By email - wmelofchik@ncoil.org

June 10, 2019

Assemblyman Andrew Garbarino
Representative Lewis Moore

Dear Mr. Garbarino and Mr. Moore,

This paper is submitted to provide information and background in connection with NCOIL's consideration of an Insurance Business Transfer (IBT) Model Law.

Background

In many jurisdictions worldwide, organizations increasingly utilize business transfer mechanisms as a strategic tool to allow global insurance groups, captive insurance companies, and others to restructure their business operations by exiting certain lines or transferring portfolios of business to unleash excess capital, focus on emerging opportunities, and to free management attention and oversight to core activities.

Since it came into effect in 2001 the UK's insurance business transfer mechanism, commonly known as a Part VII transfer, has acted as a key driver for companies looking to restructure their operations and utilize capital more effectively. As of April 2019, there have been 285 successful transfers completed none of which have subsequently encountered financial difficulty.

The Equitas Experience

A UK Insurance Business Transfer was a crucial, final component of the reconstruction and renewal plan that saved the Lloyd's of London insurance market in the 1990s. In the first stage, all 1992 and prior liabilities, including extensive US asbestos and environmental losses, were reinsured to the newly created vehicle, Equitas that also centralized processing resulting in better claim management and reduced costs. But this did not bring finality. It was not until Berkshire Hathaway became involved and a UK Insurance Business Transfer legally removed the liabilities away from the original names, that they at last achieved finality.

The Equitas experience highlights the importance of finality that brings efficiencies, clarity, and transparency to run-off situations.

It is important for the US insurance market to have similar restructuring options that are available in almost all advanced countries to remain competitive and thrive in the global economy. Without effective restructuring tools, problems are left to fester and can ultimately threaten the financial health of the company.

The need for restructuring mechanisms

Many companies have portfolios of legacy business that are either inconsistent with their core competency or provide excessive exposure to a particular risk or segment of the market. These non-core and/or discontinued policies and portfolios are often associated with potentially large exposures. Further, they frequently are characterized by lengthy time periods before resolution of the last remaining insured claims, resulting in a costly administration process with significant financial uncertainty to the insurer or reinsurer covering those risks. Collectively, these factors can distract management, absorb capital, reduce return on equity and negatively impact the credit ratings of both insurers and reinsurers.

In a recent survey conducted by PwC of the global insurance runoff market, U.S. P&C runoff liabilities were estimated to be $335 billion.[1] The life runoff market is estimated to be even larger. In their May 2018 analysis, Moody's estimated that insurers have over $420 billion of annuity, life insurance, long term care and other liabilities publicly designated as "legacy" or "run-off that are targeted for an exit transaction.[2]

Some of the major challenges facing companies with runoff or legacy liabilities include:

- Access to restructuring/exit mechanisms
- Maintaining reputation
- Capital constraints
- Operational costs
- Adverse impact to a company's rating
- Lack of skilled resources
- Reinsurance credit risk

Legacy business ties up significant amounts of capital, staff time, and management attention. Increased oversight, ongoing expansion of state regulation and limited restructuring options create operating issues, increase compliance costs and raise additional concerns that consume management time and attention. Yet the complex and inconsistent US regulatory system makes it difficult to rationalize the risk management and administration of scattered portfolios and optimize capital.

---

[1][1]Available at https://www.pwc.com/gx/en/industries/financial-services/publications/global-insurance-run-off-survey.html

[2]Available at https://www.investmentnews.com/article/20180523/FREE/180529954/insurers-are-selling-off-old-annuity-business-x2014-what-advisers#.XOqq_sdVQOY.email

For many companies, legacy business becomes a distraction to management that would prefer to focus on core business. If legacy business can be transferred or acquired by runoff specialists or consolidators these buyers can create centers of excellence for specialist claim expertise. This specialized knowledge can generate savings in administration and reserve management and provide a better claim experience for the claimant. Transfers also can allow different portfolios to be combined and diversification benefits realized, allowing buyers to operate lower cost business models. The finality that is achieved through a transfer means the seller can move on and focus on new strategic priorities and the buyer can take full control of the runoff portfolio resulting in a more efficient approach.

