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PROPOSED ACQUISITION OF ONEBEACON INSURANCE COMPANY AND POTOMAC INSURANCE COMPANY

BY

ARMOUR GROUP HOLDINGS LIMITED

SUPPLEMENTAL EXPERT REPORT OF JONATHAN TERRELL

ON BEHALF OF

THE PENNSYLVANIA MANUFACTURERS ASSOCIATION, ASSOCIATED INDUSTRIES OF MASSACHUSETTS, CROSBY VALVE, LLC, ITT CORPORATION, POLYONE CORPORATION, THE PROCTER & GAMBLE COMPANY, 3M COMPANY, UNITED TECHNOLOGIES CORPORATION, AND THE WILLIAM POWELL COMPANY

October 16, 2014

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Scope of Report.

I have previously submitted a report in this proceeding, entitled Expert Report of Jonathan Terrell, dated July 21, 2014 ("Report"). The purpose of this Supplemental Expert Report is to respond to certain points made in the OneBeacon Response to Public Comments dated August 12, 2014 ("OneBeacon Response") and the Towers Watson Response to Public Comments dated August 11, 2014 ("Towers Watson Response").

OneBeacon and Towers Watson do not find merit in *any* of the many concerns and observations made by the various representatives of policyholders, underlying claimants and others objecting to the Proposed Transaction. They also seek as far as possible to discredit and even impugn the professional integrity of the witnesses who take issue with OneBeacon: its lawyers visit particular criticism and personal attacks on my contributions. I agree that certain of the responses to my observations have merit, and will specifically acknowledge those that do. However, I continue to stand behind the substance of my written and verbal observations for the reasons that will be set out below.

This supplemental expert report is confined to those elements of the OneBeacon and Towers Watson Responses that address my own written and verbal observations. I will not burden the Department with a "blow by blow" recounting of all the points raised at the July 23, 2014 hearing but will confine myself to the major themes.

This Supplemental Report adopts the terms and abbreviations used in my original Report.

Qualifications of Objectors.

OneBeacon and Towers Watson summarily reject ***all*** of my observations concerning the unsupported and counter-factual assumptions underlying Towers Watson's actuarial analysis, on the basis that I am not a qualified actuary. OneBeacon Response at 30; Towers Watson Response at 1-2. But they fail to explain why the universe of knowledge and experience that exists concerning the insufficiency of the insurance industry's asbestos reserves, the valuation of insurance coverage, the rate at which insurance policies will pay out over time, the relentless progression of asbestos malignancy claims, the administration of runoff vehicles, the economic incentives of runoff managers, and other aspects of the Proposed Transaction should be confined to members of the actuarial academy.

In fact, the notion that actuaries have a monopoly on opining about reserve adequacy and capital support is discredited by the very case, *In re Garlock Sealing Technologies, LLC*, 504 B.R. 71 (Bankr. W.D.N.C. 2014), which Towers Watson cites to support their untenable position that the asbestos litigation environment is improving. Towers Watson Response at 12. The experts retained in that case by the representatives of the debtor, the future asbestos claimants and the current asbestos claimants to estimate liabilities for present and future asbestos claims included Mark Peterson, Francine Rabinovitz and Charles Bates. These same individuals have provided expert testimony in numerous other asbestos estimation proceedings, and they come from varied backgrounds. Dr. Peterson is a lawyer with advanced degrees in psychology; Dr. Rabinovitz has a background in political science and statistics; Dr. Bates is an economist. All three have been qualified as experts in the process of estimating asbestos liabilities by numerous courts. Not one is a member of the actuarial profession.[1]

I am well qualified to offer the opinions that I have presented, notwithstanding the personal criticism directed at me by OneBeacon's lawyers. I am a Fellow of the Institute of Chartered Accountants of England and Wales. I also have decades of financial services experience, including significant experience working for both the insurance industry and corporate policyholders in managing and administering asbestos claims. I have direct experience with runoff operations, having managed the runoff of the Home Insurance Company as an officer of Zurich Financial Services. I have a working knowledge of insurance statutory financial statements, and have offered expert opinions on credit risk. My forecasts of future liabilities (including asbestos liabilities) have been used in dozens of settlement meetings between policyholders and insurers, and those estimates have been accepted for financial reporting purposes by independent auditors. In addition, I am an expert in the allocation of mass tort liabilities to insurance policies, and my company, KCIC, has developed the industry leading platform for modeling the interaction between long-tail liabilities and available insurance assets. Finally, KCIC serves as a claims administrator for numerous corporate entities, and processes thousands of mass tort claims every year.

I believe that my background qualifies me to offer the opinions I have presented. Moreover, as noted below, many of the criticisms I and others have raised with the Proposed Transaction do not concern the particular actuarial methodology employed by Towers Watson in its undisclosed "proprietary" model. Rather, my criticisms are directed at the unsubstantiated legal, medical, scientific and social science assumptions that Towers Watson has uncritically accepted, and that it is simply not qualified to make. It is demonstrably clear that actuarial predictions of A&E liabilities like the ones Towers Watson has provided to the Department have

[1] Dr. Bates has estimated asbestos liabilities for W.R. Grace, ASARCO, and Babcock & Wilcox. *See* Bates White Economic Consulting, *at* http://www.bateswhite.com/professionals-Charles-Bates.html. Dr. Rabinovitz has served as an expert in asbestos loss estimates in the Owens Corning, W.R. Grace, Johns Mansfield, and U.S. Gypsum bankruptcies, among many others, and as a consultant for Dow and Honeywell, Inc. *See* Hamilton, Rabinovitz & Associates, Inc., *at* http://www.hra-inc.com/team/partners/franscine.shtm. Dr. Peterson has been involved in the Western Asbestos/McArthur and Federal-Mogul cases, as discussed in the *Garlock* opinion.

consistently and materially understated insurers' exposures and reserving requirements in the past. It would require a leap of faith for the Department to assume that Towers Watson has finally got it right, and that its latest predictive exercise is any more reliable than the many failed attempts that have preceded it.

Reliance and limitations.

