



Dr Eilers

The End Of The Story? The Run-Off Of Reinsurance Portfolios Can Be A Success Story

With the volume of reinsurance business discontinued and put into run-offs increasing, Dr Wolfgang Eilers and Dr Hubertus W Labes of Chiltington International GmbH, Rellingen /b Hamburg, look at how to make a success of the so-called failure, while giving an overview of the trends in the run-off business as well as the processes involved.



Dr Labes

Developments in the direct and reinsurance markets are not the primary cause. It is rather the unprecedented expansion of the industry that has led to a surprising amount of reinsurance business being discontinued and put into run-off.

The Global Statistics

Following an above average rate of expansion in the 1970s, the industry experienced a slew of catastrophes and major claims in the 1980s and 1990s, technical losses, and a deluge of latent liability claims which forced many companies to quit the market. A buoyant market in mergers and acquisitions in recent times has also played its part. This inevitably led to the withdrawal, from the market, of many companies.

Around the world, no fewer than 700 insurers and reinsurers have gone into run-off since the late 1970s, with some eventually having to be declared insolvent. This has resulted in a considerable increase in the number of insurance and reinsurance contracts which are now in run-off. In the last four years, the total amount of business in run-off has risen from around \$220 billion to over \$400 billion, of which some 30% is reinsurance, and the amount of business in run-off around the world is expected to increase at a rate of 10% per annum.

Direct Market Cases

In the direct insurance market, the fall-out has been most widespread among small subsidiaries and branch offices as well as the withdrawal from specific lines of business. The scale of this business in global terms is small, but this consolidation trend lead to some companies not actively trading forward. Even today, discontinued business is very much a live issue as

insurance and reinsurance organisations yield to ever increasing competition and cost pressure, compelling them to cancel portfolios and/or withdraw from lines of business in a drive to focus on core activities.

The total cessation of all underwriting activity is not a pre-requisite for assigning to a company a run-off 'tag'. Any company which has been involved in the writing and management of (re)insurance over a number of years will have at least a part of its portfolio in a run-off mode, either because it has been cancelled, not renewed or ended for some other reason.

A Quick Global Comparison

The run-off situation in Europe, the US or Japan are different in several areas. In both the US and the UK for example, most companies which go into run-off conclude by becoming insolvent as in most cases, they do not have sufficient reserves or investment income to cover their liabilities.

By contrast, the capital strength of companies in Japan is such that insolvencies due to adverse loss development on the international portfolios accepted has not occurred. Also Germany has been protected from insolvencies in recent decades by the maintenance of a strongly regulated insurance market until 1994. As a result of deregulation, in 1998 three small insurers almost went bankrupt but were bailed out by other companies. In this context, protecting policyholders' interests must also be considered in the light of growing cross-border activity by insurers within Europe. The Council of Europe has recognised the increased need for regulation as well as the fact that policyholders do not have sufficient legal protection at a European level in

the case of their insurer going bankrupt or into administration.

In Japan, the majority of non-life companies have portfolios of international reinsurance business underwritten over a large number of years. Much of this business was introduced through London and US intermediaries, sometimes as far back as the 1960s. Due to the age of this business, a significant volume of contracts continue to exhibit deteriorating results especially because of latent claim problems. However, the problems of run-off administration are not unique to Japan, not even to Asia.

The different approaches to run-off in the main markets are apparent especially in the field of insolvency law. In the US, the liability crisis of the 1980s and Hurricane Andrew in 1992 kept insolvencies up at record levels for at least a decade. In the UK, the concentration of natural catastrophes at the end of the 1980s combined with the soft market of the early 1990s led to enormous losses, which in turn fuelled a wave of insolvencies. In France, the property crisis of the early 1990s was a major cause of insolvencies.

In many cases, shareholders have ensured, either through reinsurance contracts or the injection of new capital, that insolvency can be avoided. A company in serious financial difficulties could have hidden behind an acquisition, merger or transfer of business. As experience of run-off has developed, more companies have become willing to consider outsourcing the management of some of their run-off business to specialists in this field. This reflects the general trend towards outsourcing in insurance.

Reasons For Run-Off

There are several reasons why a

company places its entire book, or a portion of it into run-off. Besides legislative developments and structural changes in some markets, the decision is grounded primarily in the acute deterioration in loss experience. Research has highlighted that the main factors are:

- “Adverse loss experience” (43%);
- “Poor underwriting” (32%);
- “Over capacity” (14%); and
- “Lack of capital” (4%).

Even with good management and sizeable claims reserves, it is not always possible to plan for every eventuality associated with some high-risk exposures.

The Options Opened

The decision to run-off a company (or an account within a company) has far-reaching consequences for shareholders, management, employees and, above all, for the contracting parties, the cedants and reinsurers alike. If one considers that the goal of every run-off is to provide the ultimate finalisation of all liabilities and obligations and to remove any exposure to future liability, there are several key options available besides “in-house” administration:

- Sale of the company;
- Portfolio transfer to another company;
- Various forms of liquidation (eg Scheme of Arrangement);
- And, unfortunately, in increasing cases as a result of a decision to run-off, taking the decision to declare a business insolvent.

There are also various technical solutions of capping exposures, such as through the different forms of financial reinsurance available in the market.

Preparatory Work For A Run-Off Decision

It is necessary to undertake extensive research to decide on the best option. One must consider the following to determine the run-off status:

- Estimation of liability/exposure;
- The assets available to cover the exposure;
- The anticipated costs.

