115

IX. REPLY TO TW AND OBIG COMMENTS

102. In its responses to questions raised at the Hearing, OBIG incorrectly asserts the following benefits to the Runoff Companies policyholders upon consummation of the Proposed Transaction:

- Sufficient assets;
- Being free of the uncertainty from new business with a dedicated pool of assets;
- Cost savings; and,
- Experienced runoff managers.[92]

103. Based on new information obtained from the Hearing, and the subsequent OBIG and TW responses to questions raised at the Hearing, I have developed a number of responses to these assertions:

<u>Sufficient assets are NOT provided to the Runoff Companies</u>

A: The public record in this proceeding does **<u>NOT</u>** support approval.[93]

B: Using 10,000 scenarios does **<u>NOT</u>** make TW's results more reliable for assessing the Proposed Transaction than 1,000, or even less, scenarios.[94]

C: Technical Insolvency **<u>is relevant and significant</u>** in assessing the Proposed Transaction.[95]

D: The separation of assets and liabilities between companies in the Proposed Transaction is **<u>NOT</u>** proportionate to the risk of the companies.[96]

E: Capital adequacy **<u>is relevant and significant</u>**.[97]

<u>Being free of the uncertainty from new business with a dedicated pool of assets is an illusory benefit</u>

F: The Runoff Companies policyholders are **<u>NOT</u>** safer in a separate company with dedicated assets.[98]

G: The Proposed Transaction leaves the Runoff Companies exposed to the Ongoing Companies' risks.

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[92] Cumulative Log, Document 107 (OBIG Reply, pp. 15-17).
[93] Cumulative Log, Document 107 (OBIG Reply, pp. 15, 24-26).
[94] Cumulative Log, Document 107 (OBIG Reply, p. 14).
[95] Cumulative Log, Document 107 (OBIG Reply, pp. 50-52).
[96] Cumulative Log, Document 107 (OBIG Reply, pp. 14-15).
[97] Cumulative Log, Document 107 (OBIG Reply, pp. 50-52).
[98] Cumulative Log, Document 105 (Hearing Transcript, 23:14 -23:19; 28:22-29:2); Document 107 (OBIG Reply, pp. 15-17, 54-56).

05

There is no evidence of cost savings

H: OBIG's statements regarding cost savings are contradictory, and there is **NO** evidence of any cost savings from the Proposed Transaction.[99]

There is no evidence that the change in runoff managers improves the status quo

I: There is **NO** evidence in the public record that the change in runoff management will be a benefit to the Runoff Companies policyholders compared to the status quo.[100]

Other issues

J: OBIG's arguments about parental support **side-step the issues** involved.[101]

K: TW's scope in its stochastic modeling does **NOT** address the commitments made by OBIG in June 2013 regarding the areas of interest to policyholders and, presumably, the PID.

L: There are questions from the Hearing not yet addressed by OBIC or TW.

104. The remainder of this section elaborates on my above responses to comments made by OBIG and TW. It should be noted that I do not address any of OBIG's comments related specifically to other expert presenters.

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[99] Cumulative Log, Document 105 (Hearing Transcript, 23:3-23:8; 201:1- 202:6); Document 107 (OBIG Reply, p. 15).
[100] Cumulative Log, Document 105 (Hearing Transcript, 28:12 -29:2); Document 107 (OBIG Reply, pp. 15-17).
[101] Cumulative Log, Document 107 (OBIG Reply, p. 53).

A. THE PUBLIC RECORD IN THIS PROCEEDING DOES **NOT** SUPPORT APPROVAL

105. OBIG asserts that the public record supports their claim that the Proposed Transaction provides sufficient Financial Capacity for the Runoff Companies. This is not correct, as the financial aspects of the OBIG assertion appears to be based on the following:

- A 0% payment failure in first 10 years and only 1% in 15 years based on Table 1 to the TW Stochastic Report.[102]

  OBIG's assertion regarding the significance of the 0% payment failure in ten years and 1% payment failure in 15 years is a misinterpretation of the TW's Table 1. TW did not study and has no opinion on the timing of the recognition of the payment failures. Any such payment failures would be recognized long before the company completely exhausted its assets.

  The OBIG interpretation is equivalent to concluding that a malpractice insurer with low capital is safer than a private passenger automobile insurer with equivalent capital because the malpractice insurer will hold the funds for a longer period.

- A 12% Payment Failure Rate from the TW report.

  As discussed in detail in Section VII, in my opinion, the TW analysis (12% Payment Failure Rate) shows that the capital provided in the Proposed Transaction is inadequate relative to any relevant standard of which I am aware.

106. Further, as discussed in Section IX.K below, TW did not opine that the Financial Capacity was adequate.

B. USING 10,000 SCENARIOS DOES **NOT** MAKE TW'S RESULTS MORE RELIABLE FOR ASSESSING THE PROPOSED TRANSACTION THAN 1,000, OR EVEN LESS, SCENARIOS

107. In the OBIG Reply, OBIG states:

> As Deputy Commissioner Johnson observed at the Hearing, the Department is well aware of the uncertainty faced "across the whole industry, not just [by] runoff companies," over a period of years, and "uncertainty is why we had 10,000 scenarios" modeled by Towers Watson. Transcript at 106. Based on the results of those scenarios, the assets reflected in the proposed *pro forma* closing balance sheets are designed to satisfy all liabilities of the Runoff Companies, even under scenarios of considerable stress (emphasis added).[103]

[102] Cumulative Log, Document 107 (OBIG Reply, p. 25).
[103] Cumulative Log, Document 107 (OBIG Reply, p. 14).

108. OBIG goes on to state:

> The resulting balance sheet has been stochastically tested over 10,000 scenarios . . . (emphasis added).[104]

109. OBIG refers to 10,000 scenarios as if to conclude that capital adequacy is more certain with 10,000 scenarios than would have been the case if the modeling had been done with 1,000 or 100 scenarios. Based on my experience in building and using models such as the stochastic model used by TW, this is not the case:

- Running as many as 10,000 scenarios would be important in testing whether the event of "cash being exhausted" was a 1-in-1000 event (99.9% success) or 1-in-100 event (99%).
- Capital modeling work often uses 10,000 scenarios or more, because the failure rate being considered is of the 1-in-100 to 1-in-1000 range.
- However, it appears that the event 'cash being exhausted' is a 1-in-8 event (approximately), and a simulation with 1,000 scenarios would be more than sufficient.
- For example, it does require 10,000 simulated die rolling experiments to conclude with high confidence that the probability of a '2' is 1-in-6.
- When deciding, in advance of the modeling, to use 10,000 scenarios, it appears that TW, RRC, OBIG and/or the PID anticipated that that frequency rate of 'cash being exhausted' would be much less frequent than 1-in-8 (12%).

110. Thus, the fact that the TW modeling used 10,000 scenarios provides no more confidence that the Proposed Transaction provides adequate capital than would a study using only 1,000 or less scenarios.

C. TECHNICAL INSOLVENCY **IS RELEVANT AND SIGNIFICANT** IN ASSESSING THE PROPOSED TRANSACTION

111. OBIG asserts that the issue of Technical Insolvency arises from flawed assumptions.[105] The basis for that assertion is that OBIG conflates two distinct aspects of my comments at the Hearing: that of Technical Insolvency and that of Inadequate Capital.

112. The issue of Technical Insolvency is merely accounting/actuarial terminology describing that the timing of a failure is based on when the time the failure is recognized and not on when the assets are exhausted.

113. As explained in Sections VI and VIII, the timing of Technical Insolvency is critical to statements about when timely payment to policyholders would be interrupted.

[104] Cumulative Log, Document 107 (OBIG Reply, p. 15).
[105] Cumulative Log, Document 107 (OBIG Reply, p. 50).

114. Moreover, as discussed in Section VIII, the absence of balance sheets needed to measure Technical Insolvency also means that the stochastic modeling is not reflecting other risks to timely payment in full for valid claims. As such, the failure rate is higher than the 12% Payment Failure Rate indicated by TW.

D. THE SEPARATION OF ASSETS AND LIABILITIES BETWEEN COMPANIES IN THE PROPOSED TRANSACTION IS **NOT** PROPORTIONATE TO THE RISK OF THE COMPANIES

115. In the OBIG Reply, OBIG states:

> As illustrated, the proposed, combined *pro forma* closing balance sheet reflects less assets and surplus than the pre-sale combined balance sheets, but it also reflects less combined liabilities, because the Runoff Companies, post-closing, are not exposed to the liabilities of the ongoing specialty business, including the loss reserves and the unearned premium reserves of the specialty business, with exposure to, among other things, natural catastrophe and terrorism related losses.[106]

116. I agree that assets, liabilities and capital are all reduced. However, the capital in the Runoff Companies is reduced disproportionately relative to the decrease in risk. This disproportionate reduction in capital is illustrated in three ways:

- Liabilities vs. capital
- ACL vs. capital
- Stochastic modeling of risk vs. capital

i. LIABILITIES VS. CAPITAL

117. **Exhibit 4** shows that when separated from the Ongoing Companies, the Runoff Companies have 41% of the liabilities,[107] representative of "risk," and only 18% of the capital of the combined companies before the Ancillary Transactions and the subsequent Proposed Transaction with Armour.

118. By that measure the capital provided to the Runoff Companies is disproportionately low.

ii. ACL VS. CAPITAL

119. Table IX-1 below compares the ACL and capital of the Runoff and Ongoing Companies in the event that the Proposed Transaction is approved.

[106] Cumulative Log, Document 107 (OBIG Reply, p. 14).

[107] OBIG may argue that some of liability risk is absorbed by the NICO and GenRe treaties so that 41% overstates the risk. Actually, based on the TW central estimate, the NICO and GenRe treaties are fully exhausted and have no further risk absorbing capacity.

Table IX-1

Capital and ACL Share Runoff vs. Ongoing Companies After the Proposed Transaction

	(A)	(B)	(C)	(D)	(E)
	Entity	**ACL** (in millions)	**% of Total**	**Capital** (in millions)	**% Total**
(1)	Ongoing Companies (ASIC)	$129	44%	$746	82%
(2)	Runoff Companies (Proposed Bal. Sheet)	$161	**56%**	$162[108]	**18%**
(3)	Total	$290	100%	$908	100%

Source:
B1, B2 = **Table IV-1**
Col. C = Col. B as % of Col. B Total
D1, D2 = **Exhibit 5**

D3 = **Exhibit 4** (balance represents implied consolidated capital for ASIC and OBIC, including Potomac, post-Proposed Transaction)
Col. E = Col. D as % of Col. D Total

120. This table shows that while the Runoff Companies will have 56% of the OBIC pre-Proposed Transaction total risk, measured as ACL, the Runoff Companies will have received only 18% of the OBIC capital after the Proposed Transaction.