The actuarial reports of Towers Watson and the quick review conducted by RRC are very heavily qualified. OneBeacon's SEC disclosures are also very heavily qualified with respect to reserve adequacy – another red flag in assessing the Proposed Transaction. Towers Watson's response is that these reliances and limitations are required by their profession (just as the 10-K caveats are required by securities lawyers), and are "key to allow the reader to fully understand the scope of the actuarial work." Towers Watson Response at 2. While that is undoubtedly true, it cannot be gainsaid that these repeated qualifications have meaning and significance. There is a serious dissonance between (a) the confidence portrayed in Towers Watson's oral statements to the Department on July 23 and its follow-up Response, and (b) the qualifications, hedging and caveats that permeate its initial Reports. In the latter, Towers Watson (and RRC) carefully emphasize that "there is a great deal of uncertainty in making these estimates," but it is the best that actuarial science can come up with in a volatile legal environment. RRC Letter of Oct, 2, 2014 at 1. In the former, Towers Watson summarily dismisses any criticism that its conclusions are less than confident predictions of what the future will hold for the questionably capitalized runoff entity OneBeacon proposes to establish under Armour Group's thinly capitalized ownership.

The point in highlighting these caveats and qualifications is this: there are inherent, glaring uncertainties in the Towers Watson work and in the disclosed and undisclosed assumptions (legal, sociological and medical) underlying that work. They recognize it, RRC recognizes it, their profession requires them to recognize it, and the Department should recognize that the whole point of the Proposed Transaction is to transfer these massive uncertainties and the liabilities associated with decades of insurance policies away from OneBeacon - the party that agreed to bear these risks and received premiums for doing so – back to the Policyholders. Only the most compelling of justifications should suffice for altering the insurance bargain in such a potentially consequential fashion. No such justification has been provided here.

That my Report is supposedly "riddled with factual errors."

I do not believe my Report is "riddled with factual errors." The only example that OneBeacon and Towers Watson cite is my supposed misquotation from RRC. OneBeacon Response at 5. The putative misquotation is in footnote 49 on page 19 of my Report. The footnote itself consists of three extracts from the RRC report. I wrote:

> RRC also acknowledges that "[n]ew claims, new causes of action, and new judicial precedents will continue to change the landscape," "that, as Towers itself notes, new judicial precedents or other unforeseeable actions could adversely impact this book," and "that the ultimate costs of these claims will exceed the high end of the Towers' range due to the purpose of the high estimate as stated above."

Report at 19 n.49 (quoting RRC Review of Towers Watson Analysis of Unpaid Loss and LAE, Summary Report, at 7-8). The allegation of OneBeacon's lawyers that "accuracy and credibility were beside the point" in my Report consists solely of the fact that I omitted the phrase "the possibility exists" from the last cited passage above. OneBeacon Response at 5.

OneBeacon's counsel curiously do not mention that the entire quotation, including the language they claim would make it less "transparently inaccurate hyperbole," appears on the prior page of my Report (p. 18), quoted in full. If I was attempting to mislead the Department, I would not have provided the quote in its entirety just a few paragraphs earlier.

Moreover, the statement to which the footnote applies is completely accurate. OneBeacon has not suggested (and cannot suggest) otherwise: "RRC and Towers Watson agree that future litigation and settlement developments are more often negative than positive, that more defendants see unexpected increases than decreases in their litigation profile, and that the discovery of new coverage limits and claim re-openings only move the estimated liabilities upward, often dramatically." Report at 19. Anyone with experience in the volatile field of mass tort liabilities knows that these observations are true, including OneBeacon.

Read in this full context, my quotation from RRC is not misleading. Moreover, after scouring the entire record of the July 23 hearing and my lengthy report, this is apparently the only example OneBeacon's lawyers could come up with to support the inflammatory assertion that my report is "riddled with blatant factual errors" and "punctuated ... with statements he knows to be untrue." OneBeacon Response at 5, 31. These are serious charges, to which I take umbrage as a professional, and they are unsubstantiated.

<u>OneBeacon's reserving history.</u>

The points made in my report and testimony that OneBeacon and Towers Watson choose to ignore are almost as revealing as those to which they do respond. At some length in my Report and in my testimony, I recited the abysmal history of under reserving for long-tail claims by the insurance industry in general, and by OneBeacon in particular. I also pointed out that equally confident actuarial opinions prepared under the same actuarial standards as those to which the Towers Watson work is subject were issued shortly before multiple material increases in reserves by OneBeacon since 2001. I further pointed out that OneBeacon is considerably under reserved according to the Towers Watson reserving analysis. Report at 3-23.

The Towers Watson non-Response is that they "did not comment on the reasonableness of OB's held reserves or comment on OB's reserving practices." Towers Watson Response at 6. But the fact that they did not do so is immaterial: the question is still begging for an answer. OneBeacon - the proponent of this transaction who wants to shed contractually assumed liabilities and focus on other, more profitable lines of business - has a chronic history of under reserving for asbestos and other long-tail claims; is still under reserved today, based on Towers Watson's own work; has repeatedly cautioned shareholders in securities filings that their reserves may not be adequate; and has pointed regulators and investors to unqualified actuarial opinions only a year before enormous increases in reserves. Yet this is the same management that now is assuring policyholders and this Department that the reserves are more than adequate to meet future liabilities that will be dumped into a new, independent runoff vehicle.

Neither Towers Watson nor OneBeacon provides any convincing basis for distinguishing the most recent set of A&E reserving estimates from the failed estimates that have been provided by equally qualified actuaries in the past. The more likely outcome is that, as before, professional actuarial analysis will substantially underestimate the true costs of these liabilities as they mature. As I explained in my prior report, in light of the abject failure of the actuarial profession to adequately forecast asbestos, environmental and other long-tail liabilities on an industry-wide or insurer-specific basis for many years, it defies credulity to suggest that the latest edition of Towers Watson's A&E forecasting should instill confidence that the new reserve estimates are suddenly more accurate.

Other runoffs

OneBeacon asks the Department to consider comparisons to other insurance companies in run-off as a measure of how successful these transactions can be. OneBeacon Response at 24. The examples cited, however, are so far afield from the situation at hand as to be both irrelevant and misleading.

