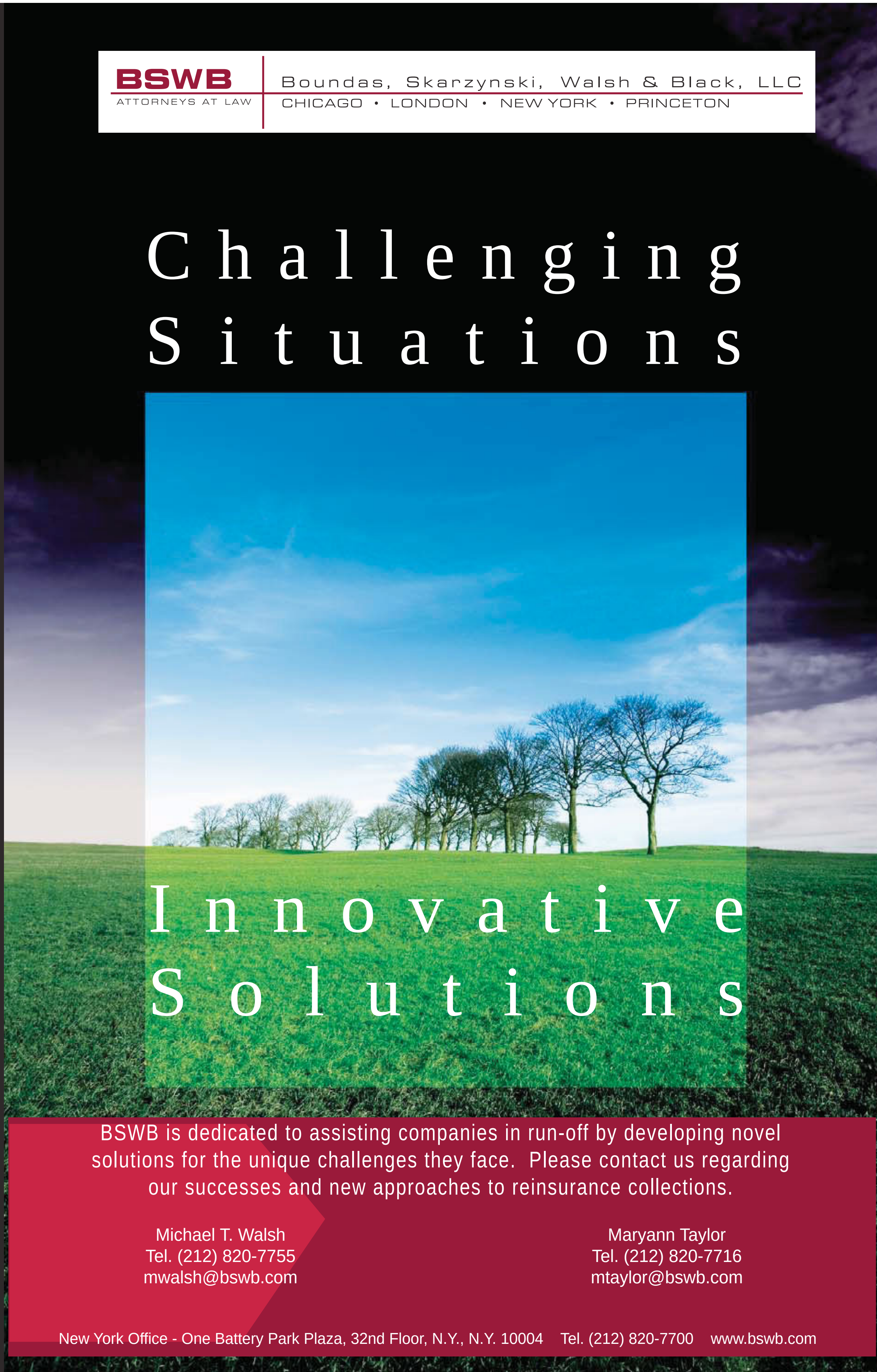
How was this achieved?

The most important actions taken to provide the early momentum that was necessary to get support for the Scheme off the ground were the face-to-face meetings that took place with as many of the stakeholders as possible. In order to demonstrate confidence, it was necessary to deal

continued on page 12

Mike S. Walker is a Partner and head of the KPMG Restructuring Insurance Solutions team in London. He can be reached at mike.s.walker@kpmg.co.uk.

James Bolton is a Director of KPMG in London and can be reached at james.bolton@kpmg.co.uk.


BSWB
ATTORNEYS AT LAW
Boundas, Skarzynski, Walsh & Black, LLC
CHICAGO • LONDON • NEW YORK • PRINCETON
Challenging
Situations
Innovative
Solutions
BSWB is dedicated to assisting companies in run-off by developing novel solutions for the unique challenges they face. Please contact us regarding our successes and new approaches to reinsurance collections.
Michael T. Walsh
Tel. (212) 820-7755
mwalsh@bswb.com
Maryann Taylor
Tel. (212) 820-7716
mtaylor@bswb.com
New York Office - One Battery Park Plaza, 32nd Floor, N.Y., N.Y. 10004 Tel. (212) 820-7700 www.bswb.com

Was it such a Payne? *continued from Page 10*

with stakeholders concerns on the spot and to give them a clear and robust indication of the likely financial consequences of the Scheme. This meant we needed to focus on obtaining a clear understanding of the key features of the proposed Scheme and the financial data in the early phases of the project.

Conflicts in underwriting pools are easy to find and difficult to manage.

A robust and flexible financial model was built at the outset which, amongst other things, allowed for the production of principal-based statements showing the value of unpaid and outstanding reserves, and the allocation of these amounts to the underlying creditors.

It was also important to demonstrate that the complexities caused by the number of pool participants, their differing participations by year, the commutations and corporate restructuring they had undertaken, could be dealt with accurately and in a timely manner to reflect the commercial reality of their current involvements in the Pool. By way of example, one of the most difficult challenges to overcome was the fact that the London run-off market is very fluid. Companies were still operating commercially throughout the consultation period and commutations between the parties continued at a prolific rate. Faced with a constantly moving target, the data had to be adjusted weekly to reflect the substantial commutation activity taking place.

The policy of keeping stakeholders appraised of the latest position with regard to the level of support from other key participants and key creditors, particularly those who were undecided as to whether or not to support the Scheme, worked to create a "snowball" effect of support; as more and more participants and creditors agreed to support the proposal then it became easier to obtain support from other key stakeholders who didn't want to miss out on the obvious benefits of finality for the Pool.

What were the features of the Scheme that made it easier to support?

The overriding concerns were simplicity and transparency; the Pool relationships were complex enough in their own right without adding an additional layer of complexity through the design of the Scheme itself.

The Scheme's promoters considered the estimation methodology as one area which is often difficult to interpret. A simple but innovative application of a loading on outstandings, by claim type, to calculate IBNR, as a replacement for a more detailed and complex actuarial methodology was considered. The validity of this approach was tested with a number of key stakeholders in the process who were able to support the proposed loadings for asbestos, pollution and other claim types.

The Pool managers had done a considerable amount of work in reflecting the outcome of commutations, business transfers, mergers and acquisitions in the Pool's records. Rather than being put to one side and filed, this information was used to populate voting forms. This made the process of submitting a vote in the proposed Scheme far simpler.

These voting forms became the basis for the claim forms, again simplifying the process for creditors. Furthermore, these voting forms also represented a commitment from the participants to the creditors of the Pool that they would pay the amounts included on the voting form regardless of whether or not the creditor submitted a claim form (unless the parties became subsequently aware of commutations that had not been reflected on it).

The Result

The High Court sanctioned the 82 Schemes on July 17, 2008 after creditors voted overwhelmingly in favour. The Schemes bar date passed on 16 December 2008, and we expect creditors to see settlement of their Scheme claims during the second quarter of 2009.

For policyholders of the Pool, this represents a much earlier payment of future liabilities and a significant saving in future run-off costs. It is true finality for their Pool liabilities.

The EW Payne Pools template could be used to resolve the key issues and bring true finality to many other pools in run-off.

This is a terrific result for all stakeholders in the process. Whilst the number of pool participants was a significant barrier to getting the scheme underway, simplicity and transparency were key in achieving commitment to the process. The scheme of arrangement process has been able to provide a solution to the problems associated with the run-off of a complex underwriting pool. The EW Payne Pools template could be used to resolve the key issues and bring true finality to many other pools in run-off. ■

Think Tank

The Power of Commutations

Chris Reichow

Neil Martin

By Chris Reichow and Neil Martin

Why are they Popular

To an observer of the reinsurance market, it appears more commutations are taking place with more companies participating than ever before. While commutations may have originally developed as a solution, such as accelerating the closure of insolvent portfolios, now their popularity has increased due to the wide range of benefits which they offer to the participants:

- reduce the potential for claims deterioration
- enhance collection as a means of resolving a dispute
- mitigation of solvency risk
- maximization of offset management.

Commutations have been widely considered the most popular exit strategy because they are manageable and can be relatively quick and inexpensive to finalize even when using a third party.

Given that commutation is generally a voluntary process between parties (not considering commutation clauses), it is clear that trends are influenced by the potentially distinct perspective of the parties. A company's stance to commutations will differ in terms of their interest, strategy, knowledge of underlying exposures and execution capability.

