

Young pretenders in the US run-off market

Professional run-off companies are relatively new in the US, but they have a lot to offer, argues Bart Frazzitta.

The insurance and reinsurance industry seems never to learn by its mistakes. Several companies will diversify their product lines, not out of sound business planning and judgement, but rather because certain competitors have taken that course and there is a need to follow them.

In an industry in which timing and niche activity play a major role, we find companies following the fortunes of those they deem to be leading competitors. Thus they step into a class or type of business at a time when the so-called leaders are already thinking about the next niche in which to focus their efforts.

Research and development is probably the least considered item in a company's budget process and yet it is probably the most critical in today's business environment. An astute person once said: "those who fail to plan, plan to fail" and it is a saying that holds true in our insurance community today.

When a company realises that poor underwriting results cannot be altered to make the product line profitable, a decision is usually reached to discontinue the business. It is not uncommon for a company to have a substantial amount of its liabilities housed in discounted operations, sometimes as high as \$5bn. Yet, "Out of sight — out of mind" is often management's response to the question "What do we do now?", following a decision to cease underwriting.

In the US, companies with discontinued operations fall into three major categories:

Large insurers and reinsurers

In this category, most companies place all their discontinued operations in a department or division that specialises in handling this type of operation. Usually the staff that were involved in the handling of the specific book will move with the run-off and will become part of the discontinued operations division of the company.

There is a certain negative connotation to this, since the staff that are moved often view themselves as being in a dying or dead operation and begin to look for another job that represents a future for them. If the truth be known, however, discontinued or run-off operations will, in many cases, probably exist as long as the normal operations of a company.

Large companies in the US are beginning to see the impact that a poorly managed discontinued operations division can have on their bottom line, and have started to build a strong staff to address the long-term claim problems that are inherent in a cancelled book of business.

Companies who opt to keep the discontinued book of business under their control must create a sense of urgency among their staff. A well managed, technically sound run-off operation is expensive and can continue to have a negative impact on the bottom line in terms of administrative costs.

To realise their full value, the staff must be aggressively pro-active individuals who can mitigate losses, since their contribution to the corporation can be measured only by the loss savings they generate, thereby having a positive impact on the loss ratio of the company.

In many cases this is still to be recognised by senior management.

Captives

Because of certain tax benefits that were available to large industrial corporations, there was a trend for them to establish insurance companies. Most of these captives, not being expert, suffered large underwriting losses on third party business.

Since most of the tax advantages have either been narrowed or eliminated by tax law revision, these large industrial companies now find themselves with insurance subsidiaries that are of no value to them, and in some cases represent a major liability in their financial statements.

These companies face the task of how to extricate themselves from this situation, without being tied to a subsidiary that has been put into liquidation by a state insurance department.

Since the insurance subsidiary is its only discontinued operations entity, the company can opt to try to run-off these liabilities or attempt to sell the entity.

Most corporations in this position have chosen to run-off the liabilities. In doing so they must commit themselves to paying substantial salary and bonus amounts, expensive severance packages and other associated expenses to keep the staff interested enough to stay and continue to function, when in fact what they really need are pro-active aggressive staff to accomplish the run-off promptly. They are unlikely to obtain the latter when the result would be for those concerned to work themselves out of a job.

The other alternative — selling the captive insurance entity — has proved to be a problem. In today's society the latent claims aspect of our industry's coverages have created a great deal of uncertainty as to the ultimate cost associated with environmental and pollution losses, and who will ultimately be asked to pay for these losses.

When these potential expensive losses are translated into reserved liabilities and into today's present dollar value, it has been difficult for the buyer and seller to reach an agreement in which they each consider themselves to be the winner.

US subsidiaries of foreign companies

There is a substantial insurance and reinsurance market in the US that is viewed by the worldwide insurance community as a marketplace in which they must be represented.

Experience has shown that the best way to take advantage of this market has been either to establish an insurance subsidiary under the laws of a specific state or to create a US branch. Either approach places the operation under the rules and regulations of the insurance department where the parent chooses to license the entity.

Given the political, judicial and social impact which this has on the insurance product, several foreign entities have decided to stop writing business in the US. In making that decision they have created a need to run-off their insurance and reinsurance activities, under the ever-present and watchful eye of the insurance department.

As in the previous example, the owner is faced with keeping the staff in place. Higher salary and bonus arrangements, expensive severance packages and other similar enticements must be put in place to keep the staff necessary to handle the run-off activity.

Both the captive and foreign-owned company categories represent situations where putting the business in the hands of a professional run-off manager should be considered. Concerns about working oneself out of a job do not exist for the staff of such an organisation, so the owner can obtain a commitment to finalise the run-off as quickly as possible.

Such an approach would not be in the interest of its own staff, who would be relying on the run-off for their income.

Surprisingly, however, this seems to have happened rarely in the US to date. The reason for this is that while in the UK professional run-off companies were formed in the early 1980s to manage discontinued operations, the trend only started in the US more recently.

In the US it is only in the last three or four years that several entities have been created that were specifically formed to address run-off or discontinuing operations and to provide an alternative option for companies to consider in determining how to approach this problem.

Because the companies which have been established are young and still growing, they are just coming into their own as an alternative to in-house run-off operations.

The key for these companies is to demonstrate with confidence the plan and approach that they have in entering this field, and both the staying power and quality of staff and systems employed to handle the assignment in an effective and efficient manner. They have to demonstrate that they can 'add value' to the run-off process. IE

Bart Frazzitta is chief executive of Market General Run-Off Services, the US subsidiary of Market Group Management.