The Proposed Transaction is about the sufficiency of loss reserves for legacy liabilities, and asbestos and environmental exposures in particular. I have reviewed the Annual Statements for each of the five companies cited for the year ended December 31, 2013. Note 33, Asbestos/Environmental Reserves, reveals that four of the companies, Clarendon America, Clarendon National, Quanta Indemnity and Western General have *zero* asbestos and environmental liabilities. One of them, Providence Washington, has insignificant asbestos and environmental reserves (approximately $15 million). This is in marked contrast to the runoff entities that are the subject of the Proposed Transaction. OneBeacon discloses legacy asbestos and environmental liabilities that will be assigned to the runoff entities of approximately $616 million in its December 31, 2013 10-K.[2]

Each of the companies cited is also far smaller than OneBeacon. Quanta Indemnity and Western General disclose net reserves of losses and loss adjustment expense of approximately $13 million and $10 million respectively at December 31, 2013. Clarendon America and Providence Washington disclose approximately $62 million and $52 million respectively. Only Clarendon National would appear to be a runoff of any significant size, with net reserves of $293 million. But even Clarendon National is dwarfed by the net loss reserves of the runoff entities of $1,037 million.[3]

As I noted in my initial report, since the NICO retroactive reinsurance agreement took effect in 2001, OneBeacon has had adverse loss development of $1.347 billion. Report at 8. And as further noted, OneBeacon is consistently listed by A.M. Best and other authoritative sources as among the 15 insurers with the largest A&E exposures. *Id.* at 7. More than anything else, it will be the adequacy of reserves established for long-tail risks such as asbestos and environmental exposures that will determine the success or failure of the Proposed Transaction, and the examples cited by OneBeacon are irrelevant to that consideration.

More appropriate comparisons would include insurers of similar size with similar portfolios. At the hearing, the Department questioned whether the Home Insurance transaction was an appropriate point of comparison because of how long ago the transaction occurred. While I believe it is, I would also point to Arrowood Insurance Company, the run-off vehicle for Royal Indemnity Company approved by the Delaware Insurance Commission when its UK parent company pulled out of the entire U.S. property casualty market. As demonstrated by a comparison of Arrowood's initial surplus and its most recent filing, Arrowood is hemorrhaging money. *See* Report at 37 (Arrowood's surplus has gone from $1.5 billion in 2003 to $260 million at the end of 2013). At the current rate of loss, it will likely be insolvent or forced into liquidation in just a few more years, which is less than ten years after the run-off transaction was approved in 2007. Yet OneBeacon's lawyers cite this transaction as a success model.

OneBeacon and Armour also point to the 2006 Randall & Quilter ("R&Q") acquisition of ACE American Reinsurance Company ("ACE Re") as a model for the current transaction. There are, however, numerous and important differences between this Proposed Transaction and the R&Q transaction. First, the assets being

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[2] See Exhibit 1 comparing the asbestos and environmental reserves, and the net loss and LAE reserves of the cited companies to OneBeacon.

[3] Per Potomac Insurance Company 2013 Annual Statement. Potomac is the entity which reinsures the other runoff entities (e.g. OneBeacon Insurance Company) and retrocedes that risk to NICO. For that reason, the net reserves per Potomac is likely the most accurate measure of the reserving level of the runoff entities for comparison purposes at December 31, 2013.

transferred were reinsurance, not direct insurance; thus, the interests of policyholders were not part of the calculus. Decision and Order, *In re Application of Randall & Quilter Investment Holding Ltd. in Support of the Request for Approval to Acquire Control of ACE American Reinsurance Co.*, July 3, 2006, Findings of Fact ¶¶ 31-34 (attached as Exhibit 2).

Second, ACE Re was not a run-off vehicle. It was a pre-existing, ongoing business of the ACE family that had its own assets and liabilities. It was not a "bad bank" into which run-off assets were dumped, like OneBeacon proposes here. *Id.* Findings of Fact ¶ 28. Third, unlike here, the Department hired its own experts to do a bottom-up review of all levels of the transaction, not merely a "peer review" like the one conducted by RRC. In fact, the Department's own experts determined that the high end of the likely losses was significantly higher than the applicant's, and the Department required an additional contribution by ACE Re. *Id.* Findings of Fact ¶¶ 114-16, 134-47.

At the hearing, the Department noted that it has discretion to allow an insurer to continue operating even after it is technically insolvent or below the minimum capital benchmarks established by statute or regulation. Transcript 107:10-108:2. While that may be true, those scenarios typically do not end well for policyholders. For example, a similar strategy was followed in the Kemper/Lumbermen's run-off, where the Illinois Insurance Department allowed Kemper to formulate a run-off plan and continue operations even though most knowledgeable observers viewed Kemper as deeply insolvent and a candidate for orderly liquidation after decades of unsustainable underwriting of environmental, asbestos, construction defect and other risks. *See* Kemper Run-Off Leadership Team Announced, April 15, 2004, *available at* http://www.lmcco.com/press_releases/2004/ pr_04152004.html. In the meantime, Kemper pursued exactly the strategy outlined above by OneBeacon: cutting preferential commutations with policyholders who were willing to settle on the cheap, refusing to deal with those who wanted fair value for their policies, and declining to enter into "coverage in place" arrangements with policyholders and other insurers for the efficient handling and defense of asbestos cases.

Less than ten years later, Kemper was forced into liquidation with substantially fewer assets to distribute equitably to its remaining creditors. *See* Letter from Office of the Special Deputy Receiver, Notice of Liquidation, May 10, 2013, *available at* http://www.lmcco.com/pdf/LMC_Notice_of_Liquidation_Policy_Holders_of_Loss_ Claims.pdf. Thus, those who took highly-discounted commutations with Kemper were shortchanged by the threat of insolvency, and those who refused to surrender their insurance asset on the cheap received less than they would have if an orderly liquidation had been initiated at the appropriate time. The May 2013 notice of liquidation has been followed by a claim bar date of November 2014, an extremely short time period and one that will further defeat legitimate claims. The Kemper debacle may be a harbinger of what will occur here if the Proposed Transaction is approved. Yet it is not discussed at all by OneBeacon's lawyers; they would rather focus on runoffs of small insurers with no A&E exposures as their paradigm.

<u>Towers Watson now claim that they made indirect provision for the emergence of new mass torts. Did they or did they not?</u>

In their July 23 testimony and their written Response, Towers Watson try to distance themselves from certain statements originally made in their September 17, 2013 Analysis. With respect to Direct and Assumed Other Mass Tort exposures ("OMTs"), they originally stated that, "While our estimates make allowance for increases in the losses associated with OMT claims, we have not included any specific allowance for the emergence of wholly new areas of mass torts." Towers Watson Analysis of Unpaid Loss and LAE, Summary Report at 26. They point out the difficulty in reserving for OMTs: "traditional historical accident year development is not predictive of future emergence for these types of claims. For many of these classes of claims there is essentially no industry information that can be used to estimate ultimate losses." *Id.* I agree with those statements, which acknowledge the essential impossibility of predicting the onslaught of new mass torts from the pool of data on existing but different mass torts.