Commutations have been widely considered the most popular exit strategy because they are manageable and can be relatively quick and inexpensive to finalize even when using a third party. They bring certainty and eliminate the problems of managing ongoing operations, eliminate continued negotiations on claims going forward and the threat of arbitration with all of its associated costs.

These basic reasons demonstrate why commutations are globally popular, however, there are also specific current stimuli for their continued popularity:

- regulatory penalties against insurers or reinsurers for non protected or collateralized reinsurance assets
- control of inwards exposure to traditional toxic tort as exposure modeling becomes more sophisticated and reliable
- subprime crisis may cause broad scale commutations between affected insurers and reinsurers after the full impact of the crisis is understood
- companies finalize selected books of business pre or post re-domestication
- increased shareholder and capital market pressure to make the most efficient use of capital and remove uncertainty from the company's books.

Specific markets' views

Depending on the location of the company and the underlying exposures, there are often different objectives for performing commutations.

In the UK, commutations now are almost always undertaken for broad strategic reasons rather than previously where factors such as administrative savings and/or concerns about solvency were the prime drivers. It appears that the volume of party to party commutations is trending down in the UK and it is speculated this may be due to increased Solvent Scheme activity, mergers/acquisitions or Part VII transfers.

In Continental Europe, activity is mostly limited to the run-off arena and associated with administration and solvency. It has been debated that the implementation of the European Reinsurance Directive in 2007 and the forthcoming Solvency 2 in 2013 will trigger greater commutation activity. It is believed that these regulatory drivers will force companies to make the most efficient use of their capital which should lead to non-core books being put into run-off and potentially being downsized by commutation prior to sale or transfer.

continued on page 14

Chris Reichow is Vice President of PRO IS Inc. and can be reached at chris_reichow@prois-inc.com.

Neil Martin is Manager of PRO Insurance Solutions Limited in the UK and can be reached at neil_martin@pro-ltd.co.uk.

The Power of Commutations *continued from previous page*

While in the US many companies, particularly ongoing companies, consider commutation primarily as a tool for management of reinsurance solvency and dispute resolution. However, as companies experience the benefit of commutations, more than just as a management tool, they are becoming more strategic in the business model as companies determine whether they want to exit a market or close out a portfolio.

…as the companies' experience with commutations grow, the value as a strategic tool increases and companies' commutation strategies vary significantly by the status of the counterparties – live vs. run-off, small vs. large multinationals…

The industry view

We posed questions to a number of experienced commutation managers and were struck with the diversity in responses. We asked them to rate factors that most influenced commutation - geography, size of portfolio, size of liabilities, lines of business, cedant profile or cedant willingness. Most of the differences in rating were somewhat explained by their perspectives as a manager for a live company, a liquidated company, a service provider on behalf of a pool versus a service provider on behalf of a company in a scheme of arrangement.

Live companies tended to rate the willingness of cedants to commute and the size of the liabilities as the largest impact, where as run-off companies tended to consider the lines of business. Most agreed that geography was the least important factor. However, it was agreed that as the companies' experience with commutations grow, the value as a strategic tool increases and companies' commutation strategies vary significantly by the status of the counterparties – live vs. run-off, small vs. large multinationals, insurers vs. reinsurers, financially distressed vs. financially strong, resourcing commutation as a tool vs. a function.

- Live companies tend to consider commutation as a necessary tool to address solvency or dispute management and not as a preferred and defined strategy and even resourced function.
- Run-off companies tend to consider it based on extent and quality of ceded leverage.
- Run-off's modeled for acceleration tend to be resourced for commutation while those playing out in a longer term model do not cite that they are particularly influenced by the difficulty in assessing ultimates.
- Companies with both ceded and assumed exposures tend to have a hybrid strategy that reflects maximizing a ceded offset and mitigating inwards risks.

As more companies are put into run-off, sold or Part VII transferred, commutations are being viewed as an opportunistic tool to influence sellers, buyers and third party managers.

Where commutations are considered the best strategy

Realizing asset value

Commutations are undoubtedly the best strategy in terms of realizing a reinsurance asset, specifically when conducting global negotiations with a counterparty across different entities and pursuing other strategic alternatives such as managing the "front end" of the inwards book without having to consider reinsurance implications. The decision to commute is determined by the facts and circumstances involved such as whether it is a credit risk or an exit strategy. Commutation can be an excellent strategy when the ultimate liabilities are determined with a high degree of confidence with today's advances in actuarial modeling.

Commutation can reduce the provision for uncollectible reinsurance thus improving the management of the overall credit risk.

Solvency risk

When there are solvency concerns with a reinsurer, a counterparty is prompted to work to remove the credit risk element. Commutation can reduce the provision for uncollectible reinsurance thus improving the management of the overall credit risk. It can be a tool to reduce the amount of aggregate exposure to a single reinsurer that may challenge the overall reinsurance asset from an enterprise risk perspective. Even initially highly rated companies can weaken and create the need to establish a credit default provision and in light of the past six months, it is even more difficult to predict who that might be.

continued on next page

The financial failure of a reinsurer will leave the cedant with minimal expectation of a recovery and collections will likely be drawn out over time. Therefore, a cedant is better served seeking to commute today for a much larger amount, albeit not 100%, rather than waiting to see what they receive and when through an insolvency. A counterparty may be more inclined to take 70 cents on the dollar today than risk getting 25 cents or even zero after a drawn out insolvency.

Alternatively, a reinsurer will often prefer commuting and paying a reinsured rather than a liquidator if that reinsured is in financial difficulty. The reinsurer must be conscious that commuting shortly before a reinsured becomes insolvent may prompt the liquidator to pursue funds under a voidable preference argument. Therefore, due diligence into the reinsured's financial position and the likelihood of such a scenario should be vetted before proceeding. State approval of commutations should be considered depending on the status and relationship of a counterparty with its regulators.

Risk of claims deterioration

Coinciding with the insolvency factor for both sides of the transaction is the danger of staying on the risk and the unforeseen claim deterioration that it could bring. For the reinsurer, a view of the claims universe at year end may appear stable and minimal. In spite of this, an unforeseen wave of claims can cause serious financial problems for the reinsurer. By reaching an agreement through commutation, the reinsurer closes out its exposure and reduces the potential for claim deterioration.

Pre-cursor to portfolio exit

Commutation is also appropriate when a company wishes to accelerate a run-off, to put itself in a position to later execute strategic exit alternatives such as sale, transfer or scheme. For example, the reinsurer may choose to take an aggressive approach to exiting by targeting its larger cedants and pursuing commutation. This approach will operate to reduce the size of the book of business while at the same time send a message to the remaining cedants that the reinsurer's exit strategy is moving forward and negotiating a commutation earlier rather than later in the reinsurer's exit plan could be simpler and more valuable.

Further, by simplifying and reducing the reinsurer's portfolio through a series of commutations, the portfolio may now become a more valuable asset that can be sold. Thus, the reinsurer has successfully exited and for more value than originally anticipated.

Conclusion

Commutations are considered by many as the best strategy when compared with other solutions that are available to a party such as arbitration or immediate portfolio sale. They are informal and can be monitored as a strategic tool. Commutations are seen as flexible which can be relatively quick and inexpensive whether handled in-house or through a third party. It is a final settlement which brings certainty - in terms of time, scope and final economic outcome.

> *…it is clear that the use of commutations is an essential part of achieving a sound financial result from an ultimate exit solution.*

The commutation managers that we consulted with, generally agreed that the best commutation results were achieved when they understood the risks of the exposures, employed a multidisciplinary team of claims, actuarial and reinsurance experts, and built trust through compromised negotiations with the counterparty. All agreed that the use of third parties throughout the process improved the overall commutation result.

Whether commutation can be proven to be the most popular exit strategy is debatable, but it is clear that the use of commutations is an essential part of achieving a sound financial result from an ultimate exit solution. As discussed above, there are a number reasons commutation, whether on assumed or ceded business, appeals to companies who want to:

- cut costs by eliminating labor intensive administration and claim management or reporting
- protect the balance sheet by minimizing reinsurance credit risk
- reduce the potential for claims deterioration
- achieve negotiated results through avoiding costly contractual dispute
- maximize its financial position for a potential sale or transfer.

Whatever the reason, commutation remains a popular and reliable tool that cedants and reinsurers continue to look to when exiting a contract. ■

Present Value

By Nigel Curtis

Run-Off News

Randall & Quilter acquires KMS

September 2008; Randall & Quilter, the AIM traded run-off management service provider and acquirer of solvent insurance companies in run-off, acquired KMS, the London-based provider of insurance run-off services, through the acquisition of the holding company, Continuum Holdings Limited, for a total cash consideration payable on completion of £1.78 million. See www.rqih.uk.

Enstar acquires Unionamerica

October 7, 2008; Enstar Group Limited announced that its wholly-owned subsidiary, Royston Run-Off Limited, had entered into a definitive agreement for the purchase of Unionamerica Holdings Limited from St. Paul Fire and Marine Insurance Company, an affiliate of The Travelers Companies, Inc., for a purchase price of $343.4 million. Unionamerica Holdings Limited is comprised of the discontinued operations of Travelers' UK-based London Market business, which were placed into run-off between 1992 and 2003.

NY Liquidation Bureau seeks bids for Midland

The New York Liquidation Bureau announced at the annual AIRROC/Cavell Commutation & Networking Event in October, 2008 that it will solicit proposals from private run-off companies to take over the liquidation of Midland Insurance Co.

