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October 2, 2014

Mr. Stephen J. Johnson, CPA
Deputy Insurance Commissioner
Office of Corporate and Financial Regulation
Pennsylvania Insurance Department
Strawberry Square, 13th Floor
Harrisburg, PA 17120

RE: RRC Review of Towers Watson Response to July 23, 2014 Hearing Record Regarding One Beacon Form A Filing

RRC has reviewed the August 11, 2014 response prepared by Towers Watson (Towers) to the statements and testimony presented at the July 23, 2014, hearing concerning the One Beacon/Armour Form A filing. Tower's response, as well as RRC's review, concentrates on the actuarial aspects of these statements and testimony with regard to its analysis of One Beacon's unpaid loss and loss adjustment liabilities and its stochastic modeling of One Beacon's proposed balance sheet as of the most recently assumed transfer date of June 30, 2014. We have also addressed other questions raised by the public which were relevant to our analysis of the actuarial aspects of the Form A filing.

Overall, Towers responded appropriately to the technical criticisms made at the hearing. Several commenters suggested that actuaries have understated A & E liabilities in the past, and that these projections are likely to have the same flaws. For example, several commenters referred to articles in the trade press predicting a coming "third wave of asbestos litigation". Towers replied that it has already incorporated much of the new findings in their models, including that deployed here. Towers offers further explanation of technical aspects of the models, including parameter risk, process risk, use of a lognormal distribution for loss payments, etc. Some commenters cite Towers' caveats concerning uncertainty (new mass torts, new causes of action, and new judicial and legal precedents) as evidence that the work is unreliable, but Towers responds that such caveats are appropriate and required by standards of actuarial professionalism, and we agree with that response. Towers notes that its Incurred but not Reported (IBNR) provisions implicitly address these possible occurrences, and many of the 10,000 simulated scenarios in its stochastic model include very high A & E losses, arguably as a result of the events not explicitly considered. For example, the worst scenario in the stochastic model (with respect to NICO losses) shows gross NICO losses nearly twice as high as the mean estimate. Although there is a great deal of uncertainty in making these estimates, the insurance

industry looks to actuaries to perform this work, and Towers is generally recognized as an industry leader.

We note the current modeling does show failures in the highest loss scenarios. The success rate is approximately 88% and the failure rate is approximately 12%, including the impact of the additional \$81 million in capital from the proposed transaction. Note the additional capital had the impact of increasing the success rate in the proposed structure.

Set forth below are certain issues raised by commenters, and our observations.

1. ***The Towers modeling report does not contain sensitivity testing or reverse stress testing.***

Towers replied that its stochastic model is robust enough that additional metrics are not needed. RRC did do some stress testing when it asked Towers to run the model with asset yields slightly lower than their baseline scenario. The model's stochastic output does provide a good sense of the risks for the Company, and we do not think additional sensitivity or reverse testing would be likely to yield additional information or lead to a different conclusion.

2. ***Towers prepares its analysis based on the actuarial central estimate of reserves, thus valuing the risk of the low and high estimate of reserves at zero.***

Towers noted that this is completely untrue, as the 10,000 simulations include ultimate losses above and below the central estimate. We agree with Towers.

3. ***Towers does not include the risk of "known unknowns".***

Towers noted that it cannot explicitly consider new causes of action and the like – events that may occur but cannot currently be quantified because they have not happened yet. Towers also noted that the IBNR provisions (included in the actuarial central estimate) are designed to address this "implicitly". Also its 10,000 simulations included some extremely high A & E losses – presumably caused by one or more of these currently unmeasurable events. As noted earlier, the worst scenario in the stochastic model (with respect to NICO losses) shows gross NICO losses more than twice the level of the mean scenario. We note that such outliers show significant stressing by Towers. We also note that the stress scenarios with the highest assumed loss development would cause solvency problems for the "as is" runoff as well as the "Form A" proposed structure. The "Form A" proposed structure does have an additional \$81 million in capital which improves the success rate.

4. ***Slower-than-expected release of \$90 million in Securities on Deposit (SODs) could create a cash flow problem.***

One Beacon does have approximately \$90 million in securities on deposit with jurisdictions around the country and the model does project that these are liquidated over time, as the companies' WC liabilities decrease. The model assumes that these are released in proportion to Towers' estimated WC payout of its high reasonable reserve estimate. This assumption seems to be prudent. Regulators know that it is often difficult for a company to get its securities on deposit returned to them, even if the company is experiencing financial difficulty. However, in this case, Towers is projecting a relatively slow release, and the Companies should be able to satisfy most of their WC obligations (thus freeing the deposits) before they would need the money to pay post-NICO A & E losses. We asked Towers and One Beacon if they had done any sensitivity testing with regard to release of the SODs. They replied that they had

tested the impact of slower-than-anticipated release on the failure rate. The mean scenario assumes that the deposits will revert to the Companies roughly one year after it is determined that they can be returned. Towers tested the model using a two-year lag (for example, reserves at the end of 2014 would indicate that some funds could be released, but this does not occur until sometime in 2016-2017). They noted that the additional year of lag did not significantly affect the model's results. It appears to us that delayed release of SODs might have an impact on investment returns, but should not create a cash flow problem unless the BBB portfolio suffers severe defaults at the same time.

5. ***Towers says it was not engaged to assess capital adequacy under metrics such as RBC or ORSA and that it decided that the stochastic model was the best way to answer whether assets were sufficient.***

Risk Based Capital (RBC) requires capital over and above a reasonable estimate of loss reserves. RBC is a specific measure utilized by state insurance departments to determine when a company should be placed under supervision. RBC law allows companies in run-off to operate under RBC thresholds under the supervision of the Insurance Commissioner. Therefore, the RBC ratio may not be a pertinent regulatory tool in this case. For ORSA (also a regulatory tool arguably more appropriate for an active company than for a runoff), there also in theory would be a consideration of needed capital during periods of stress, over and above the carried reserves. Towers' stochastic model includes thousands of scenarios with payouts worse (faster payment patterns and/or larger dollar payouts) than their central estimate, and with poorer-than-average asset returns. Most of these worse-than-average scenarios do not result in failure. In this sense, the stochastic model is a good stand-in for ORSA-type stress testing.