However, at the hearing Ms. Santomeno appeared to change course. She explained that Towers Watson actually utilized a survival ratio approach to project the emergence of future OMTs. This is the same approach that Towers Watson not only ignored, but described simply as a "metric" with respect to asbestos liabilities and reserving requirements. They "selected OneBeacon's annual payment rate for historical mass tort claim payments. That includes payments for mass torts that are not expected to continue or generate future losses, as well as mass torts that are. By doing this, we have *implicitly* reflected a provision for future claims arising for potentially new or unforeseen mass torts." Transcript at 46:6-13 (emphasis added).

These explanations are plainly inconsistent with the September 17, 2013 Analysis, and appear designed to plug a rather large hole in their reserve estimates for the new runoff entity. Having initially stated that they did *not* make an allowance for new emerging mass torts, they now inform us that they made an *implicit* allowance. In essence, they assumed that wholly new areas of mass tort exposure that may arise in the future – much as breast implants, lead paint and various pharma claims have in the recent past - would be equivalent to the payments for mass torts that are not expected to continue or generate future losses. In other words, Towers Watson assumes that new and unpredictable liabilities would precisely mirror those known liabilities that are now trending toward extinction.

With all due respect, this improvised approach is untenable, and amounts to nothing more than a "back of the envelope" analysis. What we do know, and as set forth in my Report and testimony, is that new mass torts do emerge regularly (e.g., breast implants, tainted blood, Agent Orange, pharmaceutical products, etc.). Report at 13. Neither OneBeacon nor Towers Watson disputes this, or that reserve increases inevitably follow such developments. The assumption that new mass torts that we currently know nothing about will emerge at the same rate as "mass torts that are not expected to continue or generate future losses," based on data drawn from recent accident years, is wholly lacking in empirical support and logic. This is not an actuarial conclusion: it is blind guess work. The survival ratios selected of four, six and eight years are also not supported and may bear little resemblance to the actual evolution of a new mass tort.

This is not to say that I or anyone else has a crystal ball to divine how OMTs should be forecast. I understand the lack of industry data and the limitations this imposes on the ability to forecast new emerging exposures. My observation is simply this: wholly new areas of mass tort will likely emerge in the future, there is no explicit allowance for them by Towers Watson, the "implicit" allowance is guess work, and the liability risk associated with them is being transferred back to Policyholders. The Department should, and in my view must, be provided with a more thorough and reliable analysis than this one before transferring the risk from the party that agreed to bear it - OneBeacon - to its Policyholders through the Proposed Transaction.

Discount Rates and Inflation.

My criticisms of the discount rates used in the Towers Watson reserve analysis are dismissed by Towers Watson now as unimportant, ostensibly because they were not used in the stochastic model. "We do not believe that the discounted figures shown in in our reserve summary report are important now. . . . Per Mr. Bozman's testimony these assumptions were not used in the stochastic report." Towers Watson Response at 9, 23.

We are now told that the investment returns used in their stochastic model were generated by Towers Watson's proprietary Economic Scenario Generator ("ESG") with unspecified input from the investment consulting practice with which Towers Watson judgmentally adjusted the ESG. *Id.* at 24. But as RRC emphasizes in discussing projected asset yield, "Success relies on the ability of assets to grow for an extended period of time, particularly in view of the likelihood that significant NICO losses will not be paid for many years." RRC Report on Stochastic Model at 4.

We are provided no information as to how investment assumptions were generated from the ESG and then subjected to judgmental adjustments by Towers Watson based on input from its investment group. The Department has noticed the same omissions, and has asked OneBeacon for more details concerning the investment group's analysis and recommendations. Letter from Stephen J. Johnson, Pa. Ins. Dep't, to James R. Potts, at 3 (October 6, 2014). It is clear, however, that equity returns, the most speculative class of asset, are a significant component of the Runoff Entity's projected investment returns.[4] As observed by RRC, "Some equity investment,

[4] An early version of the model assumed 26% allocated to equities growing to 46% after five years. The latest version assumes 15%.

according to OneBeacon, is a key element of the transaction because much of the anticipated loss payments are not expected to be made for many years and long-term investments in equities is expected to produce a higher return than other investments." RRC Report on Stochastic Model at 4.

The success of the Proposed Transaction is thus dependent on the unknown future performance of an undisclosed investment strategy. It requires those investment assets to grow at a speculative rate for an extended period of time. This represents yet another significant risk transfer to policyholders that would not exist if the Proposed Transaction is disapproved.

In the event that the Transaction is approved, I recommend to the Department that OneBeacon guarantee the investment performance of the runoff companies at a rate sufficient to assure the long term grown of those investment assets. There is precedent for imposing such conditions.[5] If OneBeacon's assumptions are realistic, it will cost them nothing. If they are overly optimistic, this would provide a measure of protection to policyholders.

As far as asbestos claim award inflation is concerned, while Towers Watson now appears to agree with me that societal and legal factors drive changes in claim awards rather than medical inflation, they continue to cling to their position that "a natural assumption is that claim values will trend upward at the underlying medical and wage inflation rate." Towers Watson Response at 13. I disagree. As explained more fully in my Report, while medical and wage inflation may be positively correlated with inflation in asbestos claim awards, increases in asbestos claims awards are primarily driven by economics, the motivations and tactics of the plaintiffs' bar, and by trial verdicts. Report at 14-15.[6]

<u>Model for Asbestos Estimates.</u>

Towers Watson relies entirely on their ground-up study for the purposes of estimating asbestos liabilities and forecasting reserves. I do not disagree that this method is the superior measure, but I strongly disagree that other accepted techniques should be entirely ignored. Other analytical techniques, including survival ratios and market share data,[7] raise the concern that OneBeacon is under-reserved, and the Department and policyholders should have an explanation for any disconnect between the Towers Watson ground up work and other metrics. After all, Towers Watson does not

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[5] In the Home transaction, Zurich guaranteed Home's investment performance for a fixed period.

[6] In just the last year, I note a $190 million award in a consolidated trial in the New York asbestos docket and a $7 million premises "trophy verdict" against Long Island Lighting Co. *See* Exhibits 3 - 4.