121. Regarding this result I note that:

- The comparison of the runoff and ongoing position in Table IX-1 does not recognize that OBIG might provide support not legally required for its Ongoing Companies but not for the Runoff Companies then-owned by Armour.

  Said another way, the Runoff Companies have lost the potential for future support from the parent while the Ongoing Companies continue to have that potential for future support.

- Moreover, since OBIG will hold the Runoff Companies' surplus notes,[109] favorable experience from the Runoff Companies would provide OBIG with a source of funds to support the Ongoing Companies if the Ongoing Company experience were unfavorable.

[108] Based on TAC as presented by OBIG, rather than the lower TAC capital reflecting the TW central estimate. The comparison is even less favorable to the Proposed Transaction if the adjusted TAC were used, as I think is a more correct description of the Proposed Transaction.

[109] Cumulative Log, Document 079 (Amendment 1 to Form A, Exhibit SPA-A3, pp. 1-2).

iii. STOCHASTIC MODELING OF RISK VS. CAPITAL

122. Stochastic modeling of both ongoing and runoff businesses would provide even more evidence for whether the allocation of capital is proportionate to risk. However, OBIG has not provided the stochastic modeling information for its ongoing business.

123. Nevertheless, the TW stochastic modeling indicates a 12% Payment Failure Rate for the Runoff Companies with the proposed distribution of capital. As described in Section VII.A.v, with an 'A' A.M. Best rating, OBIC operates with a 3.5% target failure rate over the same time horizon as the 12% Payment Failure Rate for the Runoff Companies.

124. Thus, on publicly available information related to stochastic modeling, the allocation of capital is not proportionate to risk.

iv. CONCLUSION

125. It is clear that the Runoff Companies have been disadvantaged by the distribution of assets and liabilities between the Runoff and Ongoing Companies. The position of the Runoff Companies policyholders will be riskier than the positon of the Ongoing Companies policyholders should the Proposed Transaction be approved in its current form.

E. CAPITAL ADEQUACY IS **RELEVANT AND SIGNIFICANT**

126. As discussed in detail in Section VIII, the scope of the TW Stochastic Report did not include preparation of balance sheet projections. Therefore, important issues affecting the Payment Failure Rate, such as capital adequacy, are not recognized in TW's stochastic modeling. Proper consideration of the issues increases the chance that policyholder claims will not be paid in full on a timely basis.

F. THE RUNOFF COMPANIES POLICYHOLDERS ARE **NOT** SAFER IN A SEPARATE COMPANY WITH DEDICATED ASSETS

127. In the OBIG Reply, OBIG states:

> Of course, what is also clear from the Towers Watson model is that to achieve such favorable results, it must be "certain" that the assets in the proposed balance sheet are dedicated solely for the benefit of the policyholders of the runoff liabilities – that is, isolated from the fortunes of ongoing operations of its affiliates.[110]

128. Nevertheless, TW made no such assertion.

129. Further, I understand that OBIG's reference to "the benefit of the policyholders" means the Runoff Companies would, on balance, have a lower failure probability. From a Financial

[110] Cumulative Log, Document 107 (OBIG Reply, p. 55).

Capacity perspective, the OBIG statement with respect to the Proposed Transaction is not correct:

- First, as demonstrated above, the capital provided to the Runoff Companies is not commensurate with its risk. From that perspective the Proposed Transaction is not a benefit to the Runoff Companies.
- Second, suppose the capital were allocated between the Runoff Companies and Ongoing Companies in proportion to their risk. Still, the probability that either business alone would become insolvent is higher than the probability that the combined business would become insolvent. From that perspective, any "equitable" separation would be to harmful to both parts of the business.
- Thus, the proposition that the Runoff Companies would benefit from the separation of its business would only be true if OBIG believes the Proposed Transaction gives "too much" capital to the Runoff Companies and "too little" to the Ongoing Companies.

G. THE PROPOSED TRANSACTION LEAVES THE RUNOFF COMPANIES EXPOSED TO THE ONGOING COMPANIES' RISKS

130. Notwithstanding OBIC's assertions regarding the importance of separating the Runoff Companies' and Ongoing Companies' assets and liabilities, OBIG fails to mention that there are Ongoing Companies risks that the Runoff Companies retain.

131. As of December 31, 2013, OBIC retained over $350 million of reserves ceded to ASIC.[111] Those reserves are secured only by ASIC's continued financial strength. However:

- That added exposure was not modeled by TW.
- That exposure increases the chance of OBIC insolvency beyond the level indicated by TW, accepting all other features of the TW analysis.
- Given TW's expressed scope, it is not clear why that risk was not included in the TW assessment.

132. Once the Proposed Transaction is effected, OBIC retains the obligation to write business on a "fronting basis" for ASIC for a period not to exceed one year.[112] This will increase OBIC's exposure to ASIC business until claims are fully paid, albeit by a, perhaps, marginal amount. This exposure is also not reflected in TW's modeling.

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[111] OBIC 2013 Annual Statement, Schedule F – Part 3.

[112] Cumulative Log, Document 004 (SPA, pp. 61-62).

H. OBIG'S STATEMENTS REGARDING COST SAVINGS ARE CONTRADICTORY, AND THERE IS NO EVIDENCE OF ANY COST SAVINGS FROM THE PROPOSED TRANSACTION

133. The public record on cost savings is inconsistent, and assertions regarding these benefits are not supported by the public record.

- First, at the Hearing, Mr. McDonough states:

> After reviewing a number of options, we determined that a transaction with Armor [sic] was the best alternative because, number one, **it is economically neutral to OneBeacon. That is, the cost of the sale is comparable to the cost of continuing to administer the runoff business internally** (emphasis added).[113]

  I understand OBIG's statement to mean that the Proposed Transaction will be economically neutral to OBIC, the future Runoff Companies.

  Thus, it appears that OBIG claims that there are no expense savings.

- Second, TW states:

> Unallocated loss adjustment expenses (ULAE) for non-NICO lines are modeled using assumptions based on the variability of gross losses. ULAE for NICO is assumed to be a fixed percentage of the net NICO loss and ALAE payments. These amounts are included with the Loss and ALAE amounts in the model.
>
> The incurred underwing expense assumption by year was provided to us by OneBeacon. These amounts include one-time IT costs associated with the transfer of the business to Armour, Armour's management fees, and certain other costs such as premises insurance, audit expense, and actuarial services. These amounts have been partially offset by an expected retro premium receivable.[114]

  As such, perhaps OBIG means that any cost savings are offset by these one-time IT costs.

- Third, OBIG says any expense savings referred to by Mr. Huntington:

> . . . have been reflected in the expense assumptions incorporated in the analysis and projections prepared in support of this acquisition.[115]

[113] Cumulative Log, Document 105 (Hearing Transcript, 23:3-23:8).
[114] Cumulative Log, Document 080 (TW Stochastic Report, p. 13).
[115] Cumulative Log, Document 107 (OBIG Reply, p. 16).

I understand that "the analysis and projections" refers to the TW modeling, and thus there are no expenses savings anticipated in addition to the provisions in the TW modeling, and perhaps none, according to Mr. McDonough.

- Fourth, Other than Excalibur, I have not identified any other US-based runoffs, managed by Armour. Perhaps sharing financial systems across multiple platforms, mentioned by OBIC, but not Armour, as a source of savings, involves a mixture of US and UK operations, where shared platforms may not be as practical as OBIG (but not Armour) has suggested.

I. THERE IS **NO** EVIDENCE IN THE PUBLIC RECORD SHOWING THAT THE CHANGE IN RUNOFF MANAGEMENT WILL BE A BENEFIT TO THE RUNOFF COMPANIES POLICYHOLDERS COMPARED TO THE STATUS QUO

134. OBIG asserts that the change in runoff mangers is an advantage of the Proposed Transaction for the Runoff Companies policyholders.[116] While an evaluation of Armour as a runoff manager is beyond the scope of this report, I note that Table V-1 in this report suggests that Armour has less experience in US runoffs than other runoff managers we have identified, e.g., Enstar (5), Catalina (4), and White Mountain Solutions (owned by White Mountains Insurance Group, Ltd., OBIG's parent, 3), Fairfax (2), NICO (2).

135. Thus, there are no reasons offered to conclude that Armour is "better" for policyholders than OBIG.

J. OBIG'S ARGUMENTS ABOUT PARENTAL SUPPORT **SIDE-STEP THE ISSUES** INVOLVED

136. With respect to the obligations of a company to its subsidiaries/affiliates, OBIG states:

> It is a further premise of the Objectors' argument that the specialty insurance business of the OneBeacon Group will always be successful and prosperous – it will always maintain sufficient assets and surplus to provide a response to a perpetual call by the Runoff Companies. This is the very same argument made by several of the same objectors in the AARe transaction, and it should receive the same analysis and response from the Department – rejection (emphasis added).[117]

137. OBIG has created a straw man argument with references to always and perpetual. My analysis of the capital required to maintain the status quo for policyholders of the Runoff Companies assumes no ongoing support from OBIG, only the capital equivalent to the status quo.

138. In considering the capital adequacy relative of the Runoff Companies compared to the Ongoing Company, I recognize that while not legally required, the Ongoing Companies have some possibility of receiving additional support from its parent, depending on the

[116] Cumulative Log, Document 105 (Hearing Transcript, 28:12-29:2); Document 107 (OBIG Reply, pp. 15-17).
[117] Cumulative Log, Document 107 (OBIG Reply, p. 54).

situation. That conditional support is a well-recognized feature of an insurance company's financial strength rating.[118]

139. Given that my analysis places little reliance on intra-group support, OBIG's argument is moot. Further, OBIG's comment does not address the most immediate aspect of the Proposed Transaction, i.e., the duties of subsidiaries to their parent companies vis-à-vis their policyholders.

