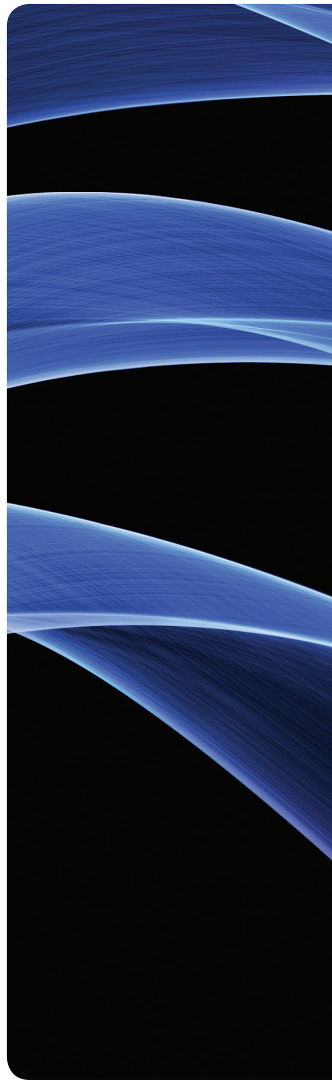
Kenneth Pierce, **Clifford Schoenberg** and **Brian O'Sullivan** of Mayer Brown[1] take a look at insurance runoff risk and find it to be an asset class ripe for securitisation



New asset class?

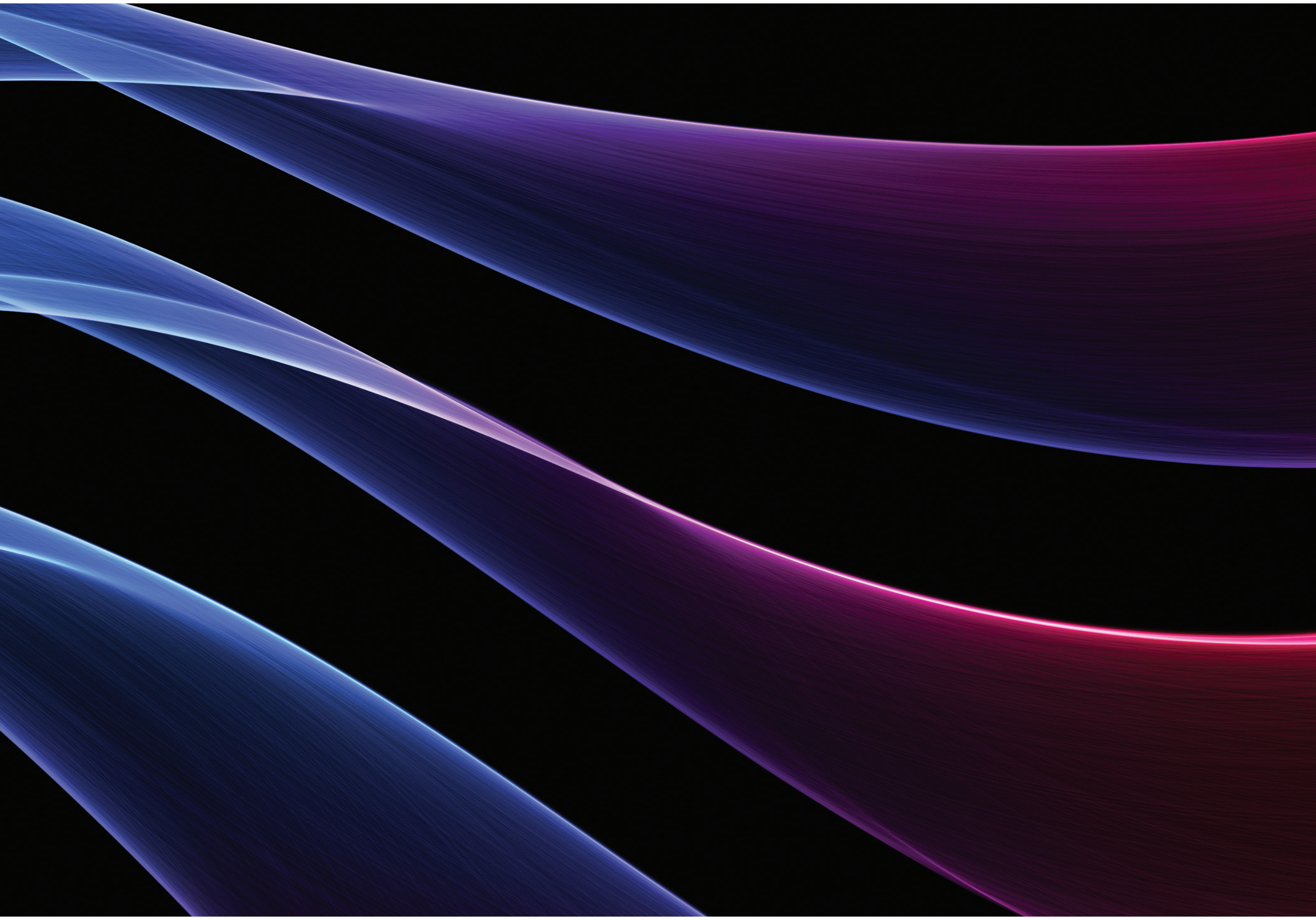
Numerous insurance and reinsurance companies have 'runoff' businesses and blocks of business – portfolios of assets and liabilities that do not relate to current or core business lines, but rather arise from (i) older, now discontinued products and lines of business, or (ii) mergers and acquisitions through which, along with desirable businesses, insurers and reinsurers acquired unattractive businesses or lines that have now been shuttered.