[7] OneBeacon has often been in the top 15 insurance groups in Best's analyses of asbestos exposures.

dispense with survival ratios in their environmental exposure analysis and in their projections of Other Mass Torts. *See* Towers Watson Analysis of Unpaid Loss and LAE at 25.

Towers Watson also addresses the usefulness of survival ratios in its own research papers:

> Survival ratios for individual companies very widely depending upon the insurer's book of business, reserving protocol and settlement practices, and therefore, the ratios must be interpreted with caution when used to assess relative reserve adequacy. *Notwithstanding these limitations, companies with low survival ratios are more likely to require reserve additions in the near future to fund continuing claim payments.*[8]

Towers Watson is also extremely selective in their reference to A.M. Best in seeking to justify their modeling of asbestos exposures. A.M. Best actually says:

> A.M. Best utilizes a combination of three approaches when evaluating an insurer's A&E reserve adequacy: historic premium market share, post-1990 paid loss share (1991 – 2012) and three-year survival ratios. In the event a company has completed a current ground-up study of its A&E exposures, A.M. Best will weigh the high end of the study's range by 50% to 80%, depending on the credibility of the study, while weighing A.M. Best's own estimate by 20% to 50%.[9]

A.M. Best clearly agrees that a current ground-up study should be weighted heavily; however, they do not endorse ignoring the other metrics. It should also be noted that A.M. Best weights the *high* end of the range from the ground-up study, whereas the Towers Watson stochastic model is scaled to the Towers Watson central estimate. The Towers Watson model would provide significantly less comfort as to the adequacy of the Runoff Entity's projected reserves if it were scaled to the A.M. Best approach for determining reserve adequacy.

Reinsurance disputes.

There are serious discrepancies in the discussion of reinsurance collectibles between the Towers Watson Analysis of Unpaid Loss and LAE dated September 9, 2013 and the more recent Response. This is what Towers Watson said in its September 2013 report about estimating asbestos liabilities net of reinsurance:

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[8] Insights. Summary of U.S. Property & Casualty Insurers' Asbestos Claim Reserves at Year-End 2012. Towers Watson. Page 5. Exhibit 5. (emphasis added)

[9] Best's Special Report. Asbestos Losses Fueled by Rising Number of Lung Cancer Cases. October 28, 2013. Page 3. Exhibit 6.

> After deriving estimates of the gross unpaid liabilities, we project the liabilities net of external reinsurance by selecting net-to-gross ratios to be applied to the indicated gross liabilities of the various exposure segments (tier groupings). Our selected net-to-gross ratios for Tiers 1-2, 3-4 High; and 3-4 Medium Extended *rely on the results of the ceded modeling performed by OneBeacon as of year-end 2010..... We are unable to independently test the assumptions and procedures used by OneBeacon in its ceded model.....* Since we were unable to review the assumptions used by OneBeacon in its ceded model, *we have assumed the 7.5% miscellaneous uncollectible provision is reasonable and have incorporated it in our estimates.*

Towers Watson Analysis of Unpaid Loss and LAE at 21 (emphases added). With regard to reinsurance for environmental exposures, the Towers Watson was even more candid about relying on assumptions and conclusions provided by OneBeacon:

> We have selected a net-to-gross ratio on unpaid loss and ALAE of 50%, which is consistent with OneBeacon's selected net-to-gross ratio in their December 31, 2010 review. Our net-to-gross ratio was selected judgmentally based on OneBeacon's paid pollution net-to-gross ratios over the past twelve years.

Id. at 24.

Towers Watson's assertions in their more recent Response are inconsistent with the statements in their original analysis. Having said that they were unable to review the assumptions in the outdated OneBeacon 2010 model, and having acknowledged that the 7.5% provision for uncollectible reinsurance was something they simply assumed was reasonable, they now inform us that:

> While certain elements of the NICO lines ceded projections were not subject to independent testing, as disclosed in our Reserve Report, we considered all of the available data and information in drawing our conclusions. . . . The 7.5% estimate was made by Towers Watson after considering all of the data and available information.

Towers Watson Response at 10-11.

So which is it? Did Towers Watson rigorously test the OneBeacon model or not? Did they simply assume that the 7.5% provision for uncollectible reinsurance was reasonable (as stated in the original report), or did they do more? What "additional data and information" was considered, and what additional analysis was done? Given the material importance of the prospective reinsurance asset to the Proposed Transaction, a straight answer would surely be helpful to the Department.

I am not disputing that Towers Watson did some work on the *credit risk* associated with the prospective reinsurance asset. My point is that they have done no independent work to calculate the *amount* of the prospective reinsurance asset, and to look behind OneBeacon's estimate that only 7.5% of that prospective asset may be uncollectible. Towers Watson, by its own admission, has relied on an outdated internal model presented by OneBeacon, which has an economic incentive to minimize the extent of uncollectible reinsurance.

Reinsurance contracts are subject to the same opportunities for disputes over coverage positions as direct insurance contracts, and such disputes are very common. The outdated OneBeacon model may perhaps be calibrated with reasonable assumptions (despite OneBeacon's contrary incentives) but nothing has been done to test that they are realistic. Reinsurance disputes are usually arbitrated rather than litigated, and thus are commonly resolved under the radar. Based on my direct experience in managing runoffs, it is clear that reinsurance disputes increase in runoff situations for two reasons. First, the change in claims handling philosophy, with a greater emphasis on policy buyouts, increases disputes because reinsurers resist "acceleration" of their payment obligations. Secondly, reinsurers no longer have the prospect of additional premium income with a run off entity, and therefore tend to harden their bargaining positions, much as runoff entities do with direct policyholders.

Although Towers Watson asserts that this argument "defies common sense," Towers Watson Response at 23, these actuaries do not have any discernible experience managing runoffs and negotiating with reinsurers, which I have done for many years. The Towers Watson personnel responsible for the stochastic modeling exercise have never been involved in ceding a policy buyback to reinsurers, seeking contribution from reinsurers on an accelerated basis for global resolutions with direct policyholders, or defending against reinsurer claims that a cedent breached various policy conditions. I invite the Department to obtain advice from others in the industry who have actual, hands-on experience with runoff reinsurance disputes, which is not within Towers Watson's area of expertise.