140. An early step preceding the Proposed Transaction is the Ancillary Transaction involving the extraordinary dividend from OBIC, the subsidiary, to OBIG, the parent. According to the exhibits to the SPA, OBIC will contribute all of ASIC's capital, totaling approximately $700 million at June 30, 2014, without receiving fair market consideration in return:[119]

> The second page in this section of the handout represents the effect of the final step of the restructuring, which is to dividend Atlantic Specialty Insurance Company from OneBeacon Insurance Company to its parent, OneBeacon, LLC, which would complete the separation of the ongoing and runoff groups of companies and would position the runoff companies to be transferred to Armor [sic] in the proposed sale.[120]

141. Based on my experience as an Independent Director of a subsidiary of a Bermuda-based global insurer, I observe that if I were an OBIC Board Member, I would seek independent advice that the extraordinary dividend did not damage the interests of other OBIC stakeholders, most notably policyholders. There is no such independent advice on the public record.

K. TW'S SCOPE IN ITS STOCHASTIC MODELING DOES **NOT** DOES ADDRESS THE COMMITMENTS MADE BY OBIG IN JUNE 2013 REGARDING THE AREAS OF INTEREST TO POLICYHOLDERS AND, PRESUMABLY, THE PID

142. In June 2013, OBIG comments:

> OBIG is confident it has determined those Companies' liabilities through sophisticated and ongoing actuarial reviews Before the Transaction is approved, the liabilities will *also* have been subjected to an independent actuarial review, conducted by a leading independent risk specialist that was retained in

[118] "Holding companies and their associated capital structures can have a significant impact on an insurance company subsidiary's overall financial strength. Holding companies can provide subsidiaries with a level of financial flexibility, including capital infusions, access to capital markets and, in some cases, additional sources of cash flow from other operations." (Best's Credit Rating Methodology: Global Life and Non-Life Insurance Edition, September 5, 2014, p. 19.)

[119] Cumulative Log, Document 062 (Exhibit: Restructure to SPA); ASIC June 30, 2014 Quarterly Statement, p. 3.

[120] Cumulative Log, Document 105 (Hearing Transcript, 25:22-26:4).

consultation with the Department. (A summary of that review will be made public.)[121]

143. Yet TW says that its scope does not include:

> Assessments or characterizations of the adequacy or reasonability of OneBeacon's held reserves.[122]

144. Therefore, contrary to those commitments, there appears to be no independent expert review with an opinion on the adequacy of the reserves in the financial statements submitted in the Form A or otherwise in support of the Proposed Transaction.

145. Further in June 2013, OBIG states:

> Under the SPA, that is, the aggregate purchase price to be paid at closing will be calculated under a formula designed to ensure that the Runoff Companies retain an adequate level of capital (the "Target Statutory Capital"), based on the information in their balance sheets at that time. If, after that price has been determined, the Department concludes that additional capital is needed, the SPA expressly provides that such capital will be provided at closing, in the form of surplus notes. Although the Commenting Policyholders' Petition specifically refers to some of these provisions of the SPA, it does not make a single argument purporting to show that this approach to capitalization is inadequate to protect policyholders.[123]

146. Regarding the determination as to whether additional capital is or is not needed in accordance with the SPA, TW emphasizes that the scope of its work did <u>not</u> include:

- "Assessments as to the capital adequacy of the beginning balance sheet, based on RBC results or any other metrics (e.g., ORSA requirements)";[124]
- "Estimates of the frequency and timing of 'technical insolvency,' defined as situations in which surplus is less than 0"; and,
- "Commentary as to whether the observed success rates are acceptable or desirable."[125]

147. I understand those TW limitations to mean that TW is not offering an opinion on what solvency tests, if any, are or are not met by the proposed level of capitalization, or any opinion on what basis, if any, the capital in the Proposed Transaction might be considered adequate. I understand that the RRC Stochastic Report, being a review of TW Stochastic Report, does not offer any further input on the adequacy of capital.

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121 Cumulative Log, Document 048 (OBIG Response to Substantive Comments, June 2013, p. 3).
122 Cumulative Log, Document 108 (TW Reply, p. 2).
123 Cumulative Log, Document 048 (OBIG Response to Substantive Comments, June 2013, pp. 3-4).
124 I understand that to mean that TW would not agree that the stochastic modeling results themselves are a reason to conclude that the beginning balance sheet of the Proposed Transaction was adequate.
125 Cumulative Log, Document 108 (TW Reply, p. 2).

148. As such, it does not appear that the PID has received adequate input from OBIG to conclude that the capital in the Proposed Transaction is adequate.

L. THERE ARE QUESTIONS FROM THE HEARING NOT YET ANSWERED BY OBIG OR TW

149. At the Hearing, I asked two questions that remain unanswered by OBIG and TW:

- First, are the reserves on the Closing Pro Forma balance sheet based on TW's central estimate?[126]
- Second, what is the basis for suggesting that a 12% Payment Failure Rate is good enough?[127]

Conclusion 6:
TW and OBIG have not fully responded to the questions raised at the Hearing. In instances when they have responded, I disagree with a number of their responses.

[126] Cumulative Log, Document 105 (Hearing Transcript, 189:6-189:12).
[127] Cumulative Log, Document 105 (Hearing Transcript, 189:20-189:23).

X. ACCORDING TO RRC, THE PAYMENT FAILURE RATE MAY BE HIGHER THAN INDICATED BY TW[128]

150. In prior sections of this report, I have accepted the results of TW's analysis of the Payment Failure Rate, while indicating the limits on Payment Failure as a measure of capital adequacy.

151. The RRC report identified features of the TW stochastic model that understate risks (and therefore understate the failure rate). Yet, neither the TW Stochastic Report nor the RRC Stochastic Report quantify the effect of those features through sensitivity testing, stress testing or other methods.

152. Any of those features might increase the indicated Payment Failure rate. The features, as described by RRC in its report, include the following:

Measuring Variability

- "To the extent that there may be more uncertainty or more correlation between lines in One Beacon's book than has been modeled, the failure rate may actually be higher than 11.7% over the 70 year projection."[129]
- "There is also the potential uncertainty resulting from the possibility that the models used are not appropriate (model risk)."[130]
- Regarding asbestos and environmental stochastic modeling, "The use of the lognormal distribution along with three industry benchmark payment patterns is a reasonable approach. We [RRC] caution that historical data may fall short in simulating future claim activity that is unprecedented and Towers modeling of the variability does not attempt to include this explicitly."[131]

Interest Rates and Equity Returns

- TW "made judgmental adjustments to the ESG [Economic Scenario Generator, a software tool that provides input to Igloo, TW's tool that produces the stochastic results] regarding interest rates, equity returns, and BBB defaults, based on input from Towers' investment consulting practice. We [RRC] concluded that the adjustments made by Towers to the economic scenario generator inputs are not unreasonable. However, we [RRC] view these adjustments, as adding somewhat to the riskiness of the model results."[132]

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[128] This section is based on the RRC Stochastic Report. In the TW Reply (Cumulative Log, Document 108), TW asserts that certain RRC observations are not correct. As RRC has not responded, and in particular not agreed with TW on those points, this section is based on the RRC Stochastic Report, as written.
[129] Cumulative Log, Document 083 (RRC Stochastic Report, p. 5).
[130] Cumulative Log, Document 083 (RRC Stochastic Report, p. 5).
[131] Cumulative Log, Document 083 (RRC Stochastic Report, p. 13).
[132] Cumulative Log, Document 083 (RRC Stochastic Report, p. 11).

Inflation

- TW overlooks "scenarios in which claims inflation significantly exceeds returns on assets."[133]
- "At the present time, inflation rates have been historically low for several years. We [RRC] do not know when inflation will rise above these low levels. However, over a thirty year period of time, it seems likely that this will occur. It appears to us that the resulting impact on claim inflation for these important lines may be low."[134]
- TW's "internal asbestos model assumes a long term ground-up severity trend that reflects future medical inflation partially offset by the favorable impact of the aging of the claimant population. We [RRC] observe that this offset may have the effect of underestimating the true impact of claim severity."[135]

153. Despite RRC's observations, the RRC Stochastic Report identified no areas where they concluded that TW might have also underestimated the Payment Failure Rate.

Conclusion 7:

In the conclusions in Sections IV-IX, I accept the TW Payment Failure Rate. However, on balance, it appears that the RRC Stochastic Report implies that the Payment Failure Rate is higher than the 12% indicated by TW.

[133] Cumulative Log, Document 083 (RRC Stochastic Report, p. 11).
[134] Cumulative Log, Document 083 (RRC Stochastic Report, p. 11).
[135] Cumulative Log, Document 083 (RRC Stochastic Report, p. 11).

XI. CONCLUSION

154. In my opinion, in the event the Proposed Transaction is approved, to place the Runoff Companies policyholders in the same position with respect to Financial Capacity in 2009 when the OBIC restructuring began, i.e., to maintain the status quo, the Financial Capacity of the Runoff Companies would need to be increased by one of or a combination of methods such as the following:

- Added capital of **$530 million**; or
- Additional retroactive reinsurance of **$1.6 billion**; or
- Financial guarantees from the Ongoing Companies (or their successors).

155. My opinions are based upon information available to me as of the date of this report. Should additional information become available I reserve the right to modify or supplement my analysis and opinions.

XII. LIST OF EXHIBITS

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Allan Kaufman is a Managing Director at FTI Consulting and is based in New York. Mr. Kaufman is a member of the Insurance Practice in the Forensic & Litigation Consulting segment. Mr. Kaufman is an insurance professional and Fellow of the Casualty Actuarial Society with nearly 40 years of experience in executive and consulting roles in the US, Europe and Asia. His assignments have included expert testimony, capital modeling and adequacy, financial planning, risk assessment, regulatory issues, Solvency II, loss reserving, ratemaking and rating plans, merger and acquisition analyses, product development, and design of actuarial functions. Mr. Kaufman has prepared testimony for USA and English Courts and has testified in depositions and at Court.

Mr. Kaufman's consulting clients have included multi-line primary and reinsurance companies, Lloyd's syndicates, other London market reinsurers, and specialty companies in areas including workers comp, medical malpractice, professional liability, health, title and warranty insurance.

Mr. Kaufman has prepared depositions and provided testimony and expert opinions and reports before arbitration and regulatory forums, and US and UK courts in a variety of matters, including professional liability; reinsurance disputes; insurer litigation; rating plans; financial conditions; and tort reform.