According to some estimates, the aggregate amount of 'legacy' insurance and reinsurance liabilities in the US is well in excess of $150bn. Depending on the type of business, the runoff of these legacy liabilities could take decades.

There are numerous disadvantages to insurers and reinsurers which choose to keep and run off these legacy products and businesses. First, pursuant to state mandated risk based capital rules, US insurers and reinsurers are required to allocate a significant amount of capital and surplus, in excess of reserves, to support these portfolios – an inefficient, low ROE use of capital that the company could otherwise use to support (and grow) its core business.

Second, the insurer or reinsurer bears all the staffing and administrative costs associated with the runoff of business that is no longer part of its current or strategic business. By the same token, management is forced to invest time and energy better devoted to growing the company's core business.

Moreover, the fact that various insurers and reinsurers handling very similar blocks of legacy business must separately maintain personnel serving the same function is an obvious failure to achieve economies and efficiencies that could inure to benefit of all those companies. Third, the insurer or reinsurer



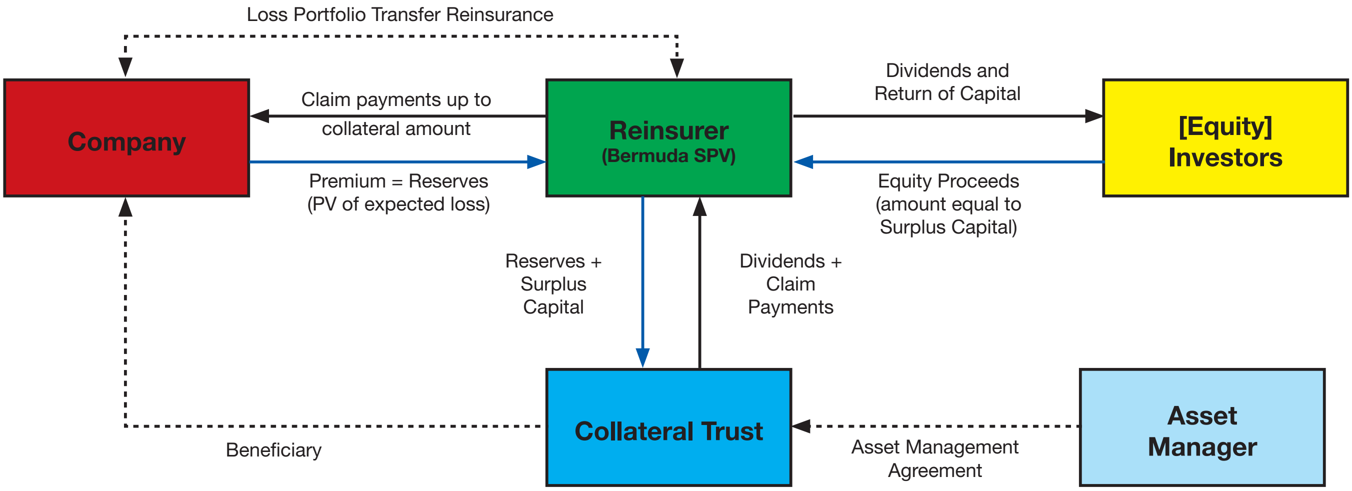
bears the risk of adverse development and unexpected new sources of claims from these legacy blocks – in other words, potential 'time bombs' on the balance sheet that have not escaped the notice of investors and rating agencies.