Midland, placed in liquidation in 1986, wrote a substantial amount of excess coverage for major Fortune 500 companies. According to the Bureau, the Midland estate has assets of $924 million ($38 million in cash) and liabilities of $2.9 billion.

PRO receives Lloyd's Run-Off Broker Accreditation

Insurance run-off specialist PRO Insurance Solutions is now an accredited Lloyd's Run-Off Broker. This status enables PRO to provide a complete range of Broker Collection Services to both new and existing clients, with full access to the London Market accounting and settlement systems. The company is a member of the Swiss Re Group.

People

Paul Corver has been appointed as the new Chairman of ARC, the UK trade body for legacy management professionals. He succeeds Philip Grant who, after seven years on the board, the last three as Chairman, has decided to step down.

Colin Johnson and **Mike Palmer**, Directors of Helix UK limited, have joined Randall & Quilter the Insurance Run-off Services and Acquisition specialists. Colin Johnson co-founded Helix in 1995 and was Managing Director. Mike Palmer, who joined Helix from Axiom 6 years ago, played a central role in its strategic development.

Jerry McArthur has also joined Randall & Quilter as CEO of its US and Bermuda operations. Mr. McArthur was previously chairman of Capita Commercial Insurance Services, where he was responsible for its run-off, finality, London market and international operations.

Neil Wood, **Chris Luncheon** and **Graham Wollaston** have joined PRO from Guy Carpenter. Neil Wood, who was General Manager of the ReSolutions Claims Broking Department, will head-up PRO's Broker Services Team. Chris Luncheon, who was at Guy Carpenter for over 20 years, will act as the front line claims broker in the Broker Services Team. Graham Wollaston will assist with all credit control issues and the transfer of business from brokers. He has over 40 years of experience in the reinsurance market, including both broking and underwriting and at Equitas. ■

If you are aware of any items that may qualify for inclusion in the next "Present Value"; upcoming events, comments or developments that have, or could impact our membership; please email potential items of interest to Nigel Curtis of the Publications Committee at ncurtis@fastmail.us.

Message from CEO and Executive Director

continued from page 1

brochures, it reflects our rebranding, a colorful energetic representation of "the winds of change." We also thank our advertisers who give financial support to the production of "AIRROC Matters." We would appreciate your suggestions for article topics in the three regular editions of "AIRROC Matters" scheduled for 2009. Please send your suggestions to Peter Scarpato at peter@conflictresolved.com.

To meet your needs, we also solicit your ideas for topics you would like to see in AIRROC's membership meeting educational sessions. You can send your suggestions to Kathy Barker (Kathy_Barker@prois-inc.com) and/or Karen Amos (Karen.Amos@resmsl.co.uk). Your support makes us an even better association; the place to belong during your entire run-off.

We look forward to seeing you on February 11, 2009 at our one-day commutation event and many of you at our February 12, 2009 AIRROC membership meeting. Details of both events will be posted by mid-January on our website (www.airroc.org) through which you can already register attendance for each day.

AIRROC rocks! ■

Ms. Getty has been active in the insurance and reinsurance industry for over forty years, specializing in reinsurance claims. She has significant experience evaluating liability and reserve adequacy and planning and implementing claims and operational audits. In 1996, Trish expanded her focus to include sales and marketing of reinsurance services. In addition to active business, Trish has provided consulting services to regulators for the reinsurance administration of troubled and liquidated companies. She can be reached at trishgetty@bellsouth.net.

Mark Your Calendar

May 14, 2009: AIRROC Membership Meeting at the offices of Dewey & LeBoeuf LLP
1301 Avenue of the Americas, New York, NY 10019

July 23, 2009: AIRROC Membership Meeting at the offices of Dewey & LeBoeuf LLP
1301 Avenue of the Americas, New York, NY 10019

October 19, 2009: AIRROC/Cavell Commutation Event. Further details will be provided nearer to the time.

(AIRROC Members and Non-members who participate on AIRROC committees, presenters or those invited by special invitation from AIRROC are eligible to register for attendance at the AIRROC membership meetings.)

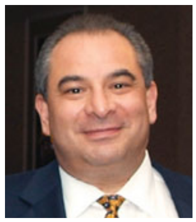
AIRROC

Feature Article

A Roundtable Discussion: A Comparative View of Run-Off Providers in the US vs. UK and EU

Interview conducted, condensed and edited by Ali Rifai* and Peter Scarpato*

Peter Scarpato



Ali Rifai

Kathy Barker

Ian Marshall

Richard Hershman

Peter Scarpato: *Ali Rifai, chairman of the Publications Committee, and I would like to thank Kathy Barker, Richard Hershman and Ian Marshall for participating in this roundtable discussion on a topic of interest to our members, a comparison of UK versus US and EU run-off service providers. We'd like to have an open and candid discussion, and I begin with a very general question for Kathy: as background to the types of service providers needed in certain jurisdictions, what issues face run-off insurers and reinsurers in the US versus the UK? Are they similar, are they different, and if different, how so?*

Kathy Barker: There are a lot of similarities in what UK and US run-off companies face in terms of achieving the effective use of capital to reduce the impact to ongoing live business operations.

There are common issues with staff motivation and retention where knowledge and experience with a run-off focus is required. What is also common are the challenges of expense management relative to the book's tail. One more significant difference is the exit solutions available in the UK versus the US.

Ian Marshall: One additional comment as far as the difference between the UK and the US, the question of records, the completeness of records of companies operating in the London market. In earlier times, they relied on brokers to keep certain records, and that can cause issues today when trying to recreate the run-off company's position. Otherwise, Kathy hit the nail on the head.

> *...there are a lot of similarities in what companies in run-off are facing between the UK and the US in terms of achieving the effective use of capital so as to reduce the impact to ongoing live business operations.*

Richard Hershman: The other thing I'd like to add which probably would be a difference is which stakeholders might be engaged or active in the exit strategies based upon what the economics could be. One must place the regulatory differences in the US versus Europe and the UK in the context of how a regulator will view or work with the team to achieve a common goal of a successful run-off.

continued on next page

Kathy Barker is President of PRO IS, Inc., an affiliate of PRO Insurance Solutions Ltd. and can be reached at kathy_barker@prois-inc.com.

Richard Hershman is Senior Managing Director of FTI Consulting Inc. and can be reached at richard.hershman@fticonsulting.com.

Ian Marshall is Group Head of Consulting at Chiltington International Group in London and can be reached at imarshall@chiltington.co.uk.

**Ali Rifai is Chairman and Peter Scarpato is Editor of the AIRROC Publications Committee. They can be reached at ali.rifai@centresolutions.com and peter@conflictresolved.com, respectively.*

Peter Scarpato: *Richard, I was going to ask about the "typical stakeholders" behind some of the UK/EU versus US run-offs. Are there any differences or similarities between them and how might that impact the services provided to those constituents?*

Richard Hershman: I'll start and then let Ian address the overseas perspective. The first thing you must do to have a successful US run-off is get buy-in of the US insurance regulators to accept the run-off plan, the run-off team in place, and ultimately the oversight of a successful plan. The level of regulation will differ depending on what the plan is; if, however, you receive the regulators' full cooperation, you can implement the plan on a more normalized basis and move towards achieving the stakeholders' goals.

Ian Marshall: That's pretty similar in the UK. An entity entering run-off submits a plan of operations to the FSA, regardless of its solvency level. It really sets how it proposes to operate. That obviously requires buy in from the stakeholders and owners of the company and the regulators' concurrence to the plan being adopted.

This procedure has been in force for many years and in my opinion, it definitely led to a consensual approach between regulator, reinsurer or insurer in run-off, as well as service providers.

I think that sounds like a pretty similar process between the UK and the US although I think that the regulators might have a different process internally but it sounds to me like the basic objective is very similar.

Ali Rifai: *I have a couple of questions related to current happenings in the financial markets. Kathy mentioned the effective use of capital. In the old, pre-bailout plan days, companies entered run-off mostly because of their liabilities. They examined the liability side and didn't like how the liabilities were growing. It generally wasn't the asset side.*

Now that the asset side is an issue, do you think more companies are either going into run-off or looking at lines of business that don't need much capital and placing capital intensive ones into run-off? So, would there be more run-off opportunities or less?

My other question, "Is there an appetite for people to buy companies in run-off now with the capital markets the way they are?" Or is it going to be incumbent on the owners of these run-off companies to manage the run-off themselves?

Ian, you can give us the UK side? I'll ask Kathy and Rich to tell us what might happen in the US.

Ian Marshall: In time, we will see asset-driven run-off. As you observed Ali, old run-offs were liability-driven. But diminishing asset values, I think undoubtedly in some situations will lead to reduced solvency, and reduced solvency historically has always driven run-off.

> *…old run-offs were liability-driven.*

On your question whether the capital markets crunch might impact the availability of capital for acquisition of blocks of run-off business, that situation changes day-by-day. But today, in my view, it must be that the reduction of capital will reduce the capital available to purchase blocks of business and run-offs.

Richard Hershman: Just to shape this further, I am seeing some of the dynamic changes Ali referred to because we are retained on behalf of investors and creditors to analyze some troubled companies. It actually is changing to a much more integrated approach. Asset driven run-off is going to be a new phenomenon. The appetite for buying or managing run-offs is very large right now. There have been many approaches from people that have funding and have been waiting on the sidelines to make a move on this. And the next opportunity relates to deploying capital to take over companies on the edge and evaluate whether there is a chance for building value by continuing their existing business.