Mr. Kaufman has been involved in leading roles in Solvency II development, including as a member of Institute of Actuaries Solvency II working parties; providing comments to CEIOPS regarding Solvency II issues on Group regulation and technical provisions; authoring/co-authoring several major papers illuminating risk issues and guiding Solvency II model development; reviewing Quantitative Impact Studies prepared by companies in response and individual country regulators; and, while CAS Vice President Research and as President Elect, leading the US actuarial profession society research on developing DFA models.

Mr. Kaufman has been the practice leader for the actuarial practices of a major actuarial consulting firm and a big-four firm in the US and Europe and other jurisdictions. He has served as Board Chairman and President of the Casualty Actuarial Society; as a Director and President of the American Academy of Actuaries; as a Member of the General Insurance Practice Executive Committee of the Institute of Actuaries; as Chairman of the Audit Committee and Member of the Education Committee of the International Actuarial Association; and on various Advisory Committees of the NAIC. He holds the designation Certified Property/Casualty Underwriter and has held a Lloyd's Reserve Practicing Certificate.

Mr. Kaufman has published papers on US risk-based capital, capital management, loss reserving, liability measurement, Solvency II, and other insurance related subjects. He has held various board, executive, and committee positions with the Casualty Actuarial Society, the American Academy of Actuaries, the International Actuarial Association, and the Institute of Actuaries (UK).

Mr. Kaufman has held various positions, including Independent Consultant, Audit Committee Chairman of Lloyd's subsidiary, Actuarial Practice Leader at big four consulting firm, National Casualty Director and Board Member of international consulting firm, Principal of big four consulting firm, and Actuary and Assistant Secretary at national insurance company.

DOCUMENTS RELIED UPON

Pennsylvania Insurance Department Cumulative Log:

1. Document 004 – Stock Purchase Agreement
2. Document 005 – Amendment No. 1 to SPA
3. Document 043 – Exhibits to the SPA
4. Document 048 – Saul Ewing Response to Substantive Comments
5. Document 057 – June 19, 2013 AK Public Comment Letter, Petition to Intervene
6. Document 062 – Exhibit to SPA – Restructure
7. Document 063 – Exhibit to SPA – Organization Chart before Proposed Transaction
8. Document 064 – Exhibit to SPA – Organization Chart after Proposed Transaction
9. Document 065 – Exhibit to SPA – Director & Officer List
10. Document 079 – Amendment #1 to the Form A
11. Document 080 – Towers Watson Stochastic Modeling Summary Report
12. Document 082 – RRC Reserve Report
13. Document 083 – RRC Summary Report of Stochastic Modeling
14. Document 089 – AK Public Comment Letter
15. Document 105 – Transcript of July 23, 2014 Public Hearing
16. Document 107 – OneBeacon Response to Public Comments, August 12, 2014
17. Document 108 – Towers Watson Response to Public Comments
18. The Supplemental Expert Report of Jonathan Terrell, dated October 16, 2014 [not yet posted on the Cumulative Log as of the date of this report]

DOCUMENTS RELIED UPON

Other Publicly Available Information:

19. AIG 2013 Form 10-K

20. A.M. Best One Beacon Insurance Company Credit Rating Report, revised July 16, 2014

21. A.M. Best's Special Report, Best's Impairment Rate and Rating Transition Study 1977-2013, March 31, 2014

22. An Update to P/C Risk-Based Capital Underwriting Factors: September 2007 Report to the National Association of Insurance Commissioners P/C Risk-Based Capital Working Group, American Academy of Actuaries' P/C Risk-Based Capital Committee

23. Annual Statement of Alea North America Insurance Company for the year ended December 31, 2009

24. Annual Statement of American Millennium Insurance Company for the year ended December 31, 2011

25. Annual Statement of American Safety Casualty Insurance Company for the year ended December 31, 2013

26. Annual Statement of American Safety Indemnity Company for the year ended December 31, 2013

27. Annual Statement of Arrowood Indemnity Company for the years ended December 31, 2007 and 2006

28. Annual Statement of Atlanta International Insurance Company for the year ended December 31, 2009

29. Annual Statements of Atlantic Specialty Insurance Company for the years ended December 31, 2013, 2012 and 2009

30. Annual Statement of Central National Insurance Company of Omaha for the year ended December 31, 2010

31. Annual Statements of Century Indemnity Company for the years ended December 31, 2013, 1999 and 1998

32. Annual Statement of Citation Insurance Company for the year ended December 31, 2012

33. Annual Statement of Clarendon America Insurance Company for the year ended December 31, 2011

34. Annual Statement of Clarendon National Insurance Company for the year ended December 31, 2011

DOCUMENTS RELIED UPON

35. Annual Statement of Commercial Casualty Insurance Company for the year ended December 31, 2008

36. Annual Statement of Empire Insurance Company for the year ended December 31, 2013

37. Annual Statements of Excalibur Reinsurance Corporation for the years ended December 31, 2009 and 2008

38. Annual Statement of Finial Reinsurance Company for the year ended December 31, 2006

39. Annual Statement of General Fidelity Insurance Company for the year ended December 31, 2010

40. Annual Statements of National Home Insurance Company for the year ended December 31, 2011

41. Annual Statements of OneBeacon America Insurance Company for the years ended December 31, 2013, 2012, 2011, 2010 and 2009

42. Annual Statements of OneBeacon Insurance Company for the years ended December 31, 2013, 2012, 2011, 2010 and 2009

43. Annual Statements of Potomac Insurance Company for the years ended December 31, 2013, 2012, 2011, 2010 and 2009

44. Annual Statement of Providence Washington Insurance Company for the year ended December 31, 2010

45. Annual Statements of Quanta Indemnity Company for the year ended December 31, 2008

46. Annual Statements of R&Q Reinsurance Company for the years ended December 31, 2006 and 2005

47. Annual Statement of Residential Insurance Company for the year ended December 31, 2011

48. Annual Statement of SeaBright Insurance Company for the year ended December 31, 2013

49. Annual Statements of Seaton Insurance Company for the years ended December 31, 2008 and 2007

50. Audited Statutory Financial Statements of Excalibur Reinsurance Corporation for the years ended December 31, 2013 and 2012

51. Best's Credit Rating Methodology: Global Life and Non-Life Insurance Edition, September 5, 2014

52. Equitas Independent Expert Report, April 8, 2009

DOCUMENTS RELIED UPON

53. NAIC Statement of Statutory Accounting Principles No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses

54. NAIC Statement of Statutory Accounting Principles No. 101, Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10

55. Pennsylvania Insurance Holding Companies Act, Article XIV of the Insurance Company Law of 1921, Act of May 17, 192 1, P.I. 682, as amended, 40 P.S. §§ 991.1401 et seq.

56. Quarterly Statement of Atlantic Specialty Insurance Company (ASIC) for the periods ended June 30 and March 31, 2014

57. Quarterly Statement of OneBeacon America Insurance Company (OBA) for the period ended March 31, 2014

58. Quarterly Statement of OneBeacon Insurance Company (OBIC) for the period ended March 31, 2014

59. Quarterly Statement of Potomac Insurance Company for the periods ended June 30 and March 31, 2014

60. Risk-Based Capital (RBC) For Insurers Model Act, January 2012

61. Standard and Poor's Rating Services, Default, Transition, and Recovery: 2013 Annual Global Corporate Default Study and Rating Transitions, March 19, 2014

62. NAIC RBC Formulas, 2009 and 2013

EXHIBIT 3A

OBA FINANCIAL CAPACITY INDICATORS 2009 TO 2013

	12/31/2009	12/31/2010	12/31/2011	12/31/2012 [2]	12/31/2013
Financial Strength Rating - A.M. Best	A	A	A	A	A
Financial Strength Rating - S&P	A	A-	A-	NR	NR
Total Invested Assets	$ 631,994,251	$ 435,432,368	$ 433,336,263	$ 88,418,897	$ 92,259,326
Total Assets	743,070,922	485,710,693	483,405,267	88,514,868	93,051,679
Liabilities	$ 416,268,261	$ 321,942,495	$ 300,538,162	$ 13,447,896	$ 4,778,779
Surplus	326,802,661	163,768,198	182,867,105	75,066,972	88,272,900
Total Liabilities & Surplus	$ 743,070,922	$ 485,710,693	$ 483,405,267	$ 88,514,868	$ 93,051,679
Gross Losses & LAE Reserve[1]	$ 643,775,000	$ 559,089,000	$ 578,206,000	$ 1,391,498,000	$ 1,177,944,000
Recoverable on Unpaid Losses & LAE	376,007,000	326,326,000	370,322,000	1,391,498,000	1,177,944,000
Net Losses & LAE Reserve	$ 267,768,000	$ 232,763,000	$ 207,884,000	$ -	$ -
One Year Reserve Development	$ (17,352,000)	$ (10,104,000)	$ (10,706,000)	Note 4	Note 4
Ceded Unpaid Losses & LAE (Sch. F):					
Affiliates - Pooling	$ -	$ 1,377,704,000	$ 1,634,291,000	$ -	$ 1,162,037,000
Affiliates - Non-Pooling	1,568,415,000	-	-	1,372,359,000	-
Total Ceded Unpaid Losses & LAE	1,568,415,000	1,377,704,000	1,634,291,000	1,372,359,000	1,162,037,000
% Ceded to Affiliates - All	100%	100%	100%	100%	100%
% Ceded to Affiliates - Non-Pooling	100%	0%	0%	100%	0%
Total Adjusted Capital	$ 326,802,661	$ 163,768,198	$ 182,867,105	$ 122,726,894	$ 88,272,900
Authorized Control Level (ACL) RBC	34,083,179	30,577,062	24,170,038	31,473,266	400,119
Company Action Level (CAL) RBC[3]	68,166,358	61,154,124	48,340,076	62,946,532	800,238
Gross Losses & LAE / Invested Assets	102%	128%	133%	1574%	1277%
Gross Losses & LAE / Surplus	197%	341%	316%	1854%	1334%
Gross Losses & LAE / Total Invested Assets + Recoverable on Unpaid Losses & LAE	64%	73%	72%	94%	93%
Surplus / Liabilities	79%	51%	61%	558%	1847%
Total Adjusted Capital / ACL-RBC	9.6	5.4	7.6	3.9	220.6
Surplus / ACL-RBC	9.6	5.4	7.6	2.4	220.6
Recoverable on Unpaid Losses & LAE / Gross Losses & LAE Reserve	58%	58%	64%	100%	100%
ACL / Net Loss + LAE Reserve	13%	13%	12%	N/A	N/A

Source: OBA Annual Statements from 2009 to 2013. Rating information obtained from SNL, a subscription-based service.

