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The legacy leg up

As the annual run-off congress approaches, Paul Corver considers the potential issues and opportunities ahead.

THOSE OF US IN the insurance industry that have worked through previous UK recessions will doubtless be bracing ourselves for the inevitable upswing in claims activity that is the mark of cash-strapped times. It is a simple fact of life that when things gets tough financially, claims — whether due to crime, arson or increased numbers of business disputes — start to increase.

While this may seem to be primarily a 'live' underwriting sector concern, when taken in the context of the other financial symptoms of this recessionary environment — such as low interest rates, poor investment returns, deteriorating exchange rates and a shortage of new capital — the current climate may also have significant ramifications for the legacy sector.

For a start, the current interest rate environment could well affect strategy for dealing with run-off business. For instance,

those seeking to close out old books of business may find that the potential attraction of commutations have been reduced by the contraction in investment returns. This reflects the now negligible reduction against undiscounted reserves on balance sheets that it will be possible to achieve when commuting a liability on a net present value basis.

Indeed, the most severe effect of the investment income issue may well be to slow the upswing in potential schemes of arrangement that followed the case of Willis Faber Underwriting Management. With net present value discounting falling through the floor — especially for short-tail liabilities — those scheme proposers that have traditionally promoted settlement at an undiscounted rate as a reason for policyholders to support a scheme may have to think of alternative enticements.

That said, the attractions of 'cash now' in the current climate cannot be underestimated. Nor is the ability to convert assets into cash on an advantageous basis the only driver for commutations.

Under the spotlight

For instance, insurers may start looking with far greater interest at the possibility of commuting with those reinsurers that have been hit by rating downgrades, or that are generally perceived to be becoming an increasing counterparty credit risk. Similarly, the need to manage the impact of fluctuations in the currency markets may boost the attractions of commuting as a mechanism by which to convert assets into the same currency as liabilities.

Separately, the current pressure on financial institutions has created a very real question as to where insurers and reinsurers will be able to source new capital – whether to reload capacity after a market-changing event, or to make the most of new opportunities that are flowing into London's subscription market as insurance and reinsurance buyers look to spread counterparty credit risk.

Against such a background, chief executives and chief finance officers could do worse than look inwards — as well as outwards — for potential sources of capital and give some serious consideration to the potential use of legacy sector mechanisms as a way of unlocking capital that is currently needed to support prior year liabilities.

At first glance, this may seem counter-intuitive, but the potential of such initiatives can be significant. For instance, Travelers recently freed up $343m (£268m) by selling its Unionamerica book of legacy business, having first reorganised it into one entity using Part VII transfers. While every situation is unique, it would be extraordinary if there were no other companies in the sector that, on careful examination, might not find that sizeable discontinued books have the potential to become an asset.

Such initiatives present a very real opportunity for the legacy sector to sell its skills — including the ability to help both live and run-off companies assess the potential capital impact of disposals, transfers, schemes or commutation initiatives — into the live sector. Accordingly, the live launch of the industry capital modelling tool for legacy business, which the Association of Run-off Companies has been developing in conjunction with Watson Wyatt, is also expected to be one feature of the forthcoming ARC Congress.

The fallout from current events in the wider financial markets could also trigger, for the first time in years, a wave of new run-off business. This not only reflects the fact that insurers and reinsurers may be radically reassessing the lines of business in which they wish to engage, but also that current market conditions may lower previous barriers to action. For instance, the reputation issues of selling — or contracting out the management of — legacy portfolios may now seem rather less pressing when weighed against the potential benefits of either reduced cost and management distraction, or release of capital back into the business.

Opportunity knocks

What is more, such opportunities could well extend beyond the realm of insurers. Take, for example, the recent news that US run-off specialist, Citadel Risk Management, has acquired the majority of the reinsurance run-off portfolio of US broker Arthur J Gallagher.

What is particularly significant about this move is the way in which, by acquiring the portfolio, it goes a critical step beyond the UK outsourcing moves that have been announced in recent years by Marsh and Aon.

Commenting at the time of the Gallagher deal, the Citadel group described the move as an opportunity to create a run-off sector for the reinsurance intermediary market.

Given there is no doubt that dynamics change when the business falls into run-off — indeed the very nature of a broker's business means almost inevitably that the priority has to be on current clients and underwriters — it will be interesting to see the differences that an entity such as Citadel, with its years of experience in settling and collecting reinsurance for clients, can make when putting those skills to use on a broker run-off. POST

Paul Corver is chairman of the Association of Run-off Companies, which is holding its annual Congress from 24 to 25 February