Calm before the storm?

The US run-off market is in a slowdown, but not for long, suggest **Steven Bazil** and **Parker Stanhagen**

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Run-off in the US has been a curious beast for those operating in the industry. Although the US market is generally acknowledged as the largest run-off market in the world, with estimated liabilities of $150bn to $200bn, run-off as a standalone business is less mature than in the UK.

This immaturity may be a signal to some that the US is an ideal place to pursue run-off opportunities and flourish from the vast amounts of outstanding liabilities. Others recognise, however, that a degree of uncertainty comes along with attempting to operate in a US market where very little information is known and where changes in the industry have been volatile. These uncertain trends and lack of general knowledge about the US market have made many people opt to look the other way and exclusively pursue business in more secure run-off markets.

Staying away from the US however, is incredibly difficult, when the lure of a flashing neon sign beckons run-off players to the US, reading: "$150bn to $200bn. Come get it!"

Before anyone can capitalise on the vast US run-off market it is vital to understand its current state. Over the past 15 years the run-off industry has undergone a period of transition. The business of run-off was previously conducted by units within a company dedicated to bringing finality to books of business. Performance was often judged by a stopwatch, with a successful run-off being the one that was completed and provided finality to a business fast.

Over time this has changed and new players who are managing the run-off of other companies have emerged in the market. These new entities have changed the way run-off is handled. No longer are we seeing prompt finality as the ultimate measure of success. Instead these new operations are, in many ways, mirroring financial institutions and redesigning the way run-off in the US is managed. Many in our field have noticed a decrease in commutations, particularly where third parties are involved. These new techniques which are the source of the decrease in commutations have led some to believe we are seeing a significant slowdown in the market.

Slowdown

The 'slowdown' has been a result of a number of factors. New entities are entering the run-off business in the US and traditional run-off companies are not sure how to react. History has proven that the run-off industry has done a poor job of managing capital efficiently. This inefficient use of capital has enabled nontraditional run-off entities to emerge and bring a fresh outlook on how to manage the assets involved with run-off. Hedge funds have pounced upon the opportunity to enter a market that is immature and in need of fresh investment ideas.

We have also seen a number of other fresh faces bring a new prospective on how to deal with the evolving US run-off market, such as upstart Cerberus Holding Company. The entrance of these new companies has caused traditional run-off powerhouses to freeze. The new prospective on capital management is unfamiliar territory for a group of businesses who have operated in isolation for many years.

It is not simply the entrance of new players to the game that

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has led some to believe that the US market is in a slowdown. A number of recent acquisitions have consolidated many companies that had portfolios in run-off. Berkshire Hathaway, Cavell, and Enstar are a few of the companies who have actively participated in the acquisition of insurance and reinsurance companies and are now administering those businesses in run-off. The result is that some may think that fewer players means less effort is being devoted to bringing finality. The scope of the US market however, is so large that even with the numerous acquisitions and consolidations that have occurred the vast majority of the market remains primed for new run-off investors.

The slowdown has also been attributed to a significant decrease in US domiciled companies entering the run-off market. It has been several years since we have seen a move by a major company to go into run-off. Gerling is one of the few major companies to enter the run-off market in recent memory and their entry was several years ago.

The market will not remain in this frozen state for long though. While the rest of the companies are dipping the toes in the water, someone is eventually going to dive in head first and try to take advantage of the seemingly endless liabilities the market has to offer. At that point we will likely see a domino effect occur. More companies will jump into the water, both in the fear that they may miss the boat on the market, and because they will be able to monitor and learn from the mistakes of the previous entrants.

The business terrain in the run-off market has drastically changed since its creation. Run-off was originally developed to provide finality and terminate legacy business. Now however, many of the new large players are acting like financial institutions. Commutations have become less frequent unless there are compelling reasons to do so,

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such as financial peril of your security. Instead, the new preference is to manage the money carefully and utilise investment income to pay claims and satisfy ongoing operating expenses.

These changes have caused a brief standstill in the market as no one is quite sure what the next step should be. Whether this standstill can be described as a slow-down is uncertain. More likely the best way to describe the current state of the US run-off market is that we are presently in the calm before the storm. The market is at the brink change but it is unclear as to when it is going to happen. Given the value in the marketplace though, we are likely to see a flurry of activity when the storm actually cuts loose. There is no question, however, that movement is going to begin at some point in the US market. No one can turn a blind eye to $150bn to $200bn.

Run-off within State limits

Run-off as a standalone business is significantly less mature in the US than the UK.

Nevertheless the past twenty years has seen rapid growth in a sector that has begun to narrow the divide.

For example as recently as the mid-‘80s, most States did not have Liquidation Bureaus to handle the administration of insolvent estates. Instead, financially impaired companies relied on ad hoc court-appointed receivers with varying degrees of reinsurance experience to manage local run-offs.

As the complexity and frequency of insolvencies increased, States began to adopt a more European corporate structure to confront the challenges of a multifaceted global run-off.

Still, with individual States governed by their own insurance departments, they can choose to ignore recommendations and regulations introduced at a countrywide level by the National Association of Insurance Commissioners.

And not surprisingly, these State-run operations are not proactive in instituting regulations that have the binding authority to institute such run-off models as Schemes of Arrangement for solvent and insolvent run-offs. For instance, the State of Rhode Island remains the only US State to enact “Scheme-like” legislation modeled after Section 425 of the Companies Act of 1985 in the UK The success of this legislation remains to be seen.

Since companies are liquidated under the laws of its own domiciliary, States and their Courts also decide the applicable accounting methods and validate proof of claims. States along with their corresponding Insurance Departments remain hesitant to improve transparency and accountability with regard to receivership activity. As a consequence, further US run-off integration suffers as a whole from localised practices.

Financially impaired companies in the US can protect themselves and potentially pay creditors by placing the company into Rehabilitation and eventually Liquidation under the final direction of State Courts. But judges within the Courts, who may be completely unfamiliar with the run-off sector, decide critical issues related to a financially-impaired insurance company and its run-off.

For example, it is not uncommon for courts to completely disallow a creditor to admit a claim for case reserves and/or IBNR for fear that other creditors with claims for paid losses only will be prejudiced.

These major problems permeating US run-off are systemic and resistant to the types of changes necessary to operate more efficiently with its UK counterpart. Without formal mechanisms for run-offs, the US market remains fragmented, a product of its geographic makeup, and still relatively inexperienced compared to the UK.