Notes:

(1) LAE = Loss adjustment expenses.

(2) The 2012 annual statement was restated in 2013. When available, the restated amounts have been reflected above.

(3) Company Action Level (CAL) RBC is calculated as Authorized Control Level (ACL) RBC * 2.

(4) Pursuant to the terms of the intercompany reinsurance agreement with OBIC, policies written by OBA were ceded to OBIC in 2012; hence there was no reserve development 2012 and beyond.

OBIC FINANCIAL CAPACITY INDICATORS 2009 TO 2013

	12/31/2009	12/31/2010	12/31/2011	12/31/2012 [2]	12/31/2013
Financial Strength Rating - A.M. Best	A	A	A	A	A
Financial Strength Rating - S&P	A	A-	A-	NR	NR
Total Invested Assets	$ 2,611,883,257	$ 2,016,554,111	$ 1,823,962,936	$ 1,170,967,326	$ 1,005,096,002
Total Assets	3,053,305,633	2,351,767,646	2,077,595,299	1,265,708,660	1,085,924,002
Liabilities	$ 1,699,472,456	$ 1,429,726,133	$ 1,168,591,426	$ 390,509,898	$ 219,735,320
Surplus	1,353,833,177	922,041,513	909,003,873	875,198,762	866,188,682
Total Liabilities & Surplus	$ 3,053,305,633	$ 2,351,767,646	$ 2,077,595,299	$ 1,265,708,660	$ 1,085,924,002
Gross Losses & LAE Reserve[1]	$ 2,119,829,000	$ 1,840,906,000	$ 1,991,988,000	$ 2,698,492,000	$ 2,311,877,000
Recoverable on Unpaid Losses & LAE	1,238,079,000	1,074,494,000	1,275,805,000	2,486,095,000	2,123,453,000
Net Losses & LAE Reserve	$ 881,750,000	$ 766,412,000	$ 716,183,000	$ 212,397,000	$ 188,424,000
One Year Reserve Development	$ (57,085,000)	$ (33,273,000)	$ (36,883,000)	$ 14,130,000	$ 49,173,000
Ceded Unpaid Losses & LAE (Sch. F):					
Affiliates - Pooling	$ 713,977,000	$ 628,911,000	$ 516,938,000	$ -	$ -
Affiliates - Non-Pooling	1,516,828,000	1,256,863,000	1,333,666,000	1,737,698,000	1,407,445,000
Total Ceded Unpaid Losses & LAE	3,007,040,000	2,617,618,000	2,774,526,000	2,468,411,000	2,099,439,000
% Ceded to Affiliates - All	74%	72%	67%	70%	67%
% Ceded to Affiliates - Non-Pooling	50%	48%	48%	70%	67%
Total Adjusted Capital	$ 1,353,833,177	$ 922,041,513	$ 909,003,873	$ 959,661,192	$ 866,188,682
Authorized Control Level (ACL) RBC	187,071,888	165,803,475	137,672,395	210,342,163	164,727,899
Company Action Level (CAL) RBC[3]	374,143,776	331,606,950	275,344,790	420,684,326	329,455,798
Gross Losses & LAE / Invested Assets	81%	91%	109%	230%	230%
Gross Losses & LAE / Surplus	157%	200%	219%	308%	267%
Gross Losses & LAE / Total Invested Assets + Recoverable on Unpaid Losses & LAE	55%	60%	64%	74%	74%
Surplus / Liabilities	80%	64%	78%	224%	394%
Total Adjusted Capital / ACL-RBC	7.2	5.6	6.6	4.6	5.3
Surplus / ACL-RBC	7.2	5.6	6.6	4.2	5.3
Recoverable on Unpaid Losses & LAE / Gross Losses & LAE Reserve	58%	58%	64%	92%	92%
ACL / Net Loss + LAE Reserve	21.2%	21.6%	19.2%	99.0%	87.4%

Source: OBIC Annual Statements from 2009 to 2013. Rating information obtained from SNL, a subscription-based service.

Notes:
(1) LAE = Loss adjustment expenses.
(2) The 2012 annual statement was restated in 2013. When available, the restated amounts have been reflected above.
(3) Company Action Level (CAL) RBC is calculated as Authorized Control Level (ACL) RBC * 2.

POTOMAC FINANCIAL CAPACITY INDICATORS 2009 TO 2013

	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013
Financial Strength Rating - A.M. Best	B++	B++	B++	B++	B++
Financial Strength Rating - S&P	NR	NR	NR	NR	NR
Total Invested Assets	$ 10,514,294	$ 10,799,702	$ 9,959,662	$ 11,043,856	$ 10,765,466
Total Assets	10,564,050	10,858,513	10,970,972	11,065,680	10,882,300
Liabilities	$ 53,779	$ 5,949	$ 25,419	$ (135)	$ 53,895
Surplus	10,510,271	10,852,564	10,945,553	11,065,815	10,828,405
Total Liabilities & Surplus	$ 10,564,050	$ 10,858,513	$ 10,970,972	$ 11,065,680	$ 10,882,300
Gross Losses & LAE Reserve(1)	$1,516,812,000	$1,256,861,000	$1,333,845,000	$1,194,611,000	$1,037,500,000
Recoverable on Unpaid Losses & LAE	333,000	304,000	227,000	58,000	68,000
Net Losses & LAE Reserve	$1,516,479,000	$1,256,557,000	$1,333,618,000	$1,194,553,000	$1,037,432,000
One Year Reserve Development	$ 4,000	$ (27,000)	$ 133,905,000	$ 5,000	$ (1,000)
Ceded Unpaid Losses & LAE (Sch. F):					
Affiliates - Pooling	$ -	$ -	$ -	$ -	$ 68,000
Affiliates - Non-Pooling	332,000	304,000	227,000	58,000	-
Total Ceded Unpaid Losses & LAE	332,000	304,000	227,000	58,000	68,000
% Ceded to Affiliates - All	100%	100%	100%	100%	100%
% Ceded to Affiliates - Non-Pooling	100%	100%	100%	100%	0%
Total Adjusted Capital	$ 10,510,271	$ 10,852,564	$ 10,945,553	$ 11,065,815	$ 10,828,405
Authorized Control Level (ACL) RBC	159,698,428	141,990,395	155,839,899	134,439,048	116,225,801
Company Action Level (CAL) RBC(2)	319,396,856	283,980,790	311,679,798	268,878,096	232,451,602
Gross Losses & LAE / Invested Assets	14426%	11638%	13392%	10817%	9637%
Gross Losses & LAE / Surplus	14432%	11581%	12186%	10796%	9581%
Gross Losses & LAE / Total Invested Assets + Recoverable on Unpaid Losses & LAE	13983%	11319%	13094%	10760%	9577%
Surplus / Liabilities	19543%	182427%	43061%	-8196900%	20092%
Total Adjusted Capital / ACL-RBC	0.1	0.1	0.1	0.1	0.1
Surplus / ACL-RBC	0.1	0.1	0.1	0.1	0.1
Recoverable on Unpaid Losses & LAE / Gross Losses & LAE Reserve	0%	0%	0%	0%	0%
ACL / Net Loss + LAE Reserve	10.5%	11.3%	11.7%	11.3%	11.2%

Source: Potomac Annual Statements from 2009 to 2013. Rating information obtained from SNL, a subscription-based service.

Notes:
(1) LAE = Loss adjustment expenses.
(2) Company Action Level (CAL) RBC is calculated as Authorized Control Level (ACL) RBC * 2.

EXHIBIT 4

PRO FORMA OF PROPOSED TRANSACTION: ANCILLARY TRANSACTIONS PLUS TRANSFER TO ARMOUR REINSURANCE AS ASSET

($ in Millions)

	Runoff and Ongoing Companies' Consolidated Balance Sheet at March 31, 2014[1]	Pro Forma Balance Sheet: Runoff Companies Post-Proposed Transaction[2]	% Change
Admitted Assets			
Total Cash and Investments	$2,269	$280	12%
Retroactive Reinsurance Reserves Ceded	981	961	98%
Net Deferred Federal Income Taxes	74	29	39%
Receivables	289	20	7%
Funds Held	2	2	100%
Other Assets	89	17	19%
Total Admitted Assets	**$3,704**	**$1,309**	35%
Liabilities			
Loss and Loss Adjustment Expenses	$2,130	$1,117	52%
Unearned Premium Reserves	479	0	0%
Funds Held	8	8	100%
Other Liabilities	179	22	12%
Total Liabilities	**$2,796**	**$1,147**	41%
Capital and Surplus			
Gross Paid-In-Surplus and Unassigned Funds	$908	$81	
Parri Passu Surplus Note	0	44	
Seller Priority Surplus Note	0	37	
Total Capital and Surplus	**$908**	**$162**	18%
Total Liabilities, Capital and Surplus	**$3,704**	**$1,309**	35%
Net Loss and LAE[4]	$1,149	$156	14%

Notes:

(1) Cumulative Log, Document 107 (OBIG Reply, p. 14).

(2) Cumulative Log, Document 079 (Amendment 1 to Form A); Document 080 (TW Stochastic Report, p. 6).

(3) Calculated as Loss and Loss Adjustment Expenses less Retroactive Reinsurance Reserves Ceded.

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

1. In this Exhibit, I show the inputs and assumptions I used to develop the ACL and TAC values shown in Table IV-1, also reflected in Table 5-1 below.

Table 5-1
Summary of Financial Capacity
(TAC and ACL in millions)

		(A)	(B)	(C)	(D)	(E)	(F)
		December 31, 2009			June 30, 2014		
	Entity	TAC	ACL	TAC/ ACL	TAC	ACL	TAC/ ACL
(1)	OBIC+ASIC+Potomac	$1,333	$323	4.1	NR	NR	NR
(2)	Runoff Companies	NR	NR	NR	$130[1]	$161	0.8
(3)	Ongoing Companies	NR	NR	NR	$746	$129	5.8

NR = Statistic is not required for my analysis.

