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Rating Run-Off Insurers and Specialists

Although analyzed in a manner similar to other insurers, run-off insurance companies require additional analysis during the rating process. As they are no longer underwriting new business, insurance companies in run-off are focused on meeting the liabilities of present policies until these policies expire; thus, they have unique characteristics that must be considered during the rating. This criteria procedure describes 1) the approach to rating insurance companies that have been placed into run-off and 2) the approach to rating run-off specialists: insurance companies that have a business strategy of acquiring and managing run-off (re)insurers or run-off books of business.

Stand-Alone Considerations

Every insurance company that maintains an A.M. Best rating, including an insurer in run-off, is reviewed on a stand-alone basis. The insurer's strengths and weaknesses are analyzed, without any benefit or drag from its affiliation with a larger organization. As when evaluating other insurers, the balance sheet strength of an insurer in run-off is the most important area to evaluate when determining claims-paying ability.

Many life/health run-off companies are quite profitable, given the absence of new business expense strain. It is common for these companies to grow surplus organically – sometimes more quickly than companies writing new business.

On the other hand, since property/casualty run-off insurers have no renewal premium and limited business profile, the stand-alone assessment of property/casualty run-off companies generally focuses on the adequacy of loss reserves to fulfill the company's policyholder obligations; the credit risk and structure of any existing reinsurance program; and the liquidity profile, asset allocation and revenue generated by the company's investments.

For property/casualty insurers, estimating the timing and amount of future loss reserve payout patterns on a run-off portfolio is subject to considerable uncertainty, especially when policy limits are high and claim settlements are unpredictable. Credible estimates of future payout patterns are critical to the forward-looking evaluation of a run-off insurer's creditworthiness and are a key component of A.M. Best's analysis of run-off insurers. Special attention is paid to historical payout patterns of the blocks of business, as the risk of adverse reserve development could threaten a run-off company's capitalization even more than a typical property/casualty (re)insurer, given the absence of annual renewal premium income to offset cash outflows that may have unexpected size or timing. Importantly, the circumstances that led the company to be placed into run-off are considered to determine what adjustments should be made to Best's Capital Adequacy Ratio (BCAR) to appropriately reflect the company's changed circumstances.

A.M. Best evaluates the run-off company's selected asset allocation strategy for risk and sustainability, and future investment income projections are evaluated against prior portfolio yields and new money rates. Insurers may be tempted to compensate for a low interest rate environment by imprudently chasing yield or riskier investments. In addition, annuity blocks in run-off face liquidity risks from increased surrenders due to low crediting rates or distributors' behavior. Many run-off life/health companies may have significant streams of renewal premiums, particularly for life insurance products, which give them the option to fund claims/benefits with either new money or existing investments. As a

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result, liquidity risk often is not materially higher than for other companies, and the ability to change asset allocation is not diminished significantly. By contrast, property/casualty run-off companies, with no new premium to invest, have more limited ability to reallocate investments. An increase in asset risk factors to reflect this limited ability to rebalance investments may be appropriate.

Asset-liability matching (ALM) is important, given the expectation that the company will sell its existing assets to pay claims. To the extent that assets and liabilities were not well-matched, it would be appropriate to increase the risk factor associated with the assets to reflect the increased liquidity risk.

Depending on the evaluation of the relevant factors described above, an insurer's stand-alone assessment may not necessarily change when the company is placed into run-off, if the surplus level at the insurer before entering run-off is maintained and supports the remaining balance sheet risks. However, the stand-alone assessment could be downgraded if the run-off status calls into question the insurer's ability to meet its policyholder obligations, particularly when those obligations are long-dated.

The Impact of Run-Off Specialists on Stand-Alone Analysis

Property/casualty run-off specialists are (re)insurance companies with a business strategy of acquiring reserve liabilities to profitably manage the settlement and payout of claims until all liabilities are exhausted. A run-off specialist that is managing the run-off insurer may handle claims more efficiently, given its specialization. In addition, a run-off specialist's financial projections may have more credibility if management has a successful track record of executing its run-off strategy. The run-off insurer owned by a run-off specialist also may have fewer operational risks than if it were owned by a traditional insurance group (e.g., systems issues, lost personnel and employee agency problems). Furthermore, capital at an entity owned by a run-off specialist may experience less pressure to be reallocated to other areas than within an active insurance group. Finally, reinsurance dispute risk can be greater when an entity within an active insurance group is placed into run-off, causing the business relationship and associated premium with the reinsurer to end abruptly.