> *Asset driven run-off is going to be a new phenomenon.*

Ali Rifai: *Rich, to clarify that what you just discussed, are you saying that people are examining asset values and this is basically an asset play indicating a belief that assets are undervalued and it's an opportunity to acquire them at a reduced price and wait it out?*

Richard Hershman: Yes. They are examining both sides of the balance sheet much more carefully than ever before. Further, I define the assets not to be just those the company holds, but to be the company itself where the opportunity exists to obtain a company at a reduced value to enter into the insurance marketplace. It is

continued on next page

AIRROC

A Roundtable Discussion
continued from Page 20

opportunistic; there are hedge funds and other investors looking at the insurance marketplace as a good play in the future including recovery of undervalued assets.

Kathy Barker: Yes. I would agree. We are still seeing capital available and capital interested in opportunities in the traditional buying of run-off books, but also in terms of purchasing companies.

Ali Rifai: *And if the market's appetite to do this increases rapidly, are the buyers stepping into this arena going to be the money managers who will need run-off services from outside providers, or are they sophisticated buyers who have been involved in run-off before and will make judgments about use of outside vendors on a acquisition-by-acquisition basis?*

Richard Hershman: It's going to be both. You will have sophisticated people that understand what the play is and also those who don't understand it fully and will require the services of people who understand this business.

Kathy Barker: Yes. There are also firms not interested in investing in a huge infrastructure, and depending on the tail of the book, who will work with a service provider to manage the day-to-day operations relying on their expertise. They often may prefer to continue to look for other opportunities and leave the management to experienced staff.

Ian Marshall: Yes, that's how the markets developed in recent years and there's no reason to expect that will differ in the future.

Richard Hershman: I absolutely agree. It's the big reinsurer model. Write a billion dollars of premium with a staff of 100 rather than a billion with a staff of 500.

Ali Rifai: *What can the providers offer? What is your sales pitch to a new entrant? Why should they retain a provider versus trying to staff it themselves?*

Ian Marshall: It's at the point when an investor is looking at a run-off, a service provider should be able to provide support for the due diligence process and then moving on from there, if the investor is successful, to be able to offer the infrastructure to manage the business, either by absorbing the business into their own organization or, if the entity being acquired is large enough to operate it more remotely, largely using the service provider's existing management but using the staff of the entity being acquired.

Ali Rifai: *Now, one thing that Kathy had mentioned earlier is staff retention. Do service providers offer a better, more qualified employee pool because they don't have the same problems that a run-off company may have in offering long-term employment for the staff? Is that a selling point from providers, Kathy?*

> *…when an investor is looking at a run-off, a service provider should be able to provide support for the due diligence process and… be able to offer the infrastructure to manage the business…*

Kathy Barker: Yes, it is. The service provider can provide distance in managing the claims distinct from a capital source. A provider, depending on its size, can offer benefits by economies of scale. As Ian just referenced, service providers have the flexibility of tapping their pool of resources and can manage and develop working relationships with key cedants and reinsurers across their books of business that can provide improved opportunity for issue resolution.

Richard Hershman: I've lived through a couple of models. Years ago, we set up a company to do an $8 billion run-off and announced we were in the run-off business for the long term, to provide comfort to our staff that the work would be ongoing. There are generally two types of run-off staff. Those comfortable in the run-off business as a living who don't worry when the next assignment will come. And then there are those doing this one time only.

I think it works with either mentality; but it works better when the incentives are aligned as Kathy said earlier. If incentives are aligned, the service provider can be in the business of moving from one run-off to another or handling a one time deal. While there is more than one answer, you can get a good result from either type of approach.

Ali Rifai: *One thing Ian had mentioned is the support for due diligence. Do most service providers offer their services a la carte or on an all or nothing basis? Please list the services and which ones you provide a la carte?*

Ian Marshall: Chiltington certainly operates on an a la carte basis whether for the due diligence, the particular aspects the client wants us to examine, or the actual run-off services provided if the investor succeeds in acquiring the block of business or the entity. And, they might just outsource certain functions. Perhaps, as an example, the claims management or the reinsurance recoveries, retaining other functions themselves.

continued on page 23

A Roundtable Discussion *continued from Page 20*

One relevant fact as far as the UK versus US, and relating to the previous topic, is the UK employment protection legislation. If a function is transferred from one company to another, the employee's job automatically transfers with it. For example, if only claims will be outsourced in a new acquisition, the employees carrying out these functions pre-transfer must be offered jobs by the service provider on no worse terms than they enjoyed on their existing employment contracts.

I certainly don't believe that concept exists in the United States. In most Western European countries, there is a similar concept as far as employment protection if a function is transferred from one company to another.

Peter Scarpato: *I want to return to one question discussed previously. When we were discussing stakeholders, there was some mention of dealing with regulators in the different jurisdictions. My question has two parts. First, as respects the US versus the UK/EU, do regulators have an appetite and desire to work with constituents managing, starting or obtaining run-offs? Is there a strong desire and cooperative atmosphere?*

One of the facts which is relevant as far as the UK versus US… is the employment protection legislation in the UK.

And the second question, based upon the different types of structures available in the US versus the UK and EU to run-off business and for companies in run-off, must entities or service providers engage in different types of activities with regulators? If so, what are the most significant ones? Kathy?

Kathy Barker: Our experience with regulators has been very cooperative. They're looking to work with owners and service providers to come up with solutions for policy holders.

Peter Scarpato: *There are different statutorily permitted mechanisms to run-off books of business in the US versus the UK. When dealing with regulators at the ground level, are there different types of interactions or relationships or communications or approvals that need to be obtained in the US versus in the UK/EU ?*

Ian Marshall: I'll address the difference between the UK and the US. Because the difference is in the exit options available in the UK, its helpful to mention the key tools available which are, first of all, to arrange a complete exit using a solvent scheme of arrangement or secondly to portfolio transfer the business to another insurer using a Part VII transfer.

Now, that mechanism is also available in the EU as far as transfers between EU countries under each country's enactments of the EU Reinsurance Directive. And there are more traditional mechanisms available, both in the US and in the EU: straight sale, portfolio reinsurance, and transfer by novation in cases where there are not many parties involved.

In Europe, the regulators are involved in all aspects. If we're managing an entity which is looking at, for example, a scheme or Part VII transfer, early on one must discuss terms with the regulator, usually the run-off manager.

There are different statutorily permitted mechanisms to run-off books of business in the US versus the UK.

If a plan proceeds, there are also services to provide in preparing the documentation which the FSA requires, often in conjunction with legal advisers, and dealing with the FSA as far as obtaining their "no objection" to the plans proposed. Finally you must also provide services to implement that plan.

As far as schemes and Part VII transfers, that's normally done as part of the team of professionals, for example, there is a heavy legal and actuarial involvement. It also depends on what is actually going to be carried out by the client. But in all stages, liaison with the regulator, whether in the UK or the EU, is critical.

Richard Hershman: What Ian said works in the US, as the methods are pretty much the same. I also have a different angle on your question. Today more than ever, I see a problem in dealing with US regulators, that is, issues at the holding company level. Clearly, regulators are concerned about a ring fence around the regulated entities away from the holding company. But, I agree with Kathy. I've seen complete cooperation amongst the regulators in trying to ensure that holding company needs are also met so that you don't bring a greater problem to the underlying insurance carriers. Currently, regulators want to evaluate the risk at the holding company, and liquidity issues are almost always at that level. There's a lot of attention on this area and that will continue with the same ultimate goal being to protect the regulated entity.

Kathy Barker: Another challenge is the variety of stakeholders in various books of business such as pools.

continued on page 32

Reinsurance Auditing for the 21st Century


Donald Wustrow


John Kelly


Bart Frazzitta

By Donald Wustrow, John Kelly and Bart Frazzitta

Data mining is one of the new "buzz" words for the auditor, but in fact, data mining has been part of the audit process as long as auditing has been around. Data mining can be described as the process of sorting through data and extracting relevant information and performing various analytical functions on the data prior to the actual on site audit. The information extracted would be used in various aspects of decision making, depending on the data being analyzed. The reason why this has become so popular is the sophistication of the computer hardware and software that is available. With this sophistication has come a change in the approach to the auditing process in the 21st century.

The Development of Data Mining in the Audit Process

Data mining has assumed increased importance in the audit process.

Previously, detailed analysis was a time consuming process, with constraints based on the number of records that could be stored in available software. Databases gave us the ability to look at a far greater number of records, but are cumbersome to work with and are limited based on the source of the data. Today's software allows the auditor to analyze large amounts of data from various sources (i.e., different hardware and software configurations), changing the way audits are performed. Audits today have become much more focused and allow the auditor to perform many tests on the data prior to going on site making the entire audit process more efficient and cost effective. The benefit of data mining has never been more evident than on the transactional audit.

Data mining has assumed increased importance in the audit process.

In the late 1980s and early 1990s, the focus of an inspection of records was geared towards the overall administration of underwriting and claims. The accounting section of the audit was usually limited to conducting an audit trail on a limited basis, involving premiums and claims from a few files.

Companies seldom supplied electronic data. Often, data was provided in printed form, such as a printout from a mainframe. The detail would be basic at best, with little more than inception-to-date premium information or (more commonly) claims.

Samples of documents were selected based on materiality (e.g., large claims and/or large premium), plus a sample of other files based on various criteria such as every hundredth file or any files with premium/claims over a certain amount.