A. METHODOLOGY

2. I project the ACL values using the NAIC RBC formulae. The NAIC RBC formulae have six main risk categories, R0 through R5:

- R0 addresses off-balance sheet risks and risks arising from insurance subsidiaries.
- R1 and R2 address invested asset risk, including investments in non-insurance affiliates. R1 addresses fixed-income investments and R2 addresses equity and real estate risk.
- R3 addresses credit risk, mainly risks related to reinsurance.
- R4 addresses reserving risk.
- R5 addresses premium risk.

The six categories are combined using the covariance formula:

$$ACL = \tfrac{1}{2} \times (R0 + SQRT\,(R1^{\wedge 2}+R2^{\wedge 2}+R3^{\wedge 2}+R4^{\wedge 2}+R5^{\wedge 2}))$$

i. COMPANIES EVALUATED AND EVALUATION DATES

3. I calculated the ACL and TAC at June 30, 2014 for the Runoff and Ongoing Companies:

[1] This is the Runoff Companies capital of $162 million shown in the "Closing Pro Forma" (Cumulative Log, Document 080 (TW Stochastic Report, p. 6).), less the $31.7 million reserve increase indicated by the TW central estimate, i.e., the $10 million increase in TW's central estimate, plus $21.7 million, or the amount that TW's central estimate exceeds the NICO limit of coverage. (Cumulative Log, Document 080 (TW Stochastic Report, p. 6) and TW Reserve Report as of September 30, 2012, December 31, 2012 and March 31, 2013, p. 12.)

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

- Runoff Companies – OBIC, including its subsidiaries, and Potomac, treating Potomac and OBIC's subsidiaries as if the Runoff Companies were a single legal entity; and
- Ongoing Companies – ASIC and its subsidiaries.

Sections B and C below outline my assumptions related to June 30, 2014.

4. I calculated the ACL and TAC at December 31, 2009 for all companies combined, i.e., OBIC, including its subsidiaries, which included ASIC at the time, treating all as subsidiares, and OBIC's affiliate Potomac, treating Potomac as a part of OBIC (as if OBIC and Potomac were a single legal entity).

Section D below outlines my assumptions related to December 31, 2009.

ii. RESERVE AND TAC ADJUSTMENTS

5. I calculated the ACL at December 31, 2009 and June 30, 2014 reflecting the current TW central estimate of reserves for NICO-lines. This is $230 million above the December 31, 2013 carried reserve reflected on Potomac's financial statements, which is $31.7 million above the NICO limit.[2]

6. I calculated the TAC at December 31, 2009 and June 30, 2014 reflecting the net reserves of $31.7 million above the level shown in the Closing Pro Forma,[3] as that is the amount by which the TW central estimate of reserves exceeds the NICO limit.[4]

B. <u>JUNE 30, 2014 ACL AND TAC ASSUMPTIONS – RUNOFF COMPANIES</u>

7. First, I used ACL as of December 31, 2013, as reported in the Five – Year Historical Data schedule from the respective Annual Statements for both Potomac and OBIC, to conclude that the public data enabled me to reproduce the reported values.

8. Then, I calculated the June 30, 2014 ACL for OBIC and its subsidiaries, treating Potomac and OBIC's subsidiaries as if the Runoff Companies were a single legal entity.

9. Where possible I used data at June 30, 2014. When the public data at June 30, 2014 did not provide sufficient detail, I estimated the June 30, 2014 data from December 31, 2013 data, as described in the detailed assumptions below.

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[2] $230 million = $198.3 million <u>plus</u> $31.7 million in additional reserves. The $198.3 million represents the remaining limit within the NICO cover. (Potomac 2013 Annual Statement, Note 33; Cumulative Log, Document 080 (TW Stochastic Report, p. 6); Refer to Footnote 1 in **Exhibit 5**.)

[3] The Closing Pro Forma reflects net reserves of $156 million as of June 30, 2014. (Cumulative Log, Document 080 (TW Stochastic Report, p. 6).)

[4] OBIC might choose, with permission, to discount the $31.7 million in additional reserves, but TAC would reflect the undiscounted value.

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

10. Based on my calculations and assumptions, the Runoff Companies' ACL as of June 30, 2014 was $161 million, as summarized in Table 5-1 (column E, row 2).

i. R0 – R0 AFFILIATES AND OTHER R0 RISKS

11. R0 covers affiliate risk and off-balance sheet risks.

12. Affiliate risk is zero as I treated the subsidiaries, OBA and EFIC, as divisions of OBIC, and included their risks directly.

13. Other R0 risks are taken from the OBIC and Potomac 2013 Annual Statements and updated with new values from the respective June 30, 2014 Quarterly Statements where available. These consist of the following:

- On deposit with state or other regulatory body are estimated to remain at the 2013 Annual Statement value and are equal to the sum of the OBIC and Potomac values.
- OBIC contingent liabilities from structured settlements are valued as of June 30, 2014. At June 30, 2014 the value for Potomac was $0.
- OBIC deferred tax assets are valued as of June 30, 2014. At June 30, 2014 the value for Potomac was $0.

14. Table 5-2 below summarizes this information.

Table 5-2
Off Balance Sheet Risks
(in millions of dollars)

On Deposit with State or Other Regulatory Body

(1) Potomac	1
(2) OBIC	69
(3) Runoff Total Selected	70

Source:
Row 1 = Potomac 2013 Annual Statement, General Interrogatory 25.28.
Row 2 = OBIC 2013 Annual Statement, General Interrogatory 25.28.
Row 3 = Row 1 + Row 2

Contingent Liabilities	211

Source: OBIC 2013 Annual Statement, Note 27.*
*No change in OBIC June 30, 2014 Quarterly Statement.

SSAP No. 101 Paragraph 11B Deferred Tax Assets	15

Source: OBIC June 30, 2014 Quarterly Statement, Note 9, Item 9A2(b).

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

ii. R1 AND R2 – ASSET RISK

15. R1 covers fixed-income investments and R2 covers equity and real estate risk. Asset assumptions are directly from the TW Stochastic Report and are detailed in Table 5-3 below.

Table 5-3
Assets by RBC Category
(in millions of dollars)

(1)	Invested Assets	280	
(2)	Equities	41	Treated as non-affiliated common stock.
(3)	BBB Bonds	148	Treated as NAIC Class 02 Bonds.
(4)	Securities On Deposit	90	Treated as NAIC Class 01 US Government - direct and guaranteed.
(5)	Cash	0	

Source:
Rows 1-3 = Cumulative Log, Document 080 (TW Stochastic Report, p. 7).
Row 4 = Cumulative Log, Document 080 (TW Stochastic Report, p. 6).
Row 5 = Assumed to be $0.

16. In the RBC calculations:

- Securities on deposit are assumed to be backed by the full faith of the US government and thus receive a zero risk charge;

- I applied the lowest bond size charge, minimalizing the ACL, as information for the number of intended bond issuers is not available; and,

- I did not add an asset concentration charge, minimalizing the ACL, as the information for the intended concentration in the top 10 issuers is not available.

iii. R3 – CREDIT RISK

17. R3 covers reinsurance credit risk and other credit risks.

18. Reinsurance recoverable is detailed below in Table 5-4. This excludes business ceded to affiliates and mandatory pools and are reduced by OBIC's provision for reinsurance.[5] At June 30, 2014, Potomac's provision for reinsurance was $0.[6]

19. At June 30, 2014 ceded reinsurance balances are not available in the Quarterly Statement. I estimated the June 30, 2014 ceded balances by reducing the December 31, 2013 ceded

[5] $1.2 million at June 30, 2014. (OBIC June 30, 2014 Quarterly Statement, p. 3.) This is the "Schedule F penalty" amount. Reinsurance recoverable is reduced by the "Schedule F penalty" so there is no RBC charge for the penalty amount.

[6] Potomac June 30, 2014 Quarterly Statement, p. 3.

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balances by the same percentage that the OBIC and Potomac net loss and loss adjustment reserves ("LLAE") reduced between December 31, 2013 and June 30, 2014.

20. Table 5-4 below summarizes this information.

Table 5-4
Reinsurance Credit Risk:
Projected Reinsurance Recoverable at June 30, 2014
(in millions of dollars)

		(A)	(B)
	Reinsurance Recoverable	**December 31, 2013**	**June 30, 2014**
(1)	OBIC	627	567
(2)	Ceded to ASIC	373	337
(3)	Post-Proposed Transaction OBIC	1,000	904

Source:

A1 = OBIC 2013 Annual Statement, Schedule F - Part 3, column 15.

A2 = OBIC 2013 Annual Statement, Schedule F - Part 3, column 15, included in line 0399999.

B1, B2 = A1, A2 * 0.9

0.9 = Since the change in reinsurance recoverable was not available as of June 30, 2014, I used the decrease in the Runoff Companies net loss reserves from December 31, 2013 to June 30, 2014, as shown in the following table:

		(A)	(B)
	Reduction in Net LLAE Reserves	**December 31, 2013**	**June 30, 2014**
(1)	OBIC Net LLAE	188	156
(2)	Potomac Net LLAE	1,037	952
(3)	Total OBIC & Potomac Net LLAE	1,225	1,108
(4)	Reduction in Net LLAE Reserves	N/A	90%

Source:

A1 = OBIC 2013 Annual Statement, Schedule P - Part 1 Summary, column 24, line 12.

A2 = Potomac 2013 Annual Statement, Schedule P - Part 1 Summary, column 24, line 12.

B1 = Cumulative Log, Document 080 (TW Stochastic Report, p. 6).

B2 = Potomac June 30, 2014 Quarterly Statement, Part 3, line 7, columm 10.

B4 = B3/A3

21. Before the Proposed Transaction, ASIC is an affiliate of OBIC and there is no RBC charge on amounts ceded to ASIC. After the Proposed Transaction, ASIC is no longer an affiliate of OBIC and the reinsurance ceded incurs an RBC charge.