<u>The Asbestos Litigation Environment.</u>

Ms. Santomeno testified at the public hearing that the "asbestos litigation environment has been improving over the last eight to nine years." Transcript at 44:11-13. In my own public remarks, I took issue with that statement: "I really wonder on what planet that is true, because on this planet, and my experience working with major asbestos defendants every day, all day, this is getting no better. It's getting worse." *Id.* 127:15-22.

To support their view that things are betting better out there, and that OneBeacon policyholders have nothing to worry about, Towers Watson resorts to a few anecdotes, which are not the product of actuarial science. For example, they cite a

2006 Texas federal court decision in which Judge Jack found fraudulent medical diagnoses in silica cases, and the recent *Garlock* decision in which a bankruptcy court found that Garlock's estimated liability was "only" $125,000,000 (on top of the $1.7 billion it had already paid in the tort system), ostensibly because certain plaintiffs' lawyers had withheld evidence of exposure to other defendants' products. Towers Watson Response at 12.

It is difficult to understand what Towers Watson is seeking to accomplish through these vignettes, or how they relate to actuarial science rather than social science. I do not disagree that Judge Jack's decision, albeit in a silica case, had a beneficial but temporary effect on reining in abusive diagnoses in silica cases or combined silica/asbestos exposure cases. Tort reforms in certain states, such as Mississippi over the last 10 years, have also been helpful in reducing filings by non-malignant and unimpaired claimants, although some of those filings were transplanted to other jurisdictions, and the pace of malignancy filings has increased along with average jury verdicts. The consequences of the *Garlock* decision have yet to play out, but it is a single case taking a helpful position on claims estimation after dozens of other asbestos bankruptcy decisions that have relied on the debtor's pre-bankruptcy experience in the tort system to impose much larger estimated liabilities.

One wonders, for example, why Towers Watson did not mention other recent asbestos bankruptcy decisions, such as (1) the *Specialty Products* case in Delaware, which considered and rejected the same arguments that the court accepted in *Garlock*, and imposed an estimated asbestos liability of $1.2 billion on a small manufacturer of joint compound;[10] or (2) the *Pittsburgh Corning* case here in Pennsylvania, where both the bankruptcy court and the district court declined to accept the fraud defense and endorsed a reorganization plan imposing estimated liabilities exceeding $3 billion on a debtor and its corporate owners.[11] Nor is there any mention of the string of prior bankruptcy cases imposing massive estimated liabilities on asbestos producers, such as the $7 billion imposed on Owens Corning or the $9 billion in estimated liabilities visited on Federal-Mogul. Much of this financial burden will be borne by insurers. Any fair discussion of the enormous liabilities shouldered by asbestos defendants and their insurers would have considered and addressed these and other cases. And there are many more like them. That Towers Watson did not even mention the other side of the story suggests that it is defensively "backfilling" its own analysis rather than impartially assessing the asbestos litigation environment.

I agree that asbestos claims filings are lower than they were 10 years ago, when plaintiffs' lawyers were dumping their entire inventory of cases into the court system in anticipation of federal asbestos reform legislation that ultimately did not happen. However, the major change that has taken place as a result of tort reform is that the

[10] *In re Specialty Prods. Holding Corp.*, 2013 WL 2177694 (Bankr. D. Del. May 20, 2013).

[11] *Mt. McKinley Ins. Co. v. Pittsburgh Corning Corp.*, 2014 WL 4923076 (W.D. Pa. Sept. 30, 2014).

so-called "unimpaired" plaintiffs - those suffering from less serious diseases such as pleural plaques and asbestosis - make up a far smaller percentage of claim filings compared to 10 years ago. As welcome as this development may be to defendant companies that are still spending as much money as ever in defending themselves, filing rates for mesothelioma, lung cancer and other serious cancers have not fallen off, and settlement values, especially for mesothelioma, have dramatically increased over the period.

It would be worthwhile to ask Towers Watson how many experienced asbestos defense counsel or national coordinating counsel it interacted with in forming the view that the asbestos litigation environment is improving, and that OneBeacon will be left with a surplus when the asbestos contagion eventually abates. The reality described by major defendants and their defense counsel is of a "perfect storm" of well financed plaintiffs' attorneys, some of which have evolved into national plaintiff firms, and an increasing multiplication of "spinoff" plaintiff firms seeking "trophy" verdicts to compete for more claimants. There is also an increasing trend of plaintiffs firms sharing resources and information. At the same time we are seeing a reduced burden of proof on key issues such as causation and an increased population of plaintiffs as people are living longer (i.e., "living into" their asbestos disease) and therefore a higher percentage are filing lawsuits. We are also seeing a disturbing increase in "take home" cases involving people who did not work in an industrial job, but were secondarily exposed to asbestos fibers brought home by a working parent, and who eventually contracted mesothelioma. Further, the relatively easy availability of Bankruptcy Trust Funds has provided a continued source of financing for parallel litigation in the tort system. These trends, combined with certain very large verdicts[12] and punitive damages awards, has brought about this "perfect storm." Most major asbestos defendants, in my opinion, would be mystified by Towers Watson's view that the asbestos litigation environment is improving.

To verify the continued deluge of asbestos claims, one need only look at the widespread and increasing purchase of advertising for mesothelioma and lung cancer cases on radio and TV stations. "Mesothelioma" is reported as the most expensive ad word on Google, and "mesothelioma lawyers" carried a cost of well over $200 per click in 2013, up from an estimated $143 in 2011.[13] It is estimated that since 2009, asbestos plaintiff firms have spent an average of over $30 million a year in television commercials alone.[14] Annual expenditure on Google advertising by plaintiffs firms is

[12] "A third factor driving up costs in recent years appears to be the plaintiff bar's success in obtaining large claim awards from previously low-profile defendants." Insights. Summary of U.S. Property & Casualty Insurers' Asbestos Claim Reserves at Year-End 2012. Towers Watson. Page 4. Exhibit 5.

[13] 12 Google Adwords Facts & Trends from 2013. Exhibit 7.

[14] MEALEY'S Asbestos Bankruptcy Report. November 2013. Asbestos Litigation, Attorney Advertising & Bankruptcy Trusts: The Economic Incentives Behind The New Recruitment Of Lung Cancer Cases, by Marc C. Scarcella, Peter R. Kelso and Joseph Cagnoli, Jr. Exhibit 8.

estimated at over $50 million annually.[15] When plaintiffs firms have the financial wherewithal to afford an unending stream of advertising, and can afford those sorts of click charges on Google, it is hard to conclude that the asbestos litigation business is anything but thriving.