Audits with an accounting emphasis were usually carried out as part of a legal process, such as litigation or arbitration. These early audits normally involved the reconstruction of the accounts of ceding companies at certain dates. The objective was to verify the accuracy of the premium and claims representations made by the cedant to the reinsurer around the time of the renewal of a treaty, and to make sure that the ceding company had not understated the reserves at the date of the representation.

These audits would often take many weeks to complete, and would often require the full time input of an IT professional and several support staff, as well as the audit team.

Data mining has evolved rapidly in the last few years, due to the technological advances in key areas such as;

- The ability to store more data into smaller spaces; the information stored on a mainframe computer, can now

continued on next page

Don Wustrow is President and COO of Chiltington International Inc. and can be reached at dwustrow@nj.chiltingtonusa.com.

John Kelly is Assistant Vice President of Chiltington International Inc. and can be reached at jkelly@nj.chiltingtonusa.com.

Bart Frazzitta is retired from Chiltington International but remains a Partner in the Holding Company. He spends his time as President of the Esophageal Cancer Education Foundation, a cancer he has been free of since 2000.

be housed in much smaller computers and servers.

- The cost effectiveness of investment in computer technology; as a result, larger volumes of data can be handled relatively inexpensively.
- Faster processing and the increased sophistication of data mining software; data mining has become more user-friendly; algorithms have become more reliable, and are increasingly replacing older statistical methods.

Benefits of Data Mining in the Audit Process

The effect of these technological advances has been profound. Although the auditing of underwriting and claims functions is still important, a review of the accuracy and timeliness of accounts has become equally important.

These days, an auditor can ask for access to an entire database, or request certain key elements from the database. The data mining software does not alter the structure of the database; however, it does allow the development of an exception analysis by converting the data from different systems to a common platform without manual intervention. Following the analysis of the data, the relevant items can be copied into an electronic file.

Although the auditing of underwriting and claims functions is still important, a review of the accuracy and timeliness of accounts has become equally important.

To an extent, analyses are usually time-constrained or subject to budgetary limits. In the early days, claims errors and under-reserving were much easier to determine than accounting errors, therefore the focus was much narrower. Technological advances in data mining mean that the analyses that used to take several weeks can now be done in a matter of hours. The software can usually be implemented by one or two experienced auditors, without the need for full time input from the IT professional and support staff. Analysis can now be done in much greater detail than before. Instead of reviewing summaries, data mining software can drill down to the transactional level and pick out single transactions from a population of several million.

Certain information may be kept separately, such as premium and claim information. As long as the databases contain at least one section in common (usually the policy number), the data can be merged. In the past, data anomalies were usually identified by accident where zero or negative items were identified by reviewing 10's to 100's of pages of mainframe reports, and in no instance could all such anomalies be identified. Now with the advances in data mining software the auditor can have a confidence that 100% of al such instances are identified in minutes. Obviously, these are basic tests but more complex functions, such as aggregate losses or the allocation of premiums based on Increased Limits Factors (ILF's) would also be easier to calculate.

The ability to detect certain patterns becomes much easier when a database can be fully analyzed. For a reconstruction of accounts exercise, such as the early accounting audit described above, statistical information at certain dates can now be calculated easily.

Summary data, which was often provided in the early days, would not show the possible suppression of reserves at key dates, therefore the selection of large claims would not necessarily be relevant. The data mining software would be able to concentrate on certain files, where reserves had been raised around a particular date. In this way, the selection of files for testing would be more relevant.

There is a much greater ability to detect fraudulent activity. For example, insurers can detect whether certain expense billings are excessive or have been billed multiple times.

Data mining allows certain functions to be automated. Again, the construction of macros to automate queries used to be done exclusively by the IT professional. Although professional help may be required to automate the most complex data mining exercises, many functions can be done by the auditor.

Improvements in data mining have allowed the scope of audits to become much wider. These days, audits are not just carried out on ceding companies on behalf of reinsurers, but companies can now review their own data to determine such things as aging of claims, duplicate payments, and workload of claims staff.

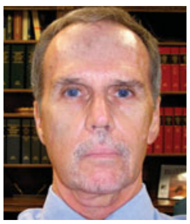
In summary, the audit function has evolved as a result of the improvements in computer hardware and data mining software, and the variety of applications to the insurance industry continues to grow.

This new technology has helped usher in a new era in reinsurance auditing. ■

Feature Article

After the Reinsurance Audit

Donald Wustrow



Richard Hughes

By Donald Wustrow and Richard Hughes

The Access to Records clause contained in virtually all reinsurance agreements gives the reinsurer the right to inspect the relevant books and records of the cedant.

Much has been written regarding the manner in which an audit should be conducted. Equally important, if not more so, is what should be done after the reinsurance audit has been completed. This next step depends on the reason for the audit, the findings from the audit, and the cedant's response to the findings.

> *The Access to Records clause contained in virtually all reinsurance agreements gives the reinsurer the right to inspect the relevant books and records of the cedant.*

Why Reinsurers Audit

Reinsurers generally seek to exercise their right of inspection for one of the following reasons:

- **Comfort audit** – Such audits are typically performed while the reinsurer is at-risk on a treaty that has good experience. This type of audit is done to ensure that the business is being properly underwritten and ceded to the treaty, and may determine whether the reinsurer will renew its participation. Generally, a comfort audit is carried out by the reinsurer's own personnel, although a reinsurer may want to consider using an independent consultant to obtain an unbiased assessment of a portfolio in which the reinsurer has a significant participation. If the audit is done by the reinsurer's own personnel, it is best to use in-house audit staff rather than company underwriters to avoid any conflicts of interest.
- **Pre-commutation audit** – When the reinsurer and ceding company have agreed to consider the commutation of a portfolio, it is common for the reinsurer to ask for an audit to verify the figures before the actual negotiations are initiated. Often, this type of audit may go beyond an accounting reconciliation and include a review of underwriting and claims, to determine if there are issues that could be used as leverage in the commutation negotiations. A pre-commutation audit may be done by either the reinsurer or its consultant. If the reinsurer is using the services of a consultant to negotiate the commutation, typically the consultant will also perform the pre-commutation audit.
- **Investigative audit** – This type of audit is in response to a specific concern and can occur either when a reinsurer is at-risk or after the reinsurer has terminated its participation. Some common issues that prompt such audits include adverse experience, a sudden increase in claim activity, premium that varies significantly from the estimated premium, and apparent accounting irregularities, among other more specific issues. An investigative audit usually involves consultants at some point in the process, as such audits may become contentious and require the expertise that the consultants bring to the table. If an audit is deemed to be potentially contentious, the reinsurer should engage legal counsel to protect the work product, and all communications between the reinsurer and consultants should be transmitted through counsel.

Donald Wustrow is President and Richard Hughes, a Sr. Consultant, at Chiltington International Inc. They can be reached at dwustrow@nj.chiltingtonusa.com and rhughes@fl.chiltingtonusa.com, respectively.

Audit Findings

The purpose of any reinsurance audit is to determine whether the items being reviewed are in compliance with the terms and conditions of the reinsurance agreement and/or the representations made by the cedant about the subject portfolio.

Information from the cedant's files may be captured either on a written form or electronically, such as on an Excel spreadsheet or Access Database, to compare the file data to the treaty terms or cedant's representations. If apparent discrepancies are found during the audit, the

continued on page 29

After the Reinsurance Audit *continued from Page 26*

auditor should discuss the specific treaty terms or representations at issue with the cedant for clarification, but not any findings of non-compliance at this time, if they are still deemed to exist after discussion with the cedant. Except in the very rare case in which everything is found to be in compliance, audit findings will either identify individual instances of non-compliance or recognize a global finding of non-compliance pervasive throughout the entire portfolio.

> *The purpose of any reinsurance audit is to determine whether the items being reviewed are in compliance with the terms and conditions of the reinsurance agreement and/or the representations made by the cedant about the subject portfolio.*

Individual findings commonly relate to mistakes resulting from simple human error such as incorrect input of premium or claim figures into the computer system, or a miscoding that results in a cession to the wrong treaty or underwriting period. These types of errors are inevitable, but a frequency of similar errors could be a sign of a larger problem. Individual findings might also include isolated instances of policies or claims that apparently do not comply with the treaty terms or representations.

Global findings affect all cessions of either premium or claims and usually relate to interpretation of treaty language or representations. Examples of global findings include charging ceding commission on premium booked net of acquisition costs rather than on the original gross premium; the apparent cession of the cedant's retention to another treaty; or using a subsidiary claim facility and billing its claim handling activities as allocated loss adjustment expenses to individual claims.

Once the findings have been ascertained after the audit has been completed, a written report tailored to the type of audit should be prepared, which details the findings, quantifies the impact of the findings, and makes specific recommendations. The report for a comfort audit would include a recommendation to either maintain, increase, decrease, or terminate participation in the treaty. The pre-commutation report would include an assessment of the accuracy of the outstanding loss reserves and identify any issues that could be used as leverage in the commutation negotiations. An investigative audit report would include a determination of the cause of the specific concern that gave rise to the audit and a recommendation for any future action.