22. Other risks include the credit risk for receivables, which are detailed in Table 5-5 on the following page.

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Table 5-5
Other Credit Risk
(in millions of dollars)

		(A)	(B)	(C)
		Line Item	**December 31, 2013**	**June 30, 2014**
(1)	Guaranty Funds Receivable or On Deposit	P2 C3 L19	6	6
(2)	Investment Income Due & Accrued	P2 C3 L14	1	1
(3)	Aggregate W/I for Other Than Invest. Assets	P2 C3 L25	12	12

Source:
Column A = Refers to the page, column, and line item within the OBIC 2013 Annual Statement.
B1, B2 and B3 = OBIC 2013 Annual Statement, using Line Item in column B.
C1, C2 and C3 = OBIC June 30, 2014 Quarterly Statement, using Line Item in column B.

iv. R4 – NET LLAE

23. R4 is based on LLAE reserves by line of business ("LOB"), net of reinsurance. At December 31, 2013 LLAE reserves are available in total and by LOB. At June 30, 2014 LLAE reserves are available only in total.

24. At June 30, 2014, the total Runoff Companies Net LLAE was $1,338 million, or:

- OBIC LLAE reserves net of reinsurance = $156 million[7]; plus,
- Potomac LLAE gross of NICO and GenRe but net of other reinsurance = $952 million[8]; plus,
- Additional reserves to reach TW central estimate for NICO-lines = $230 million.[9]

25. I estimate the June 30, 2014 LLAE reserves by LOB for OBIC and Potomac using the distribution by LOB at December 31, 2013, separately for OBIC and Potomac.

26. The $230 million of additional reserves added to reach the TW central estimate are all asbestos and environmental ("A&E") and are distributed among the commercial multiple peril ("CMP"), other liability ("OL") and product liability ("PL") LOBs using the existing LOB distribution reported in the Potomac 2013 Annual Statement (Note 23F).

27. For OBIC I applied the December 31, 2013 company to industry reserving factor[10] at June 30, 2014, as relevant June 30, 2014 data is not available. Potomac has a company to

[7] Refer to Footnote 3 in **Exhibit 5**.
[8] Potomac June 30, 2014 Quarterly Statement, Part 3.
[9] Refer to Footnote 2 in **Exhibit 5**.

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industry reserving factor of 1.0 because the 2003 and prior reserves are not subject to the company to industry reserving factor.

28. The loss concentration factor[11] was re-calculated using the distribution determined, as described above.

29. Table 5-6 on the following page shows the R4 calculation.

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[10] As part of the NAIC RBC formula, the reserve risk factor is adjusted for the difference between the company's loss development and the industry's average loss development. That adjustment is referred to as the "company to industry reserving factor."

[11] As part of the NAIC RBC formula, the total reserve risk is reduced to the extent that the reserve is distributed across multiple LOBs. The degree of concentration is referred to as the "loss concentration factor."

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

Table 5-6
RBC R4 (Reserve) Charge by LOB
($000 omitted)

	SCH P LINE OF BUSINESS	H/F	PPA	CA	WC	CMP	MPL OCC	MPL CLMS MADE	SL	OL	FIDELITY / SURETY
(A)	Potomac Dec 2013 LLAE by Sch P line, SCH P PART 1 (in 000s)	374	697	369	206,108	216,862	1	0	886	266,993	1
(B)	Estimated Potomac June 2014 Reserves by Sch P line	343	639	338	189,047	198,911	1	0	813	244,893	1
(C)	OBIC Dec 2013 LLAE by Sch P line SCH. P PART 1 (in 000s)	2,609	39,659	18,725	196,446	(106,509)	0	0	71	36,691	80
(D)	Estimated OBIC June 2014 Reserves by Sch P line	2,160	32,834	15,503	162,642	(88,181)	0	0	59	30,377	66
(F)	Distribution Additional A&E Reserves					26%				32%	
(G)	Additional A&E Reserves	0	0	0	0	60,178	0	0	0	74,089	0
(H)	**Estimated Total Runoff LLAE June 2014 Reserves by Sch P line (B+D)**	**2,503**	**33,473**	**15,841**	**351,689**	**170,908**	**1**	**0**	**872**	**349,359**	**67**

	SCH P LINE OF BUSINESS	SPECIAL PROPERTY	AUTO PHYS DAMAGE	OTHER, INC. CREDIT, A&H	FIN. / MORT. GUARANTY	INTL.	REIN. PROP & FIN	REIN LIABILITY	PL	WARRANTY	TOTAL
(A)	Potomac Dec 2013 LLAE by Sch P line, SCH P PART 1 (in 000s)	148	0	1	0	0	0	0	344,992	0	1,037,432
(B)	Estimated Potomac June 2014 Reserves by Sch P line	136	0	1	0	0	0	0	316,435	0	951,558
(C)	OBIC Dec 2013 LLAE by Sch P line SCH. P PART 1 (in 000s)	215	13	0	0	0	0	78	346	0	188,424
(D)	Estimated OBIC June 2014 Reserves by Sch P line	178	11	0	0	0	0	65	286	0	156,000
(F)	Distribution Additional A&E Reserves								42%		
(G)	Additional A&E Reserves	0	0	0	0	0	0	0	95,733	0	230,000
(H)	**Estimated Total Runoff LLAE June 2014 Reserves by Sch P line (B+D)**	**314**	**11**	**1**	**0**	**0**	**0**	**65**	**412,454**	**0**	**1,337,558**

Source
Rows B and D: Refer to ¶ 25
Row F: Refer to ¶ 26
Row G: Row F * Row G Total (Refer to ¶ 24)

Maximum LLAE, (Highest LOB net LLAE, Row H) 412,454
New Loss Concentration Factor 0.793

v. R5 – WRITTEN PREMIUM RISK

30. As of June 30, 2014, OBIC had year-to-date net written premium ("NWP") of -$0.225 million.[12] Potomac had $0 NWP from non-affiliates.[13] For the Runoff Companies, I assumed $0 NWP annually for each LOB at June 30, 2014.

31. I assumed no charge for excessive premium growth at June 30, 2014 since as of December 31, 2013, the size of the Runoff Companies is decreasing.

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[12] OBIC June 30, 2014 Quarterly Statement, p. 4.
[13] Potomac 2013 Annual Statement, p. 8.

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

vi. TAC

32. Runoff Companies TAC as of June 30, 2014 is $130 million, or:

- The Runoff Companies' Closing Pro Forma capital of $161.5 million[14]; less,
- $31.7 million for the provision for reserves in excess of the NICO limit.[15]

C. JUNE 30, 2014 ACL AND TAC ASSUMPTIONS – ONGOING COMPANIES

33. ASIC's ACL at December 31, 2013 reflects some elements of confidential information related to the accident and health portion of the ACL. Therefore, to estimate ASIC's June 30, 2014 ACL without that confidential information, I examined the ratio of ACL / (Net LLAE + NWP) for the last five years. Given that the ratio remained relatively consistent since 2009, I applied the 2013 ratio to the Net LLAE + NWP at June 30, 2014 to estimate ASIC's June 30, 2014 ACL, as shown in Table 5-7 below.

Table 5-7
ASIC – Ratio of ACL to Net LLAE and NWP
(in millions of dollars)

		(A)	(B)	(C)	(D)	(E)	(F)
	Risk-Based Capital Analysis	**June 30, 2014**	**2013**	**2012**	**2011**	**2010**	**2009**
(1)	Total adjusted capital	746	666	717	93	47	52
(2)	Authorized control level risk-based capital	129	126	84	1	1	1
(3)	Net LLAE	1,006	960	892	8	9	10
(4)	NWP	965	969	851	6	6	10
(5)	Total	1,971	1,929	1,743	14	15	20
(6)	ACL / (NWP + LLAE)	6.5%	6.5%	4.8%	6.3%	6.8%	5.9%

Source:
Columns B-F, Rows 1-2 = ASIC 2013 Annual Statement, Five - Year Historical Data, p. 17, lines 28, 29.
Columns B-F, Row 3 = ASIC 2013 Annual Statement, Five - Year Historical Data, p. 17, lines 22+23.
Columns B-F, Row 4 = ASIC 2013 Annual Statement, Five - Year Historical Data, p. 17, line 12.
A1 = $908 million (**Exhibit 4**), less $162 million of total surplus (Cumulative Log, Document 080 (TW Stochastic Report, p. 6).
A2 = A5 * A6.
A3 = ASIC June 30, 2014 Quarterly Statement, Part 3, line 7, column 10.
A4 = 2 * NWP, ASIC June 30, 2014 Quarterly Statement p. 4, line 1.4.
A6 = Selected.
B6 = B2 / B5, C6 = C2 / C5 . . . F6 = F2 / F5.
Row 5 = Row 3 + Row 4.

34. Ongoing Companies TAC as of June 30, 2014 is $746 million, or:

- Combined TAC of $908 million[16]; less,

[14] Cumulative Log, Document 080 (TW Stochastic Report, p. 6).
[15] Refer to Footnote 1 in **Exhibit 5** for the calculation of the $31.7 million reserve deficiency.

- $162 million assigned by OBIG to the Runoff Companies post-Proposed Transaction.[17]

D. DECEMBER 31, 2009 ACL AND TAC ASSUMPTIONS – COMBINED OBIC

35. First, I used the December 31, 2009 ACL as reported in the Five – Year Historical Data schedule from the respective Annual Statements for both Potomac and OBIC to conclude that the public data enabled me to reproduce the reported values.[18]

36. Then, I calculated the December 31, 2009 ACL for OBIC and its subsidiaries, treating the subsidiaries as subsidiaries (rather than as a single legal entity) and Potomac as a part of OBIC (as if OBIC and Potomac were a single legal entity).

i. R0 – AFFILIATES AND OFF-BALANCE SHEET RISKS

37. As of December 31, 2009 OBIC had eight property and casualty insurance affiliates: ASIC, OBA, EFIC, AutoOne Insurance Company, AutoOne Select Insurance Company, Homeland Insurance Company, Traders & General Insurance Company and The Northern Assurance Company of America. The insurance affiliates are included at their ACL level reported in the Five – Year Historical Data schedule of their respective 2009 Annual Statements.

38. Off balance sheet items were taken from the OBIC and Potomac 2009 Annual Statements and added together.

ii. R1 AND R2 – ASSET RISK

39. I used the assets from OBIC and Potomac's 2009 Annual Statements, added together. I made the following assumptions:

    - Securities on deposit are assumed to be backed by the full faith of the US government and thus receive a zero risk charge;

    - I applied the lowest bond size charge, minimalizing the ACL, as information for the number of intended bond issuers is not available; and,

    - I did not add an asset concentration charge, minimalizing the ACL, as the information for the intended concentration in the top 10 issuers is not available.