Towers Watson's rosy prediction is also belied by the insurance industry's own reserving trends. Insurance companies, it is important to note, are not prone to setting up unnecessary reserves but have, nonetheless, consistently and repeatedly posted reserve increases. According to A.M. Best, the U.S. Property & Casualty industry carried net asbestos reserves of $22.3 billion at the beginning of 2004. Over the nine years ending December 31, 2012, the industry increased its net asbestos reserves by another $23.3 billion. As of December 31, 2013, total carried reserves were $23.0 billion. If, as Ms. Santomeno asserts, the asbestos litigation environment has improved over that time period, why are insurance companies increasing their reserves and making payments of such significant amounts (indeed, paying essentially all their reserved dollars since 2004)? Towers Watson's sanguine statements are deeply incompatible with the actual conduct of its insurer constituency.

In fact, Towers Watson's own research papers appear to be at odds with their testimony in this matter:

> We believe the forces that have driven insurers' asbestos reserves upwards in recent years are likely to continue for a number of years. As a result, the industry can expect to add several more billion dollars to its heft tally for this vexing mass tort.
>
> Another key factor contributing to the upward development is the industry's asbestos losses, in our view, is a systematic low bias in the procedure used by insurers to estimate their asbestos liabilities.
>
> Some companies may be reluctant to extrapolate from recent adverse developments, such as higher than expected mesothelioma filings and defense expenditures to the future tail period.[16]

And notwithstanding these significant and ongoing increases in reserves, A.M. Best notes that "it appears that the industry is using a 'pay-as-you-go' approach for asbestos claims."[17] In other words, the industry is *still not fully reserved* for its ultimate asbestos exposures.

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[15] The Plaintiffs' Bar Goes Digital. An Analysis of the Digital Marketing Efforts of Plaintiffs' Attorneys & Litigation Firms. Institute for Legal Reform. Exhibit 9.

[16] Insights. Summary of U.S. Property & Casualty Insurers' Asbestos Claim Reserves at Year-End 2012. Towers Watson. Page 7. Exhibit 5.

[17] Best's Special Report. Asbestos Losses Fueled by Rising Number of Lung Cancer Cases. October 28, 2013. Exhibit 6.

Towers Watson is equally dismissive of the risk of second hand asbestos exposures: "Many states are not imposing a duty on the manufacturer to warn about second hand exposures" and "it is far from clear at this juncture whether these (lung cancer cases) will be compensated at all, and if they are, it will almost certainly not be at the same level of compensation as mesothelioma cases." Towers Watson Response at 12.

However, second hand exposures, most frequently spouses and children of the person with direct exposure, are common and increasing in frequency, and they command significant settlement values. Towers Watson recognizes this in its own research.[18] There is no empirical basis for assuming that these sympathetic claimants will not command levels of compensation at least as high as older claimants who were exposed in the workplace. Moreover, these second-generation exposures were not anticipated in the original Nicholson-Selikoff studies, and they raise the alarming prospect that additional mesothelioma cases will appear well into the future.

While it is true that asbestos-related lung cancer cases do not currently have the same level of compensation as mesothelioma cases, the population of potential lung cancer claimants is much larger. Towers Watson's attempt to dismiss this risk is not supported by knowledgeable legal and medical experts, who are very concerned about the emerging linkage between asbestos exposure and lung cancer. As just one example of how Towers Watson's views diverge from the consensus of opinion, I attach agendas from the three leading industry conferences on asbestos medicine, Perrin Conferences, DRI, and ACI.[19] [20] [21] (The Perrin Conference occurred in September this year; DRI will take place in November, and ACI in January). As can be seen, asbestos-related lung cancer is getting prime time at the conferences, indicating the increased level of concern over this worsening class of claims.

Respected industry commentators appear to be at odds with the Towers Watson Response with respect to the seriousness of lung cancer cases. A.M. Best writes:

> In addition to more traditional mesothelioma filings, the volume of lung cancer cases appears to be rising as more attorneys seek higher settlements in the face of more successful suits relative to past settlements. According to industry participants, the number of such suits has begun to increase significantly. In short, more tobacco lung cancer cases are going to court

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[18] Insights. Summary of U.S. Property & Casualty Insurers' Asbestos Claim Reserves at Year-End 2012. Towers Watson. Page 3. Exhibit 5. "Most notably, there have been more new mesothelioma claims than expected. Many of the new claims relate to claimants alleging bystander or secondhand exposure to asbestos."

[19] Perrin Conferences. Asbestos Litigation Conference: A National Overview & Outlook. September 8-10, 2014. Exhibit 10.

[20] DRI. Asbestos Medicine. November 6-7, 2014. Exhibit 11.

[21] ACI. Asbestos Claims & Litigation. January 15-16, 2015. Exhibit 12.

and more damages are being awarded. This may be fueling an incentive for asbestos plaintiffs' attorneys to file cases alleging asbestos exposures as at least a contributor to lung cancer.[22]

Beyond this, and as discussed at industry conferences, some medical researchers have documented a malignant synergy between asbestos exposure and smoking. According to these controversial studies, asbestos exposure significantly increases the risk that a smoker will develop lung cancer.[23] Cases are going to trial on the basis of such studies, whether Towers Watson credits them or not.

Other commentators, observing the enormous increase in the number of lung cancer lawsuits against asbestos defendants in key jurisdictions, point to the changing economic incentives for plaintiff law firms to recruit lung cancer cases.[24]

It may be that over time, emerging asbestos liability risks such as second hand exposure and lung cancer will not turn out to be as serious as experienced observers on the ground currently predict. But under the Proposed Transaction, these liability risks have been discounted, and the risk that such cases will continue to increase in number and associated costs will be borne by the policyholders to whom that risk is being re-transferred, while the shareholders of OneBeacon wash their hands of it.

Arguments about Standards.

OneBeacon argues that its inability "to articulate any plausible reason why the....Transaction...is necessary to OBIG's continued survival and growth" is irrelevant because the Holding Companies Act does not require such a showing. OneBeacon goes on to assert that it does not bear the burden of proof to justify the transaction and that the Department "shall approve" the transaction unless a condition for disapproval is present, which is entirely a matter of discretion for the Department. OneBeacon Response at 6-7.