If a company wants to run-off the portfolio “in-house”, it is important to establish what management resources can be made available for the task. The administration of a company in run-off/a run-off portfolio demands different management skills to those required in the writing of active busi-

ness. In run-off, activity is concentrated in assertive claim management, in the development and implementation of a carefully devised commutation strategy and in efficient cash flow and cost control. The costs invested in establishing this can be more than offset by the reduction in run-off losses and administration expenses.

Portfolio Analysis To Determine Liability/Exposure

The first task is identifying those cedants whose treaties have created the bulk of the run-off exposure. In general, indicating factors include the number of reported claims and the size of IBNR reserves. To reduce administrative costs, it is also useful to isolate those contracts that exhibit a relatively small exposure and have been in run-off for several years. In most of these cases, there is a disproportionate relationship between the exposure itself and the costs incurred in their handling. At the same time, it is important to recognise cedants that are financially insecure. In such companies, claim management and the recovery of reinsurance collections may well have been neglected. This can have a direct impact on run-off losses for the reinsurer too. These treaties must, accordingly, attract special attention.

Once the key treaties and cedant relationships have been identified, the analysis should proceed with the following steps:

- Loss reserve data should be sought from cedants. Attempts should also be made to seek IBNR details.
- During the actual examination of the treaties, it is important to also study subsequent amendments (“addenda”), endorsements to slips as well as placing and renewal information.
- Statistics should also be reviewed, or prepared on an underwriting year basis.
- Past and current loss notifications should always be diligently checked to ensure that these comply both with treaty conditions as well as previous advices, statements and disclosures.
- The examination of loss advices with latent liability potential is extremely important. Technical competence and caution are demanded when considering exposures in this regard.

This will give management an exact overview of the portfolio and be in a position to accurately evaluate and

quantify exposure.

Analysis Of Assets In View Of Run-Off Liabilities

Parallel with an examination of the underlying contractual situation, it is also appropriate to determine existing financial instruments and future costs. Deficiencies in returns can arise if there are insufficient capital reserves as well as interest yields and unless possible capital injections by shareholders or through other means are available. In evaluating the reserves, the determination of IBNR plays a critical role. It is not enough to just calculate a global IBNR for the book as a whole, but increasingly to calculate IBNR at a specific treaty level as well. It is very important to ascertain the run-off period, which can be as much as 50 years for those treaties affected by latent losses.

Analysis Of Run-Off Costs

With the decision to cease underwriting, the premium volume will fall away dramatically. It is therefore crucial that the key cost centres – personnel, EDP, premises and other (tangible) costs – are analysed and gradually reduced. It will, nevertheless, be hardly avoidable that a reduction of costs will follow the constant diminution of assets and reserves only with a time-lag. In particular, if commutation endeavours prove successful and interest disappears as the reserves are released through payment, there could also be losses arising from too high administration costs as well as from the technical losses themselves.

Performing The Run-Off

Once the analyses have been completed, management is well placed to decide upon the best option available to perform the run-off.

Active run-off management demands aggressive claims management. It is imperative that cash flow is maximised actively pursuing outstanding balances arising from reinsurance protections. To optimise interest yields, an efficient cash management policy is essential. There must be an investment strategy formulated such that sufficient funds in various currencies are available for commutations, as and when they arise. If necessary, further information and confirmation should be sought from the cedant.

Should the responses of the cedant remain unsatisfactory or absent, further avenues are available:

- **Inspection of records**

In the past, investigations of this type were not common given the relationship of trust; the guiding principle remained that of "utmost good faith" between the parties. In recent time, however, a change of attitude towards such contractual inspection has taken place. Increasingly, reinsurers are seeking support when assessing claims and indeed overall contractual relations. Just as primary insurers utilise the series of a third party in such cases, so reinsurers are relying on external consultants to perform underwriting and claim studies at the offices of their cedants.

- **Invoking Arbitration or Mediation**

This does not mean that negotiations should cease when arbitration or mediation is called. Rather all parties are brought together in a common problem, and a solution acceptable to both cedant and reinsurer alike can be brought about often with the help of a third party. It may also be the right decision, both commercially and from a common sense point of view, to allow a difference of opinion to be adjudicated by this forum. It is also a fact that compromise settlements are very often reached before an arbitration panel makes an award.

- **Release from contractual liability (commutation)**

The commutation route may present itself in those instances where one of the parties finds the loss deterioration unacceptable. Those companies which find themselves in a struggle for existence will especially be interested in commuting the current business. Savings in costs are also the fruits of commutation since the reinsurer can dispense with the resources

devoted to the discontinued treaties.

There must be continued and vigilant attention to the portfolio in a run-off. Through this careful approach, more can be saved than can be realised in profits in the active (and simultaneous) writing of reinsurance business. It is really a fatal error to believe that a run-off book of business is merely a "sideline" activity to be dealt with as such.

Get An Expert

Without determining the status of the run-off by means of a portfolio analysis, developing a run-off strategy for its effective execution the run-off itself, there will be no proper reprieve.

As it is a skilled enterprise demanding a variety of talents and knowledge, a company should not draw back from seeking external advice. Consultants, lawyers or actuaries – all are specialists in their own fields dealing on a day-to-day basis with questions that a reinsurer has to confront much less frequently. It is highly likely these specialists will have answers, before the company has recognised the existence of the problem and posed the questions. ☺

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