New Restructuring Mechanisms can address these issues

US insurance companies need effective restructuring tools to allow them to consolidate, gain efficiencies and increase profitability in order to attract new capital. Companies are looking for exit solutions for non-core business that reduce or eliminate counter-party risk, optimize capital utilization and provide economic and legal finality while ensuring that policyholders are protected. Over time credit risk problems arise, loss development can emerge, staff attrition increases, and management is distracted from its core lines of business.

Fundamentally, the need for restructuring tools is about the efficient use of capital. Insurance Business Transfers (IBT) provide a restructuring mechanism that allows a company to more efficiently and effectively address legacy business to more readily achieve stated goals of capital optimization, streamlined operations, financial and regulatory reporting efficiencies, and legal finality when segregating and disposing embedded blocks of business.

Existing options currently being used

Sale, reinsurance and loss portfolio transfers have been the most frequently used options to address legacy liabilities. But each of these has a limited application and, in many cases, is not a practical or financially rational solution, particularly in the low interest rate environment of recent years. Most companies have considered these alternatives and are looking for other more effective ways to deal with legacy liabilities that remain on the balance sheet.

Sale

Insurers and reinsurers wanting to restructure have frequently resorted to the sale of legal entities in order to divest specific legacy blocks. While sale eliminates the legacy business from the seller's balance sheet, a sale only works when the business the company is selling is in a stand-alone legal entity. Run-off or legacy liabilities are very frequently embedded with other active business and because there are no available restructuring mechanisms to segregate the businesses, a sale would not be an effective option.

Reinsurance/loss portfolio transfer

Reinsurance and loss portfolio transfers are another frequently utilized option to address legacy liabilities. While reinsurance or loss portfolio transfers provide some economic relief, the liability remains with and can revert to the original carrier. Also, reinsurance involves long term processing costs, onerous accounting requirements and credit risk, and exposes the seller to the business being put back to them if the buyer has financial challenges. There is no legal finality because the policyholder liability remains with the original insurer.

Novation/Assumption Reinsurance

Until recently the only way to transfer a block of business with finality in the U.S. was by way of a policy novation process.[3] The existing process of novating policies (i.e. assumption reinsurance) is expensive, cumbersome and time-consuming and the process is inconsistent among the states as each state has differing requirements. In most instances the novation process will not result in positive consent from all policyholders, especially for older books of business.

Commutation

Some companies utilize commutations to reduce run-off exposures. However, commutation only provides relief for a select group of policies, leaving the company with policies that it is unable to commute.

<u>Recent Developments</u>
The Insurance Business Transfer

In 2014 Vermont adopted its Legacy Insurance Management Act (LIMA)[4], which allows non-admitted insurers to transfer discontinued commercial business to a third-party company with regulatory approval. LIMA was the first US legislation that allowed companies to acquire and manage closed blocks of non-admitted commercial insurance policies and reinsurance agreements. Some had hoped that this legislation would become a US version of the Part VII Transfer in the UK. However, because of the limitations on its use and other problematic features in the approval process it has not been viewed as a viable option for transferring blocks of business.

Building on the pioneering developments in Vermont, in 2015 Rhode Island passed legislation providing for IBTs that apply to commercial P&C run-off liabilities[5]. Then in 2018 Oklahoma passed Senate Bill 1101 "The Oklahoma Insurance Business Transfer Law" that applies to all lines of insurance.[6] The RI and OK IBT legislation allow for transfers of some or all a company's business to another insurer without the need for policyholder consent, through a regulatory

[3] The Rhode Island and Oklahoma Insurance Business Transfer laws provide a transfer process that results in finality for the transferring company.
[4] Vermont Insurance Code T. 8 Section 7111, et seq.
[5] Rhode Island Insurance Regulation 68
[6] Section 1681 of Title 36

and judicial review and approval process resulting in a court-sanctioned novation of the transferred policies, including the attaching reinsurance.

The OK IBT legislation closely follow the format and processes of the UK's Part VII transfer. Governed by state legislation and regulatory approval, and supervised by the courts, it enables insurance policies to be novated from one insurer to another insurer through a judicial approval process, without the need for individual policyholder consent. Through a transparent and closely monitored approval process, the IBT brings the transferor complete finality for the transferred policies.