In addition to property/casualty run-off specialists, life/health companies exist with business segments dedicated to investing in run-off insurers and/or blocks of business, as well as companies that have long histories of holding run-off entities to support earnings.

Rating Run-Off Specialists

The approach for rating an (re)insurance enterprise predominantly focused on the business of run-off is broadly similar to the approach for rating other insurance companies. The approach described for analyzing the liabilities and assets of insurers in run-off also applies to analyzing run-off specialists. However, given its unique business strategy, additional considerations are included in the analysis for rating a run-off specialist. As mentioned, run-off specialists are (re)insurance companies with a business strategy of acquiring reserve liabilities to profitably manage the settlement and payout of claims until all of the liabilities are exhausted. A run-off specialist seeks to use its experience managing complex claims, its specialized focus and its economies of scale to profitably manage the run-off of the loss reserves. A run-off specialist will be motivated to effectively run off acquired entities and thereby ease future regulatory approval of additional acquisitions.

A seller may be motivated to dispose of a portfolio of reserves to achieve a clean exit from the business, reduce administrative costs, focus on growth opportunities or reduce the risk of adverse reserve development. The structure by which run-off specialists acquire reserve liabilities can take many forms, including loss portfolio transfer, quota-share agreement or the purchase of an entire company. Notwithstanding the form, the key element of the deal is that the run-off specialist receives assets as consideration for assuming contractual liability for the payment of losses associated with the reserves.

One distinguishing characteristic of a run-off specialist is that it acquires all of its loss reserves from motivated sellers. This raises the concern of potential adverse selection. As a result, when analyzing a property/casualty run-off specialist, A.M. Best requests actuarial reports detailing the past performance of the loss reserves of current and prospective blocks of business. In addition, A.M. Best reviews the level of conservatism built into projections of future loss payments, given the uncertainty of profitability due to the risks of mispricing and adverse selection. Finally, the track record of management's prior deals is even more important in evaluating a run-off specialist. If prior acquisitions have a track record of unanticipated, material adverse development, then A.M. Best incorporates this into its view of management's projections of profitability.

A.M. Best re-evaluates its fundamental view of a run-off specialist's capitalization upon each potential acquisition of material size. When analyzing financial projections for operating performance and capitalization, the analysis reflects that future growth will be driven by acquisitions whose size, number and profitability are uncertain and could vary widely. The uncertainty in these factors influences the amount of capital required. Also, the ability of a run-off specialist enterprise to support all of its run-off liabilities is finite, and the ability to support older acquisitions is considered each time new run-off reserves are acquired. In addition to performing an analysis of the historical claim-settlement history of a block of business targeted for acquisition, an analysis must be done of the discount rate, expenses and profit margin assumptions used in pricing the deal. Reserve portfolios considered unpredictable will require significantly higher risk charges that could affect A.M. Best's view of overall capitalization.

Consideration of Rating Enhancement

When a run-off entity is owned by a parent that is a run-off specialist or maintains a dedicated run-off business segment, strategic importance is more likely to be considered, given that a run-off specialist has a business strategy of acquiring and profitably managing the settlement of reserve liabilities. If a run-off company is part of a larger group, then the approach for applying rating enhancement to a run-off insurer is similar to the approach used for applying rating enhancement to other insurers. This includes an analysis of the likelihood and level of future financial support that will be afforded from the group based on its strategic importance to the enterprise. However, since a run-off entity within an enterprise focused on ongoing operations is less likely to be considered strategically important to the overall operation, the decision to afford rating enhancement will be based primarily on the degree to which its operations cannot easily be separated from those of the parent or affiliates for legal or reputational reasons.

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