As a result, insurance and reinsurance companies may be willing to pay a significant premium to transfer the risks associated with their legacy portfolios to other entities. Over the past decade, several companies have been formed to assume runoff risk as a principal, including (in alphabetical order): Catalina Re, Enstar, Randall & Quilter and Tawa. In addition, Berkshire Hathaway has been a major player in the space, assuming through either reinsurance or acquisition several massive runoff blocks, including Equitas.

Most runoff transactions in the past decade have taken place in the UK, not in the US This is largely because UK insurers and reinsurers have legal and regulatory tools under English law that enable the final, legal extinguishment of runoff liabilities, including Part VII transfers (which permit a company to transfer all of the liabilities and assets associated with a portfolio of business to another insurer through essentially a court-sanctioned novation) and Schemes of Arrangement (which permit a company to extinguish its liabilities through a court-sanctioned process that involves creditor approval).

In the US, by contrast, the novation of insurance or reinsurance liabilities generally requires the affirmative consent of the current owner of the insurance policy or ceding insurer in a reinsurance contract[2]. Unless the legacy business is housed in a separate corporate entity that can be sold, there is no effective way for a US insurer or reinsurer to completely cleanse its balance sheet of a legacy

Illustration 1



Source: Mayer Brown

portfolio without a cumbersome novation process in which each and every counterparty would have to consent to (or not reject) the transfer of liability.

Nevertheless, there are legal tools in the US available to insurers and reinsurers that, while not legally extinguishing the company's exposure to legacy liabilities, have the potential to: (a) release trapped capital and surplus, (b) reduce the expenses associated with the management of the runoff of these liabilities; and (c) minimise the uncertainty and volatility associated with long tail liabilities. Insurers and reinsurers would presumably be willing to pay a premium to achieve these goals, and their willingness to do so creates an opportunity for private equity and hedge fund investors to enter the space through legal structures that essentially securitise runoff.

LPT reinsurance with a SPV reinsurer

One way that an insurer/reinsurer (the Company) could securitise the runoff risk associated with its legacy portfolio (the Subject Portfolio) is by entering into a loss portfolio transfer (LPT) reinsurance agreement with a special purpose reinsurer (the Reinsurer). Investors would purchase equity interests in the Reinsurer (with any leverage provided by a lender or through the issuance of debt instruments). The Company would make a one-time premium payment to the Reinsurer in an amount based upon the present value of the expected losses on the Subject Portfolio, plus a risk premium.

Thus, assuming that the present value of the reserves was $400m and a risk premium of $100m, the one-time premium payment would be $500m. Investors might agree to contribute capital equal to a 30% cushion above the $500m, or $150m. The Reinsurer would then have $650m in assets – which would be the aggregate limit of liability under the LPT – as against $400m

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of expected liabilities. The entire $650m would be deposited in a collateral trust and would be available to pay losses under the LPT agreement. The collateral trust would be structured to permit the Company to take credit for the reinsurance on its statutory financial statements. The assets in the collateral trust would be managed by an asset manager pursuant to agreed-upon investment restrictions, and the income generated by those assets would be used to pay dividends to investors.