Because of the non-consensual nature of the process there are checks and balances that are designed to protect the interests of policyholders. These include

- Notice to all stakeholders, including policyholders;
- Extensive financial disclosure
- Review and approval or non-objection of the chief regulators in the transferring and assuming company's state of domicile
- An independent expert report that evaluates the impact of the transfer on affected policyholders;
- A hearing and opportunity to be heard; and
- Judicial review and approval

An important element of the IBT approval process is the review and report of the independent expert (IE) that evaluates the impact of the transfer on the affected policyholders. The selection of the IE must be approved by the regulator and key considerations include adequate independence from the transfer and having the appropriate skills and experience to act as IE. The role of the IE is to assist the regulator and the court in the decision whether to approve the transfer. The primary concern of the IE is security provided to the policyholders and whether this is affected by the transfer. The IE will consider many factors including capital strength, risk of insolvency and reserve adequacy.

The IBT provides a reasonable framework for transfers of insurance business while also providing multiple safeguards for policyholder protection resulting in a fair outcome for all parties involved.

<u>How will IBTs be used?</u>

The following are some examples of how the IBT can be used by insurers and reinsurers.

A group reorganization

A large insurer wants to rationalize its general insurance business. Over time it has accumulated 12 insurance entities each requiring separate governance, reporting and accounts, and capital. The group can use an IBT to consolidate into a much simpler structure with three entities, including one primary entity for general insurance underwriting, an entity for legacy liabilities and a white-label carrier. This corporate simplification also makes it much easier for the regulator – he or she can look at three balance sheets instead of 12!

A consolidation of legacy liabilities into one entity for sale

A large US insurer wishes to dispose of legacy operations, but these operations are split across 4 different entities, one of which is not even part of the group. Using an IBT, the insurer can package all the liabilities for sale into a single entity creating a simpler proposition for the sale of a single entity and thereby maximizing value.

A sale of legacy liabilities

A large insurer wants to improve its capital position by disposing of a subset of liabilities written prior to 2005. Having found a suitable purchaser, an IBT can be used to transfer the liabilities directly to the acquiring insurance company.

Implementation of IBT transactions

State insurance regulators currently have well-developed statutes, practices, and procedures to handle transfer transactions such as those that will be executed pursuant to the IBT.

In 1997 the NAIC published a White Paper regarding "Liability Based Restructuring" (LBR), that was defined as "an extraordinary transaction, or series of transactions, in which one or more affiliated insurance companies wholly or partially, isolate their existing insurance obligations from their on-going insurance operations." The IBT is very similar to, if not the same as, the LBR. The 1997 White Paper specifically considered the issues of financial solvency and reporting requirements and stated:

> Regardless of the nature of an LBR, a key responsibility of the regulatory authority in assessing whether to approve the transaction will be to analyze financial solvency issues. The regulatory authority must determine whether the resulting structure will have sufficient assets, both as to quality and duration, to meet policyholder and other creditor obligations. To make this determination, the regulatory authority will need to assess reserve adequacy, collectability of reinsurance balances, and the value and liquidity of assets. Before formulating a conclusion based on these assessments, the regulatory authority should also consider the adequacy of capital and surplus levels and whether financial support is available from the parent company or other affiliates.
>
> The restructuring insurer should provide the regulatory authority a detailed analysis of business and operational aspects of the LBR, including a detailed business plan, historical, current and pro-forma financial statements, and a description of the

transaction's tax consequences. The financial information provided should include a balance sheet of the insurer as if the restructuring plan were approved, and schedules detailing assets and liabilities to be reallocated as a part of the restructuring plan. Any special charges or write-downs that will be made as a result of the LBR should also be specifically identified. The detailed business plan should also include a discussion of how the LBR will impact obligations to policyholders and other creditors. In addition, a statement should be provided describing the consequences if the LBR is not approved.

These standards can serve as the framework and basis for regulators when considering IBT transactions. In addition, section VI of the 1997 White Paper specifically addresses the need for oversight for these types of transactions and Appendix 3 to the White Paper sets forth examples of conditions and requirements for on-going regulatory oversight that are still relevant today.