The Cedant's Response to Audit Findings

The findings from the audit must be communicated to the cedant. This may be done by means of a wrap-up session at the conclusion of an audit, in which the findings are communicated verbally. A wrap-up session is best suited when the audit has been performed by the reinsurer rather than by an outside consultant acting on the reinsurer's behalf, and when the audit findings are deemed to be relatively insignificant. Alternatively, the reinsurer can submit its findings in a written letter or report to the ceding company. When the reinsurer has used an outside consultant to conduct the audit it is generally better for the consultant not to communicate the findings through a wrap up meeting. The outside auditor should first communicate findings to the reinsurer (client) so that the reinsurer can make its own evaluation of the findings before they are communicated to the cedant. Written communication should also be considered over a wrap-up if there are potentially serious issues that arise from the audit, in order to document the matter for a possible arbitration or legal proceeding.

How the cedant responds to the audit findings is critical in the post-audit process. If the findings are a few individual errors in data input or reinsurance coding, generally the cedant will admit the mistakes and agree to make the appropriate corrections in the accounts. The reinsurer has reason for concern if the cedant is not readily willing to correct obvious mistakes. If there are global findings that would require a re-accounting of the entire portfolio, the cedant is likely to be reluctant to make such corrections without taking the matter under advisement. The best possible outcome is, of course, that after due consideration the cedant agrees in principle and makes the corrections. Delays in responding or such responses as "You could have audited this treaty years ago and are only now auditing to look for reasons not to pay" indicate that the cedant may realize it has a problem but is trying to avoid making corrections. The most troubling outcome for the reinsurer is if the cedant totally disagrees with the principle behind the finding and refuses to make any corrections.

continued on page 35

Feature Article

Trends in the Acquisition of Insurance Companies in Run-Off

By Mark Shepherd

Mark Shepherd

Recent sales of insurance and reinsurance companies in run-off have seen twenty to thirty potential bidders and prices that are close to book value; yet transactions in the early 1990s saw few interested parties, each bidding just cents on the dollar.

So why have prices risen so much, why has the asset class become so popular, and what is the future post-credit crunch? To understand trends in the market, it is helpful to analyze how acquisitions have developed over the previous fifteen years.

…transactions in the early 1990s saw few interested parties, each bidding just cents on the dollar.

The early 1990s saw a large number of insurers entering run-off. With few bidders, and apparently continual deterioration in liabilities arising from A&E and the 1987-1992 catastrophes, prices were necessarily low.

One of the earliest pure run-off transactions involved Ludgate Insurance Company. While there had been previous acquisitions of insurers with a significant run-off exposure, the focus of these earlier deals was primarily on restructuring a troubled company so that it could recommence underwriting. What was transformational about Ludgate was that profits were achieved out of managing the run-off rather than through reactivation as an ongoing underwriter.

With the establishment of specialist acquirers such as Dukes Place Holdings and Castlewood, other transactions followed in Bermuda, London and the US. However prior to 2000 it was unusual for transactions to be competitive and prices paid by acquirers were usually less than 50% – and often less than 25% — of book value.

Mark Shepherd is Director of PwC Discontinued Insurance Practice and can be reached at mark.shepherd@us.pwc.com.

However, various factors changed the market. Insurers enhanced control of their liabilities through improved claims handling, through commutations (as facilitated by events such as the AIRROC / Cavell Rendez-vous) and through solvent schemes (which at one level can be viewed as a policyholder approved mass commutation overseen by a court). In addition, regulators increasingly accepted distributions of capital from insurers in run-off, which occurred first in Bermuda, then in the UK (particularly with the introduction of the FSA's ICA regime), and then in Northern Europe.

The strong returns achieved by the early entrants to the market attracted new competitors, the demand for insurance companies in run-off began to exceed supply, and valuations started to rise. At these increased prices, most acquirers were unable to obtain an acceptable rate of return using pure equity funding and therefore sought debt to leverage their investments. Banks became increasingly keen to lend, their decisions supported by the emergence of predictable cash-flows from capital distributions and a record of successful transactions.

The strong returns achieved by the early entrants to the market attracted new competitors, the demand for insurance companies in run-off began to exceed supply, and valuations started to rise.

In theory, the use of debt benefits acquirers by increasing return on equity. In practice, with so many buyers in the market, the effect of leverage is to increase prices overall, to the benefit of the seller. Thus, the return to equity ultimately is not substantially enhanced by the use of debt, and the increased risk to equity investors of leveraging transactions is frequently neglected.

Discontinued insurance was not alone in seeing rising prices for acquisitions; prior to the credit crunch private equity groups in all sectors sought to outbid each other in ever more leveraged transactions.

So what of post-credit crunch transactions? The first stage of the credit crunch (July 2007-August 2008) certainly affected the largest, most leveraged, private equity trans-

continued on next page

actions, which reduced in volume as liquidity declined. However acquisitions of insurance companies in run-off tend to be smaller and the track record of profitability is strong. The cash-flows arising from investing in an insurance company in run-off are, to some extent, not correlated with the wider economy. Thus the initial stages of the credit crunch appeared to have a limited effect on the acquisition of insurance companies.

However, the second stage of the credit crunch (late August 2008 onwards) may have a greater effect on the market. At the time of the writing this article in late October 2008, it is difficult to predict what will happen, but we may get answers to the following questions:

- Will the credit crunch reduce the number of investors bidding on transactions?
- Will banks reduce either the amount that they lend to the sector or as a proportion of any one transaction?
- Will banks increase the interest rate at which they lend? (As of October 2008, there are signs that this is occurring, although whether this will be maintained if liquidity in the banking system is restored is difficult to predict.)
- Will banks continue to view the run-off acquisition sector as being insulated from the wider economy?
- Will a leveraged acquisition fail to repay its lenders?

The current strong market also reflects the current scarcity of supply. Investors in run-off seek to acquire a legal entity containing the run-off liabilities, and there is currently a finite supply of such companies. Therefore, investors are increasingly looking in areas other than the UK, Bermuda and the Nordic countries, as evidenced by the deals that took place in the US and Australia during late 2007 and 2008.

The acquisition of run-off liabilities in the US has been constrained previously by the limited willingness of regulators to countenance capital distributions from insurance companies in run-off. However the sheer shortage of opportunities elsewhere has seen acquirers push up the prices of those US companies offered close to valuations seen in Europe. There has probably never been a better time to be a seller of a US company in run-off.

Outside of the Nordic region, there have been relatively few transactions in Continental Europe to date. This is driven in part by structural factors — run-off liabilities are often contained within ongoing underwriting entities — and partly due to protection of employment legislation, which can make the closure of an insurance company a drawn out and expensive process. However the establishment of insurance business transfer processes in all twenty seven countries of the European Union means that mechanisms exist to separate ongoing business lines from run-off liabilities by portfolio transfer of gross liabilities and supporting assets, thereby creating stand-alone legal entities containing run-off liabilities that are available for acquisition. Another factor likely to influence this process is the restructuring of insurance groups in Europe in preparation for the introduction of Solvency II.

In the US, however, the long term supply of companies for acquisition is constrained, (except in Rhode Island) by the lack of an insurance business transfer mechanism. What we may see in the US, absent the introduction of widespread mechanisms for the mass novation of gross liabilities, are transactions whereby investors provide capital to insurers in return for taking control of the management of, and profits arising from, run-off liabilities. While currently this can be partly achieved through a loss portfolio transfer reinsurance, retrospective reinsurance ceded to third parties is treated unfavorably under the Risk Based Capital calculation. An investment of capital onto an insurer's balance sheet has potential advantages for both insurer and investor.

In the US, however, the long term supply of companies for acquisition is constrained, (except in Rhode Island) by the lack of an insurance business transfer mechanism.

The market for the resolution of run-off liabilities has developed dramatically in the past 15 years and the market for acquisitions has been equally innovative and profitable for investors. Insurers will continue to withdraw from business areas thereby creating new run-off acquisition opportunities and, where there is a potential for a profitable return, institutions will invest. Supply and demand of opportunities and capital will affect the values at which transactions take place but with so much talent and capital deployed in the run-off sector, we can expect continued rapid development of ideas and concepts for the acquisition and resolution of insurers and reinsurers in run-off. ■

A Roundtable Discussion *continued from Page 23*

For instance there may be more pools in the UK than in the US, and there are striking differences in the number and financial strength of pool members. The outsourcing of pool management is critical when trying to develop and execute a solution for the variety of stakeholders based on financial status and on a global basis. PRO has an excellent track record of managing pools to execute an exit solution.

Richard Hershman: Be on the alert for what's going on in the financial services business including the banks and others going through restructurings, some of whom are taking bailout money. Many banks and others formed insurance captives to compliment products offered in the marketplace. These entities are unlikely to continue. Add that to the list of additional opportunities.

> *…transactions in the early 1990s saw few interested parties, each bidding just cents on the dollar.*

Ali Rifai: *What's the benefit of having a service provider doing the run-off for a global company versus handling it in-house?*

Kathy Barker: Well, the right service provider can be best aligned to a strategy that manages the cost and delivers the performance to achieve the desired outcome. There are, particularly on a global basis, the benefits of using local-based talent for contacts and knowledge of what's going on in that market. There's flexibility and the ability to deliver a tailored approach for a client. We must be able to change strategy for instance where companies may change from a traditional long tail strategy versus an accelerated model.

Service providers can react to market changes because they have a broader skill-base in claims management, reinsurance collections, global commutations or audits that might augment an accelerated model.

Richard Hershman: I'd like to add that if you are a global service provider, and have operations in locations that the client is not in, that presents a major advantage in terms of providing knowledge of local regulations, customs etc.