In addition to the LPT agreement, the Company and Reinsurer would also enter into an administrative services agreement, under which the Reinsurer would assume, at its own expense, day-to-day responsibility for the runoff. Because the Reinsurer would not have the experience necessary to runoff the business, it would outsource that responsibility to a third-party administrator/management company which itself may be an equity investor in the Reinsurer, or perhaps the lead equity investor, to create an alignment of interests.

As the Subject Portfolio is run off, the Reinsurer would be permitted to withdraw funds from the collateral trust and to distribute those funds to investors as dividends, provided that the balance remaining in the collateral trust complies with an agreed-upon surplus ratio. When the runoff is complete, the Company would be liquidated, and all remaining assets would be paid to investors.

This type of transaction should free up much of the capital and surplus that the Company is presently using to support the Subject Portfolio because the Company would receive credit against all liabilities on that business as a result of the LPT both for accounting and rating agency purposes. In addition, the Reinsurer (in effect, the investors), not the Company, would bear: (a) substantially all of the staffing and administration costs associated with the runoff of the Subject Portfolio; and (b) the risk of adverse development and unexpected new sources of claims up to an agreed-upon limit.

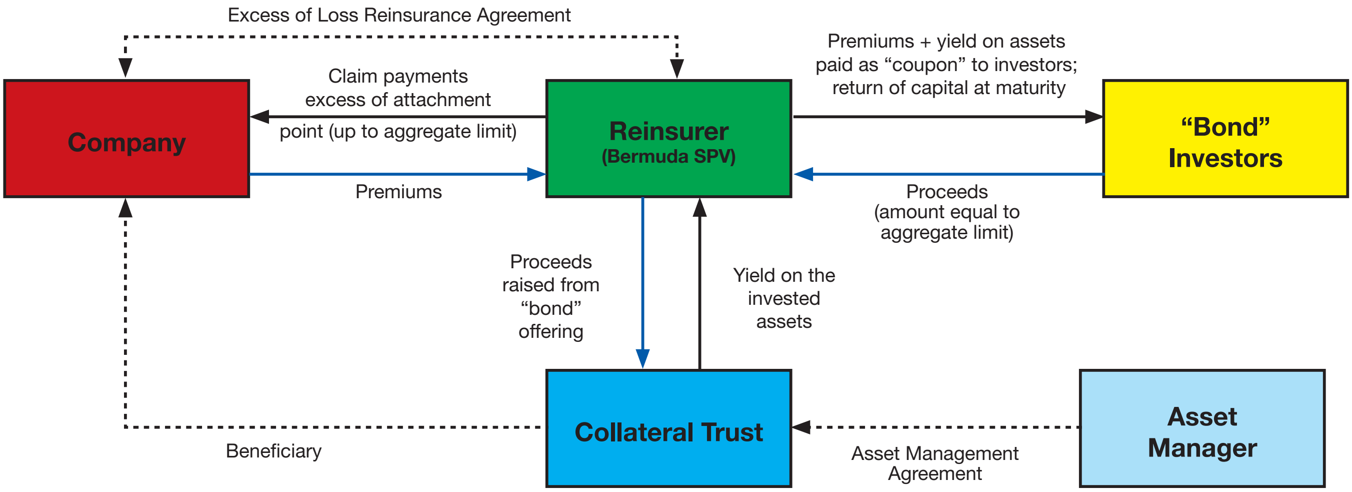
The Company would thus have substantially reduced its overall exposure on the Subject Portfolio, even though it would retain ‘tail risk’ to the extent that the adverse development and unexpected new claims exceed the aggregate limit of liability under the LPT ($650m in the above hypothetical).