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[16] **Exhibit** 4. Assuming capital equals TAC, the $908 million represents the combined TAC for the Ongoing and Runoff Companies at March 31, 2014, as reflect in the OBIG Reply. (Cumulative Log, Document 107 (OBIG Reply, p. 14).)

[17] Cumulative Log, Document 080 (TW Stochastic Report, p. 6).

[18] I found a $1 million difference in the ACL, less than 1% of the OBIC ACL of $187.1 million. I did not consider that difference to be material.

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

iii. R3 – CREDIT RISK

40. Potomac has $0 of reinsurance recoverable[19] as of December 31, 2009.[20]

41. Potomac has $0.02 million of investment income due and accrued, considered as part of credit risk for receivables, which I added to the combined OBIC investment income due and accrued at December 31, 2009.

iv. R4 – NET LLAE

42. I added net LLAE of $881 million and $1,516 million for OBIC and Potomac, respectively.[21]

43. To reflect the current TW central estimate of reserves, I added an additional $364 million of reserves, or the sum of:

- $134 million – the reserve increase made by Potomac in 2011 for accident years 2009 and prior;[22] and,
- $230 million – the reserves in excess of the carried reserves on the financial statements to equal the TW central estimate.[23]

44. Therefore, I calculated a combined OBIC total net LLAE at December 31, 2009 of $2,761 million.[24]

45. Potomac and OBIC reserves are allocated by LOB using actual 2009 Annual Statement values from Schedule P. $12 million of the $364 million in additional reserves are from non-NICO lines covered by the GenRe cover and are distributed between the CMP, workers compensation ("WC"), OL and PL LOBs using the distribution reported in the Potomac 2011 Annual Statement (Note 23F).[25] The remaining $352 million of the $364 million in additional reserves are all A&E losses and are distributed between the CMP, WC, OL and PL LOBs using the distribution reported in the Potomac 2011 Annual Statement (Note 23F).

46. Company development used to adjust the industry reserving charge was re-calculated using the sum of Potomac and OBIC Schedule P – Part 2 as of December 31, 2013. I assume that the $364 million additional reserves are from accident years 1999 and prior.

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[19] Excluding recoverables from affiliates, as there is no R3 charge for recoverables from affiliates.
[20] Potomac 2009 Annual Statement, Schedule F, Part 3.
[21] Potomac 2009 Annual Statement, p. 3; OBIC 2009 Annual Statement, p. 3.
[22] Potomac 2011 Annual Statement, p. 14.12.
[23] Refer to Footnote 2 in **Exhibit 5** for the calculation of the $230 million in additional reserves.
[24] Sum of OBIC net LLAE of $881 million, plus Potomac net LLAE of $1,516 million, plus the 2011 reserve increase of $134 million, plus the $230 million in additional reserves to equal the TW central estimate.
[25] The non-NICO portion of the OBIC reserve strengthening from December 2009 to December 2013. (Potomac 2011 Annual Statement, Note 23F.)

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

47. The loss concentration factor was re-calculated using the new net LLAE by Schedule P line.

48. See Table 5-8 below for details.

Table 5-8

RBC R4 (Reserve) Charge by LOB

($000 omitted)

	SCH P LINE OF BUSINESS	H/F	PPA	CA	WC	CMP	MPL OCC.	MPL CLMS MADE	SL	OL	FIDELITY / SURETY
(A)	OBIC Dec 2009 LLAE by Sch P line SCH. P PART 1 (in 000s)	25,313	143,648	86,088	155,718	103,506	581	70,156	50,842	198,716	1,453
(B)	Potomac Dec 2009 LLAE by Sch P line, SCH. P PART 1 (in 000s)	506	205	822	298,594	316,738	1	0	456	430,944	1
(C)	Distribution Additional A&E/NICO Net LLAE					23%				32%	
(D)	Distribution Additional GenRe Net LLAE				18%	19%				26%	
(F)	Additional A&E/NICO Net LLAE					81,703				111,948	
(G)	Additional GenRe Net LLAE				2,121	2,295				3,145	
(H)	**Est. Total Net LLAE Dec 2009 at TW central estimate by Sch P line**	**25,819**	**143,853**	**86,910**	**456,433**	**504,242**	**582**	**70,156**	**51,298**	**744,753**	**1,454**

	SCH P LINE OF BUSINESS	SPECIAL PROPERTY	AUTO PHYS. DAMAGE	OTHER, INC. CREDIT, A&H	FIN. / MORT. GUARANTY	INTL	REIN. PROP. & FIN.	REIN. LIABILITY	PL	WARRANTY	TOTAL
(A)	OBIC Dec 2009 LLAE by Sch P line SCH. P PART 1 (in 000s)	26,810	2,724	14,136	0	0	0	43	2,022	0	881,756
(B)	Potomac Dec 2009 LLAE by Sch P line, SCH. P PART 1 (in 000s)	228	(293)	1	0	0	0	0	468,276	0	1,516,479
(C)	Distribution Additional A&E/NICO Net LLAE								45%		
(D)	Distribution Additional GenRe Net LLAE								37%		
(F)	Additional A&E/NICO Net LLAE								158,049		351,700
(G)	Additional GenRe Net LLAE								4,440		12,001
(H)	**Est. Total Net LLAE Dec 2009 at TW central estimate by Sch P line**	**27,038**	**2,431**	**14,137**	**0**	**0**	**0**	**43**	**632,787**	**0**	**2,761,936**

Source:
Rows C and D: Refer to ¶ 45.
Row F: Row C * Row F Total (Refer to ¶ 45).
Row G: Row D * Row G Total (Refer to ¶ 45).

Maximum LLAE (Highest LOB net LLAE, Row H)	744,753
New Loss Concentration Factor	0.781

ESTIMATED ACL AND TAC AT DECEMBER 31, 2009 AND JUNE 30, 2014

v. R5 – WRITTEN PREMIUM RISK

49. Potomac had negative NWP of almost $0 at December 31, 2009.[26] As such, I used OBIC's December 31, 2009 NWP for the combined company of $906 million.[27]

50. I assumed no charge for excessive premium growth at December 31, 2009.

vi. TAC

51. Combined company TAC as of December 31, 2009 is $1,333 million, or:

- OBIC's December 31, 2009 TAC of $1,354 million;[28] <u>plus</u>,
- Potomac's December 31, 2009 TAC of $10.5 million;[29] <u>minus</u>,
- Reserves in excess of the NICO limit of $31.7 million.[30]

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[26] Potomac 2009 Annual Statement, p. 8.
[27] OBIC 2009 Annual Statement, p. 8.
[28] OBIC 2009 Annual Statement, p. 17.
[29] Potomac 2009 Annual Statement, p. 17.
[30] Refer to Footnote 1 in **Exhibit 5** for the calculation of the $31.7 million reserve deficiency.

LIMITATIONS BASED ON AVAILABLE DATA

1. I acknowledge that my analysis is based on publicly available information, such as statutory financial statements and the Cumulative Log. For example:
   - I only have access to summaries of the TW and RRC Reserve and Stochastic Reports,[1] and I do not have access to key documents such as the full TW or RRC Reserve and Stochastic Reports, confidential company RBC submissions to the PID and the NAIC, OBIG's Own Risk and Solvency Assessments ("ORSA"), reinsurance contracts, etc.
   - As such, since there are limitations on the analytical techniques that I can apply based on the information made available to me, I use standard financial ratios that can be constructed from public records or the information made available by the PID.
   - There are limits on my ability to confirm the accuracy of publicly available information and the completeness of my understanding of the Proposed Transaction.

2. With more complete information I might have different observations, potentially contradicting the conclusions in my analysis. In this regard, OBIG objected to the July 18th FTI letter[2] because, in part:

   > In place of that evidence, the Objectors urge the Department to depend on advocacy that is speculative at best, and often frivolous on its face. FTI Consulting, Inc. ("FTI"), for example, has provided what it calls a "preliminary review" of the work performed by Towers Watson and RRC. In the "review," an anonymous author sets forth a number of criticisms – including, for example, an (inaccurately) alleged failure on the part of the actuaries to "include the risk of 'known unknowns.'" But FTI also acknowledges, albeit only in passing, that it has not reviewed various confidential materials and that such review "might produce very different observations, potentially *contradicting* the observations in this letter." This is *not* the usual (and appropriate) actuarial disclaimer that future events might invalidate certain assumptions or projections. In this case, what FTI is expressly acknowledging is that ***it cannot warrant that its own "observations" are consistent with the evidence that is currently available to the Department***."[3]

3. In response to the OBIG objection, I point out that my analysis in the July 18th FTI letter and in this material is well reasoned and not frivolous. The caveat in that letter and in this report is a necessity created by the rules for public commentary on this Proposed Transaction.

4. For much of my work, I evaluate Financial Capacity and relative Financial Capacity using the ratio of TAC to ACL. In theory, economic capital models, analogous to the TW stochastic model, could be used to make the same comparisons. The economic capital models, to the extent they had access to more detailed information about the Runoff Companies, might identify risk features that are not reflected in the TAC to ACL

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[1] Cumulative Log, Document 080 (TW Stochastic Report), Document 083 (RRC Stochastic Report), and Document 082 (RRC Reserve Report), TW Reserve Report as of September 30, 2012, December 31, 2012 and March 31, 2013.
[2] Cumulative Log, Document 089 (AK Public Comment Letter, Exhibit 1).
[3] Cumulative Log, Document 107 (OBIG Reply, pp. 4-5).

LIMITATIONS BASED ON AVAILABLE DATA

comparison. OBIG did not provide, at least not to the public, any such economic capital modeling information and did not provide the information necessary for me to undertake that modeling. As such I consider it reasonable to approach the comparisons as I have done.

5. In calculating ACL for the Runoff Companies and Ongoing Companies currently, and in the event the Proposed Transaction is approved, I have made the approximations identified in **Exhibit 5**. Given the limits on the data available to me, I consider it reasonable to make such approximations. Should additional data become readily available to me, I can calculate ACL without these approximations.

6. I would welcome the opportunity to have a confidential expert-to-expert discussion to allow me to improve my understanding of the Proposed Transaction and to correct or clarify any features of my analysis that might require adjustment.