Ali Rifai: *That brings up a good point. If you're a company with a run-off that is more local than global, is there a difference or a reason to hire more of a global service provider versus a local TPA or a local provider in that area? What benefits would there be and what is the cost differential?*

Richard Hershman: To me, the key issue is whether the client did business in many different countries worldwide. A service provider with operations in multiple countries is more likely to stack up well with resources in the local marketplace. As for me that would be paramount over whether there is a cost differential. I wouldn't be surprised if in fact there was not a substantial cost differential between using a local company versus one with multiple offices.

Kathy Barker: There may be instances where a global provider may be positioned to safeguard a large client's reputation because of its knowledge and expertise in various markets.

Peter Scarpato: *This conversation brings up the issue of competition in different jurisdictions. Understanding as you do, the dynamic, current demand for run-off services in the US versus the UK/EU, in today's world, is the availability of service providers outpacing the availability of actual run-off where the services are needed or is it the other way around?*

Richard Hershman: In yesterday's world, there might have been too much competition for too few run-offs, and particularly for large run-offs. However, that is changing now with the world financial markets shake down. There will be a major need for this kind of talent and the question will be: "is there enough talent around?"

> *…service providers can react to changes in the market because they have a broader skill-base in claims management, reinsurance collections, global commutations or audits that might augment an accelerated model.*

Ultimately, there should be enough talent; however, it must come from the existing and new service providers and people entering this space that have been dislocated by the current environment.

Kathy Barker: I agree. There may be instances of a hybrid approach to the management of run-off bringing external experts with existing staff of a company put into run-off.

Ian Marshall: I don't think there's any doubt, but in

continued on next page

recent times in the UK, it's been a very mature run-off market and the actual value of run-off liabilities has been diminishing which then supposedly means we've all been doing our jobs properly. As a result, there has been some consolidation here.

But, on the other hand, there's a very large, less mature run-off market in Europe. And there have certainly been many comments about the ability to transfer business to the UK where we do have additional techniques available here to expedite run-off if that's what the client wants.

…there may be instances of a hybrid approach to the management of run-off bringing external experts with existing staff of a company put into run-off.

A number of observers in Europe have been highlighting that fact. For example, about a year ago, we managed the first transfer of a block of reinsurance business from Germany to the UK. I'd be very surprised if that was the last, not only from Germany, but from other countries in the EU.

So in just speaking on the UK side, the last two, three years, it's certainly been a mature market, but we can expect, for the reason that Richard and Kathy had mentioned plus the allied factor of the development of legislation in the EU, that this position will change in times ahead.

Ali Rifai: *Let me explore that a little because the impression is that the UK markets are much more sophisticated when it comes to run-off and the solutions that they have for finality for operations in run-off. It sounds like the rest of the European countries really are not similar to the UK; they may be closer to the US or maybe a hybrid in between.*

Do you think with the new EU directives, they'll be closer to the UK and a lot faster to embrace the UK model than the US will?

Ian Marshall: I think two things will happen. I don't recall the statistics, but there is an enormous volume of EU run-off liability and traditionally run-offs have been managed more in-house in Europe certainly than compared to the UK.

Because the number of run-offs in Europe is increasing, that will lead to an increase in service providers and centers of excellence within Europe itself. For companies that want to make the run-off more proactive than they could just by staying in Europe, there will be greater attention to looking at transferring business into the UK, not because the UK is the best necessarily in managing a run-off, but because there are additional legal tools available, the principle being a solvent scheme of arrangement to be able to complete their run-off and return the capital back to the parent company.

Ali Rifai: *When you say transfer to the UK, you mean reincorporate in the UK, just reinsuring it wouldn't be enough, would it?*

Ian Marshall: No. Actually legally transferring the liabilities to a company domiciled in the UK. Once a scheme has been completed, the capital in that entity can be returned back to the parent company for use in ongoing business.

Once the scheme is completed and if no other insurance business remains in the company, the run-off is complete, enabling the company to be liquidated; the remaining capital then goes back to the shareholders.

…there is an enormous volume of run-off liability in the EU and traditionally run-offs have been managed more in-house in Europe certainly than compared to the UK.

Ali Rifai: *Kathy and Richard, do you see the US moving toward anything close to the UK model?*

Richard Hershman: I don't see moving there as readily for a reason we probably should have discussed earlier when we talked about US regulators' involvement in the plan. What happens is when a company knows they're going to run-off in the UK, they see a clearer end game.

The problem we've had in the US is that with 50 state regulators, each one may have their own view. One still must negotiate with the domiciliary regulator, assuming one US domicile, and hope that other state regulators materially impacted accept the plan. Since the results against plan will change over time there may be subsequent negotiations that lead to a different result than envisioned.

Kathy Barker: Yes, I agree. Obviously, there are so many different companies in the US. For instance, those that are pure reinsurance models of run-off in that the

continued on next page

A Roundtable Discussion *continued from Page 23*

issuing paper was only used for reinsurance business, whereas many of the larger companies wrote primary or excess insurance and reinsurance and so the variety of policy holders and creditors is diverse across a number of states.

> *For the companies that want to make the run-off more proactive than they could just by staying in Europe, I think there will be greater attention to looking at transferring business into the UK…*

Ali Rifai: *Would all of you care to give us a list of the kind of services each of your companies provide and what is unique about your particular company; an informational list of what each company does. Kathy?*

Kathy Barker: PRO is a leading provider of run-off management and professional services. It has an extensive pool of experienced global resources in the US and UK and flexibility of executing solutions that are tailored to our clients. We have a proven track record of success of achieving finality for shareholders. We offer a variety of services including full run-off management to individual a la carte services and solutions such as commutations, collections.

PRO's products and services assist clients in realizing reinsurance asset through broker collection and replacement services for the UK market. We also purchase reinsurance receivables and recoverables to create certainty, minimize costs and allow companies to focus on core business.

Ian Marshall: Chiltington likewise offers an a la carte service in relation to run-off business, including insource and outsource management, whether for a complete company or a portfolio of business or just a certain function such as reinsurance collections or commutations. We also offer investigative services, which include inspection of records leading all the way up to arbitration support and expert witness testimony in relevant fields. And because of the experience of the company in run-off going back to the early 1980's, we offer consulting services to help clients with strategic planning, evaluating their business to see what solution might best fit them as far as how they might exit from the business or their particular strategy for the run-off, remembering not everybody wants to exit or carry out a quick run-off.

> *The problem we've had in the US is that with 50 state regulators, each one may have their own view.*

So we offer services across the board not only in the UK, but in Europe and the United States and South America as well and in all of those fields.

Richard Hershman: FTI is one of the leading restructuring firms in the world and that goes well beyond the insurance and reinsurance industry. Accordingly, FTI is usually the first call in a troubled situation from stakeholders whether it's banks, hedge funds, or private equity investors. We are asked to evaluate the potential recovery of their existing investment. We have financial and other resources that have the ability to assist a company in evaluating the various alternatives available to them given their current financial position and the existing markets. My personal experience in run-off is very extensive having been involved as the financial officer in one of the largest and most complex run-offs ever. Most of the other services we provide supplement or compliment a strategy to evaluate assets and liabilities and recapture value whether it's a company that is headed to run-off or a company that is going to continue. In that regard our resources support litigation including forensic investigators, accountants and expert witnesses. We also have deep technology expertise including the ability to perform e-discovery and host and analyze complex data. Further, we house some of the leading public relations experts that understand global markets and can communicate to all constituencies in the most difficult of circumstances.

Ali Rifai: *With your extensive contacts in the market, the three of you, have you also helped companies seek investors that would buy their run-off or do you strictly wait for someone to come in with a plan and retain your services?*

Ian Marshall: No, we have helped companies to evaluate proposals, helped them go through the due diligence process, essentially a consulting service, even in situations where we've not been involved as far as looking at doing the acquisition with a partner.

Kathy Barker: PRO does work with several capital providers through due diligence issues either for all or part of a book of business and then continues to work with them throughout the bidding process.

Ali Rifai: *I just wanted to refine my question a little bit. If a company is considering going to run-off, could they come to you and say, "Can you find a buyer for us?"*

continued on next page

A Roundtable Discussion *continued from Page 34*

Kathy Barker: Yes. We are working with companies that are looking for ways of defining solutions whether it might be to outsource it, to sell it or to look for some sort of reinsurance solution that would help them establish finality on a book of business.

Richard Hershman: As for us, Ali, and as I described before, we're already working on behalf of major investors whether it's a debt financing or equity financing. Our client-base is most of the leading investors in the world, so it is natural for us to recommend a capital solution.

Peter Scarpato: *I have no other questions. And again, on behalf of AIRROC and the Publications Committee, I want to thank everyone for your very insightful comments and views which will be of interest to our constituents.* ■

After the Reinsurance Audit *continued from Page 29*

The Post-Audit Decision

The reinsurer has to decide what action it will take based on the reason for the audit, the findings, and the cedant's response to the findings.

• **Comfort audit** – If the findings are relatively insignificant and the cedant agrees to make the necessary corrections, then the reinsurer should be comfortable remaining on and/or renewing its participation in the treaty. If the findings are significant and the cedant agrees to make corrections, the reinsurer should still feel fairly comfortable in its participation, but should perform periodic audits to ensure that the problems do not reoccur. Finally, if the cedant is uncooperative with regard to the audit findings, whether significant or not, the reinsurer should seriously consider issuing notice of cancellation. Any action beyond termination depends on the financial impact of the findings to the reinsurer.