Moreover, in a typical runoff situation, a rated ongoing reinsurer acquiring the runoff liabilities would charge a significant risk premium because it is assuming essentially unlimited risk as a result of that transaction. Here, by contrast, because the Reinsurer’s exposure would be capped at an agreed-upon amount, the risk premium should be substantially less. There may also be additional financial structures and approaches that the parties could use to reduce the risk premium even further while still providing the investors with the return on equity they require. Indeed, our experience has been that finding that ‘sweet spot’ will be the most crucial issue in the negotiations between the Company and the investors.

An example of a financial structure that could help the parties bridge the gap between the premium the Company is willing to pay to transfer most of the risk associated with the Subject Portfolio and the consideration investors demand to take on the risk would be to provide the functional equivalent of the $100m risk premium discussed above through an unfunded ‘keepwell’ guarantee or a subordinated debt instrument. Of course, the Company and the investors will both need to ensure that the transaction transfers sufficient risk to qualify as reinsurance under the applicable accounting rules.

The benefit to investors is that they can expect to receive a significant return on investment in a long-duration asset class that is uncorrelated with other traditional economic factors (such as the movement of the equity markets or real estate prices). The return that the

Illustration 2



Source: Mayer Brown

investors will actually receive on their investments will, of course, vary depending upon the performance of the legacy portfolio and, if the losses on that business develop much more adversely than expected, the investors could lose their entire investment.

Excess of loss reinsurance

Another way that private equity and hedge fund investors could participate in the runoff of a legacy portfolio is through the runoff equivalent of a catastrophe bond, i.e., a 'runoff cat bond'. In particular, the Company and Reinsurer would enter into an excess of loss reinsurance agreement, under which the Reinsurer would assume all liability on the legacy portfolio excess of an agreed-upon attachment point up to an agreed-upon aggregate limit. The attachment point would be an amount equal to or greater than the present value of the expected losses on that business.

Like a cat bond, proceeds would be raised from investors in an amount equal to the aggregate limit. These proceeds would be deposited into a collateral trust and would be available to pay claims under the reinsurance agreement. While it may make sense to structure the collateral trust in a way that complies with the regulations permitting the Company to obtain credit for reinsurance, it is not essential, at least until the incurred losses penetrate the attachment point (which could take decades, even if the losses develop much worse than the parties expected).

The maturity and extension dates of the 'bonds' are negotiated in order to provide meaningful protection to the Company for an agreed-upon period (which could vary widely depending upon the type of business). The collateral trust (like that which would be established with respect to the LPT) would be managed by an asset manager pursuant to agreed-upon investment restrictions, and the income generated by those assets would be distributed to the Reinsurer. In turn, the Reinsurer would pay those amounts, along with the reinsurance premium, to investors as the coupon on the 'bonds'.

The principal benefit to the Company from this type of runoff cat bond would be the limitation of its exposure in the event that the losses on the legacy portfolio develop adversely or there are unexpected new sources of claims. Unlike the LPT transaction discussed above, a runoff cat bond would not result in the release of much, if any, capital and surplus or reduce the staffing and administration costs associated with the run-off of the Subject Portfolio.

In sum, there is now an opportunity for private equity and hedge fund investors to participate in the runoff of US insurance and reinsurance liabilities through the securitisation mechanisms discussed above. While that participation could be confined to one-off transactions, it need not be. Indeed, a SPV Reinsurer could reinsure multiple legacy portfolios from various cedents and, in so doing, achieve even greater efficiencies and economies of scale. The potential for profit from these types of transactions would seem to be very attractive. SCI

Notes

1. Kenneth Pierce and Clifford Schoenberg are the co-heads of Mayer Brown's US insurance and reinsurance group. Brian O'Sullivan is a partner in the insurance and reinsurance group.
2. The exception is the negative ballot authorised in those states that have adopted the NAIC's Assumption Reinsurance Model Act. Under that Act, the policyholder's consent to the novation is presumed if he (or she) does not reject the transaction within a certain specified period (usually twenty-four months). However, compliance with the Act's procedural requirements is itself extremely cumbersome and time-consuming.