Welcome to the new world of runoff

What insurers and reinsurers need to know about the new regulations just enacted in the state of Rhode Island

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As of August 18, 2015, insurers face a significantly changed landscape in the massive commercial insurance runoff market in the United States. Newly enacted amendments to Insurance Regulation 68 in the state of Rhode Island (RI) have the potential to invigorate and transform the US market. Similar runoff legislation has had just that effect on the UK runoff market over the last several decades.

Specifically, the new regulations provide expanded options for the management of runoff liabilities and, for the first time, bring finality to legacy liabilities. This article will outline the high-level impacts of the changes for insurers and reinsurers, including both the challenges and opportunities, and highlight a few effective steps they can take to ensure those firms considering the use of the new restructuring options establish a foundation for success.
In response to these challenges, larger insurance groups are rethinking organizational structures with a view to maximizing the efficiency of capital deployed. However, both smaller property and casualty companies and large international insurance groups face a continual need to optimize capital deployments, as well as to efficiently manage runoff liabilities. Thus, the market is clearly ready to consider new tools and approaches to address the challenges of runoff businesses. These new RI regulations present an opportunity for firms to adopt such approaches.

Pursuant to Rhode Island Gen. Laws Section 27-14.5, the RI Department of Business Regulation has amended Insurance Regulation 68, providing for “Insurance Business Transfers” (IBTs), which are defined as the “transfer of liabilities and assets in accordance with the procedures delineated in this Regulation.” The amendments provide a carefully monitored, transparent process for the transfer of some or all of a company’s commercial runoff liabilities to a newly formed or re-domesticated RI company through a department-approved and court-sanctioned novation process, which brings finality to the legacy exposures of the transferring company.

The IBT also provides an effective restructuring tool for insurers or reinsurers. IBTs can be used to:

- Combine similar business from two or more subsidiaries, putting all into a single company
- Transfer business between third parties
- Separate different books of business and place them into separate companies

As a public policy matter, the amendments fill a huge void in the current regulatory environment for runoff business and are beneficial to all parties involved in the IBT transaction. The transferring and assuming companies receive value relative to their long-term interests and finality through the statutory novation affected by the Court Order. The policyholders and/or reinsureds in the transferring business benefit from the focused management of the assuming company and the oversight of the RI Department of Insurance (RI DOI).

Currently, the assumption and novation regulations in the US are restrictive and significantly limit the options available to owners of runoff companies to pay their obligations to policyholders and terminate their exposure to future liability. As a consequence, capital is trapped and unable to be deployed for more beneficial purposes. The importance of the IBT transaction is the ability to provide a fair solution that balances the needs of all the company’s stakeholders. The RI amendments allow companies with runoff business to distance themselves from these liabilities in a fully transparent manner, while also providing security to policyholders. The key is a closely monitored transfer process that must be reviewed and approved by the RI DOI as well as judicial authorities.

Consistent with the strong policyholder protections in US law, the amendments include provisions that address policyholder concerns. For instance, the statute has specific notice requirements for policyholders and other specified parties. Also, the IBT approval process requires the following:

- Extensive disclosure of financial information of the assuming company
- An expert report that will evaluate the impact to transferring policyholders and non-transferring policyholders
- An independent evaluation by the RI DOI

Most important, from the standpoint of policyholder protection, there is complete judicial review of the IBT plan. Before the transaction will be approved, the assuming company must present evidence to the Court that the transfer does not have a material adverse effect on policyholders. Any party who feels adversely affected by the transfer can make a representation to the Court for consideration. Once approved, the assuming company is subject to the continuing authority of the Rhode Island Insurance Department.
Lessons learned from the UK

A similar process has been available in the United Kingdom for many years and has resulted in hundreds of successful transfers of business. Building upon the UK process, the RI amendments permit more efficient management of transferred books of business, and allow dedicated capital and focused solutions to be applied to runoff liabilities. While providing a reasonable framework for transfers of insurance business, the amendments also provide sufficient safeguards for policyholder protection resulting in fair outcomes for all involved parties.

How it works

The IBT process is initiated by the assuming company submitting an IBT plan to the RI DOI for approval. The requirements, as stipulated by the regulation, include an expert report that opines on the potential impact to various groups of policyholders and an approval of the transfer by the domiciliary state of the transferring company. Once the RI DOI has approved the plan, the assuming company may file a petition with the Providence County Superior Court for approval of the transfer. The assuming company must comply with the broad notice requirements set forth in the statute, which include notifying all policyholders at their last known address.

Once approved by the court, the IBT results in a DOI-approved and court-sanctioned novation of the transferred policies, releasing the transferring company from liability under the transferred policies. While loss portfolio transfers and reinsurance provide some economic finality, the IBT will provide economic and legal finality to the transferring company.

Good planning and project management of an IBT are essential to navigating certain risks and potential stumbling blocks in the process. Early contemplation of potential obstacles can make a significant difference. For companies promoting the transfer, the objective must be to minimize risk of objection and to achieve regulatory and court approval of the transaction. Therefore, companies should invest time identifying potential challenges that may be raised by various parties. Once these have been identified, companies should devise a strategy to address potential objections. Effective approaches are likely to include the following:

• A communication plan designed to clearly define the business being transferred, the purpose of the transfer and the impact on potential objectors. The communication plan must also flesh out as early as possible the concerns of potential objectors, which can then be addressed, if necessary, on a one-to-one basis.

• A strategy for addressing the concerns of and engaging potential objectors to secure their support, which may include amendments to operational and/or capitalization plans.

• A contingency plan for dealing with key objectors, who are unlikely to support the transfer, which may include commutation, novation or exclusion from the transfer.

How the RI IBT differs from Vermont's Legacy Insurance Management Act (LIMA)

While the difference between the IBT and Vermont's LIMA is beyond the scope of this article, it is important to point out some key distinctions between the two transfer processes.

The LIMA approval process is solely regulatory. The approval of the transfer is effected by the Final Order of the Vermont Insurance Commissioner. In contrast, the RI IBT process requires an independent review and approval of the RI DOI as well as review and approval by the Superior Court for Providence County, RI.

Unlike the IBT, which is broad in scope, a LIMA transfer is restricted to closed blocks of non-admitted commercial property and casualty insurance business. Also, under LIMA, to be considered a “closed block,” all such business is required to have been expired for not less than 60 months and have no active premiums yet to be paid. The requirement that qualifying reinsurance must have no active unpaid premium outstanding may create a practical impediment against including reinsurance in the transfer, in light of the possible long-tail of premium payments under some contracts. Under the IBT, there is no requirement that there be no active premiums to be paid, avoiding the potential problem of disqualifying reinsurance from the transfer.

The IBT process effects a court-ordered novation of all transferring policies and reinsurance agreements providing the potential for economic and legal finality for the transferring company. The Final Order issued pursuant to LIMA effects a statutory novation of only those policies and reinsurance agreements in the closed block that have not been excluded from the transfer by opt out or otherwise, significantly limiting the ability of the LIMA transfer to provide finality.

Bottom line

The experience of the UK runoff market has proven that a well-designed IBT process can be an effective restructuring tool for insurers and reinsurers, while still providing adequate protections for policyholders. Now, for the first time, US insurers can achieve finality with respect to their runoff businesses, which will help them address challenges related to the optimal use of deployed capital.

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