• **Pre-commutation audit** – This type of audit is somewhat different in that the reinsurer will quantify the findings, which will become adjustments to the cedant's figures, and communicate the findings through a commutation offer. Typically, the reinsurer will maximize the quantum of the findings in the initial offer in an effort to negotiate the most favorable settlement. The cedant will hopefully acknowledge any accounting or coding errors and may tacitly accept any other findings in its counter-offer. It is unlikely that the cedant would confirm its agreement with certain individual findings of a contractual nature or with any global findings in case commutation efforts fail. If the cedant appears to be negotiating in good faith, the reinsurer should be willing to compromise on its findings to reach an acceptable settlement figure. If, however, significant individual or global findings were uncovered during the audit and the cedant is unwilling to accept the reinsurer's maximum offer, then the reinsurer may have to consider arbitration or legal recourse.

• **Investigative audit** – The investigative audit should reveal the cause of the reinsurer's concern that prompted the audit, but that cause may not necessarily arise from any non-compliance of treaty terms or representations. Sometimes a treaty has adverse experience due to unforeseen circumstances, premium estimates are not met due to changing market conditions, or ceding company underwriters write unprofitable accounts although the risks were accepted in accordance with the treaty terms and underwriting guidelines. If this turns out to be the case, hopefully the audit will have some individual findings such as data input errors or miscodings to justify the audit to some extent. In other cases, however, the investigative audit will uncover numerous individual findings or global findings of apparent non-compliance that have resulted in significant financial impact to the reinsurer. In these cases it is unlikely that the cedant will readily agree with the audit findings, as the financial impact would shift from the reinsurer to the cedant if corrections are made based on the reinsurer's position. If the cedant is intransigent, the reinsurer should first suggest commutation to finalize the relationship rather than immediately seeking arbitration or litigation. In this manner, the cedant may tacitly accept the findings and agree to commute, in order to avoid the cost and uncertainty of arbitration or litigation. If an acceptable commutation settlement cannot be reached, the reinsurer will need to consider legal alternatives.

Reinsurers rarely undertake an audit with the goal of pursuing arbitration or litigation. However, when such action appears to be the only means of resolving issues arising from an audit, the reinsurer should first seek a legal opinion and weigh the costs of this action against the possible outcome before making the decision to arbitrate or litigate. Fortunately, what happens after the reinsurance audit in most cases is an amicable resolution of the findings and a better understanding of the reinsurance agreement by both the cedant and the reinsurer. ■

Alert No. 27

KPMG Policyholder Support Update

KPMG's Restructuring Insurance Solutions practice has been providing Policyholder Support Alerts to the insurance industry regarding Schemes of Arrangement for a number of years. These alerts act as a reminder of forthcoming bar dates and Scheme creditor meetings. To subscribe to these alerts or access KPMG's online database of solvent and insolvent Schemes of Arrangement, please visit their website at www.kpmg.co.uk/advisory/r/ins/soa.cfm.

Solvent Schemes – Upcoming Key Dates

EW PAYNE EXCESS OF LOSS POOLS

Schemes for 82 Companies who participated in the EW Payne Excess of Loss Pools were approved at the Meetings of Creditors on 4 and 11 July 2008. The Schemes became effective on 18 July 2008 and the bar dates were set as 16 December 2008. Further details are available at www.ewpaynepools.com.

MALAYAN INSURANCE COMPANY (UK) LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 1 October 2008. The Scheme became effective on 9 October 2008 and the bar date has been set as 9 April 2009. Further information is available by e-mailing abagshaw@chiltington.co.uk.

Other Recent Developments

DEUTSCHE RÜCK UK REINSURANCE COMPANY LIMITED ("DRUK")

A Practice Statement Letter ("PSL") was sent to all known brokers and policyholders on 10 September 2008 indicating DRUK's intention to propose a Solvent Scheme of Arrangement. The PSL states that permission to convene a meeting of creditors to vote on the proposed scheme will not be sought from the High Court before January 2009. Further information is available on www.deutscherueckuk.com.

HARRINGTON INTERNATIONAL INSURANCE LIMITED

By Order of the Supreme Court of Bermuda, 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 will be held at the offices of Appleby, Canon's Court, 22 Victoria Street, Hamilton, Bermuda on 19 February 2009 at 11am. Further information is available by e-mailing scheme@harringtonintl.com or jamesbennett@kpmg.bm.

CITY GENERAL INSURANCE COMPANY LIMITED

By Order of the High Court of Justice in 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. According to the scheme documentation, the business subject to the proposed scheme was written by Generali Assurances Générales ('GAG'), a Swiss company in the Generali Group, in the UK between 1 January 1956 and 17 March 1970 under its former name Swiss Union General Insurance Company. On 15 October 2007 City General accepted a transfer of insurance and reinsurance policies from GAG, pursuant to Part VII of the Financial Services and Markets Act 2000. The Meetings will be held at the offices of Clyde & Co LLP, 51 Eastcheap, London, EC3M 1JP on 3 February 2009 at 11am. Further information is available on www.citygeneral.co.uk.

GLOBAL GENERAL AND REINSURANCE COMPANY LIMITED; GLOBALE RÜCKVERSICHERUNGS-AG

By Order of the High Court of Justice of England and Wales, Meetings of Scheme Creditors for the above companies were convened on 10 October 2008. The outcome of the meetings is not yet known. Further information is available on www.globalre.com/schemes.

RIDGWELL FOX UNDERWRITING POOL

Nine companies who participated in the Ridgwell Fox Underwriting Pool are proposing to implement solvent Schemes of Arrangement. A Practice Statement Letter

continued on next page

was sent out to brokers and known policyholders on 28 February 2008. A rescheduled date for the hearing to apply for leave to convene Meetings of Creditors is yet to be set. Further information is available on www.rfpinsurance-scheme.co.uk.

THE SCOTTISH LION INSURANCE COMPANY LIMITED

The above company is proposing to implement a Solvent Scheme of Arrangement. A Practice Statement Letter was sent out to brokers and known policyholders on 20 October 2008. The company's application for leave to convene Meetings of Creditors was expected to be heard on 15 December 2008. Further information is available on www.scottishlionsolventscheme.com.

Insolvent Estates

PACIFIC & GENERAL INSURANCE COMPANY LIMITED

The above company's Scheme was approved at the Meeting of Creditors on 9 June 2008. The Scheme became effective on 7 July 2008 and the bar date has been set as 9 January 2009. Further details are available at www.gt-pandg.com.

WALTON INSURANCE LIMITED

By Order of the Supreme Court of Bermuda dated 13 December 2007, Charles Thresh and Mike Morrison of KPMG Advisory Ltd in Bermuda were appointed Joint Provisional Liquidators of the above company. Subsequently following a first meeting of creditors, by Order of the Supreme Court of Bermuda, Mike Morrison and Charles Thresh were appointed as permanent Joint Liquidators on 20 March 2008. The Joint Liquidators have now agreed the valuation of substantially all of the company's insurance liabilities and hope to be able to make a distribution to creditors during the first quarter of 2009. The 26 October 2007 bar date has passed. Further information on the liquidation is available by e-mailing jamesbennett@kpmg.bm. ■

Please do not hesitate to contact Mike S. Walker, Head of KPMG's Restructuring Insurance Solutions practice at mike.s.walker@kpmg.co.uk should you require any further information or guidance in relation to insurance company schemes and insolvencies.

Advertisers in this Issue

SIDLEY AUSTIN LLP

SIDLEY

Sidley is:

- **one of the world's largest law firms, with more than 1,800 lawyers and offices in North America, Europe, Asia and Australia**
- **one of the few internationally recognised law firms to have a substantial worldwide insurance and financial services group, with more than thirty years of experience and a growing team of 90 lawyers serving the insurance industry**

Chambers USA 2007 ranked 15 of Sidley Austin's practice areas as ***number one***, including:

Insurance: Reinsurance Litigation (Illinois)
Insurance: Transactional & Regulatory (Illinois)
Capital Markets: Structured Products (National)
Capital Markets: Securitisation (National)

We provide transactional and dispute resolution services to the insurance industry and its investors, including advice on:

- Alternative risk transfers and contingent capital
- Competition, OFAC and FCPA compliance
- Insolvencies and rehabilitations
- Insurance and reinsurance disputes
- International and domestic restructuring and reorganisation
- Mergers, acquisitions and disposition of business
- Regulation
- Reinsurance commutations
- Runoffs and discontinued business
- UK schemes of arrangement, both solvent and insolvent

For more information, please contact:

Chicago	London	New York
James R. Stinson +1.312.853.7203 jstinson@sidley.com	Dorothy Cory-Wright +44.20.7360.2565 dcory-wright@sidley.com	Jeff S. Liebmann +1.212.839.6775 jliebmann@sidley.com
Kenneth R. Wylie +1.312.853.7157 kwylie@sidley.com	Nigel Montgomery +44.20.7360.2580 nmontgomery@sidley.com	Alan J. Sorkowitz +1.212.839.5791 asorkowitz@sidley.com

www.sidley.com

BEIJING BRUSSELS CHICAGO DALLAS FRANKFURT GENEVA HONG KONG LONDON LOS ANGELES NEW YORK SAN FRANCISCO SHANGHAI SINGAPORE SYDNEY TOKYO WASHINGTON, D.C.