Since the publication of the 1997 White Paper, there have been significant developments in the application of Principle Based Reserving and the use of economic modeling to determine both capital and reserve levels for transactions. New actuarial pronouncements, such as VM 20, have been put forth by the actuarial profession that provide additional actuarial guidelines. The actuarial profession is well versed and better positioned today than it was in 1997 in the use of these applications that will be used to establish capital and reserve levels for transfer transactions. Regulators and actuaries can apply these applications as appropriate, depending on the structure of the transaction.

Regulators must have the discretion to determine the capital requirements and reserve levels that are needed for the transaction before them. A one size fits all approach would unnecessarily restrict the regulator's ability to make required adjustments and could result in adverse impacts to policyholders. Ultimately each transfer transaction must stand on its own, and regulators must have the flexibility required to respond to the requirements of each transaction.

Conclusion

The IBT will permit more efficient management of transferred books of business and allow dedicated capital and focused solutions to be applied to run-off liabilities. The IBT provides a reasonable framework for transfers of insurance business while also providing multiple safeguards for policyholder protection resulting in a fair outcome for all stakeholders. It is expected that over time the IBT will become a widely accepted business practice in the US marketplace as it has significant strategic importance to insurance companies to allow them to restructure while ensuring that the interests of policyholders are protected.

We appreciate the opportunity to comment on these important topics. Please let us know if you need any additional information or would like to discuss this further.

Sincerely,

Luann Petrellis*
lpetrellis@outlook.com
(610) 304-4524

Richard Newton*
rn8652@aol.com
(727) 510-1177

cc: wmelofchik@ncoil.org

**Working closely with the Rhode Island Division of Insurance, Luann and Rick drafted the regulations providing for insurance business transfers in Rhode Island. Luann also worked closely with the Oklahoma Insurance Department to draft and pass the Oklahoma Insurance Business Transfer Law.*

Luann Petrellis

Luann is an insurance professional with over 26 years of experience developing run-off and restructuring strategies for companies with discontinued insurance and reinsurance business. Luann has served as a chief operating officer for global insurance carriers managing the run-off operations of P&C and worker's compensation portfolios that included ceded and assumed reinsurance business. She established and implemented successful run-off plans to achieve operational, regulatory and capital efficiencies, leading groups of professionals on a number of projects that focused on the orderly run-off of large blocks of insurance and reinsurance business.

Luann worked with the Rhode Island Division of Insurance and the Oklahoma Department of Insurance to draft and pass new legislation that provides for insurance business transfers, the first restructuring tool of its kind in the U.S. that enables companies to achieve finality for the transfer of legacy liabilities. From 2017 to 2019 Luann was employed by PwC as a managing director to focus on insurance restructuring and run-off and from 2015 to 2017 Luann worked with EY to expand their insurance run-off practice. Currently Ms. Petrellis is very involved in working with companies and regulators to develop solutions for long term care legacy liabilities – a serious challenge facing the industry.

Luann has made numerous presentations to trade organizations, regulatory bodies, and insurance companies regarding insurance restructuring and new developments in insurance restructuring legislation and she has written and published many articles on restructuring and run-off. In 2018 Luann was named "Person of the Year" by the Association of Insurance and Reinsurance Run-off Companies.

Luann is a member of the PA Bar Association. She received her J.D. from the James Beasley School of Law at Temple University.

Richard Newton

Rick has extensive experience in run-off and insurance restructuring and is recognized as a leader in the industry. Since 1982, Rick has been involved in the management of run-off portfolios, executing run-off transactions that includes ownership of several successful run-off insurance companies.

Rick was part of the group that executed the 1st MBO of a troubled reinsurance company in 1987 that was successfully run-off. In 1995, Rick formed International Solutions, LLC, a TPA / consultancy company focused on run-off and serves as its CEO. He works in both the domestic and international insurance industry, primarily providing advisory and management services to troubled run-off and turn around insurance situations. His experience includes the development of run-off business strategies, the execution of operational plans. Rick has led many successful run-off projects and has been involved in a wide range of transactional situations involving M&A, governmental privatizations, and capital raising in support of restructured run-off companies in the life, health and P&C industries.

Rick spearheaded the introduction of restructuring legislation in the US market and was significantly involved with the drafting and approval of the Amendments to RI Insurance Regulation 68 and the recent passing of the Oklahoma legislation providing for insurance business transfers. Rick continues to be recognized as a leader in promoting restructuring legislation for application in run-off and restructuring transactions.