I will leave it to the legal representatives of the interested parties to make the relevant legal arguments about standards, and confine myself to the plain language of the statute.

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[22] Best's Special Report. Asbestos Losses Fueled by Rising Number of Lung Cancer Cases. October 28, 2013. Page 3. Exhibit 6.

[23] MEALEY'S Asbestos Report. Commentary. March 2014. "A Third Wave in Asbestos Liabilities Lies Ahead: Actuarial Models are Systematically Underestimating Exposures." Bill Wilt and Alan Zimmerman, Assured Research. Exhibit 13.

[24] MEALEY'S Asbestos Bankruptcy Report. November 2013. Asbestos Litigation, Attorney Advertising & Bankruptcy Trusts: The Economic Incentives Behind The New Recruitment Of Lung Cancer Cases, by Marc C. Scarcella, Peter R. Kelso and Joseph Cagnoli, Jr. Exhibit 8.

The proposed transaction is not in the public interest and is likely prejudicial to the insurance buying public.

The insurance bargain is a public trust that allows persons to manage and mitigate their risks. It is also a bargain that is uniquely open to abuse by insurers due to the disparity that exists in the timing of performance. The policyholder absorbs a certain loss up front by paying a premium, and receives in return a promise that it will be protected if and when losses occur in the future. Because losses that do in fact emerge in the future often are inconvenient and disruptive to insurers (especially if they have made underwriting mistakes and have not been properly managed), there is an inherent incentive for some insurers to find ways to avoid performance. This is especially true in the context of long-tail claim exposures: the longer the interval that elapses between the policyholder's payment of premium and the insurer's payment of claims, the more likely the insurer will suffer a net underwriting loss and not want to meet its promises.

Persons buying insurance are also extremely particular about the insurer counterparty to their insurance contracts. Insurance is not a commodity. The claims handling reputation, management and financial condition of an insurer are all critical components in the selection of an insurer.

Contrary to what OneBeacon argues, the reasons and motivations for a transaction are highly relevant and relate directly to the conditions for approval. The fact that OneBeacon has been unable to articulate a single plausible reason for the Proposed Transaction means that the transaction is not in the public interest and is likely prejudicial to the insurance buying public because it undermines trust in the insurance bargain and degrades the public good. It is not in the public interest to approve a transaction through which, at an insurer's whim, decades of general liability policies can be transferred to a new party, with which the policyholder has no relationship, and subjected to a radically changed likelihood of eventual insolvency.

And it is surely not in the interests of the insurance buying public that the insurance regulatory resources and state guaranty funds should be burdened by a transaction that is justified only on the basis of management convenience and shareholder profits. The Proposed Transaction is a naked attempt by an insurer that made a bad bet over the course of several decades by insuring volatile risks for hefty premiums to walk away from the consequences of its underwriting decisions before the liability wave crests. It is difficult to conceive of a more palpable distortion of the insurance bargain than this transaction.

The financial condition of Armour Group will jeopardize the stability of the Acquired Companies and consequently, impair the interests of policyholders.

As explained at greater length in my Report, the financial condition of Armour Group is lamentably and demonstrably weak. It is an off-shore, privately held company for which only the most sketchy financial disclosures have been made, but even these show equity in 2011 of just $6 million, and losses incurred in 2011 and 2010.

In his public testimony, Mr. Brad Huntington boasted of Armour Group's extensive contacts in the capital markets which enable it to source significant additional capital when required as part of its business. Transcript at 56:5-13. I ask the Department to test this unsupported assertion. The meager set of financial statements that have been presented to date give no hint of these significant sources of additional capital. On the contrary, they show that the proposed new parent of the runoff companies would be incapable of injecting *any* new capital into the runoff entities in the event that the optimistic projections of OneBeacon prove to be even slightly overstated.

We can debate whether OneBeacon, the current parent of the runoff companies, *would* contribute additional capital to the current operating subsidiaries at the expense of shareholder returns if the need arose. But it is indisputable that the financial condition of OneBeacon, especially after the recent up-streaming of over $900 million in capital out of the runoff entities, *could* contribute additional capital if the projected reserves, investment returns, or runoff strategy of the runoff subsidiaries were to prove overly optimistic. The same cannot be said of Armour.

Finally, since Resolute Management, Inc. – the Berkshire Hathaway subsidiary that will continue to manage the runoff of OneBeacon's legacy A&E exposures under retroactive reinsurance agreements – has managed the runoff to date with ruthless efficiency, cost-cutting, streamlined claims handling, and tight-fisted payments, it is difficult to credit Mr. Huntington's blandishments that Armour will *further* reduce costs by 50% or more when it assumes the helm. These statements should be thoroughly analyzed, and specific examples (which have not been forthcoming to date) should be provided as to how these reductions will be achieved.

The Deferred Tax Asset.

I appreciate the straightforward explanation provided for the deferred tax asset included on OneBeacon's closing balance sheet, as well as the circumstances giving rise to the accrual of a deferred tax liability one day after the closing. Statutory accounting rules do allow for the inclusion of a deferred tax asset in "admitted assets" (those assets used for the computation of statutory surplus), subject to certain strict limitations. These are set forth in the Statement of Statutory Accounting Principles No. 101, "Income Taxes."

While I understand the business logic of the deferred tax asset presented by OneBeacon's lawyers, the conclusion remains that OneBeacon is counting – as "a substantial part of the $45.9 million in "Other Assets" on the closing balance sheet - an asset that will evaporate the very next day, and thus will not be available to policyholders to pay their claims. The Department may wish to consider why OneBeacon would need to work such illusory assets into its projected surplus if the existing reserves were adequate to satisfy future claims on the policies that will be transferred to the Armour Runoff Entity.

Finally, as a matter of statutory financial accounting, it is far from clear whether the deferred tax asset satisfies the strict criteria set out in SSAP No. 101 for including this asset for the purposes of calculating surplus and Risk Based Capital Ratios. Paragraph 11 of that standard allows for the inclusion of a portion of a realizable deferred tax asset only if the RBC ratio exceeds 200%, excluding the deferred tax asset from surplus. On the face of it, the closing balance sheet fails that test. Even if that ratio exceeded 200%, only 10% of the asset may be admitted.

I therefore reiterate my concerns about the inclusion and admittance of this asset on the closing balance sheet, and call upon OneBeacon to satisfy the Department that the provisions of SSAP No. 101 have been satisfied.

The Objectors' Underlying Assumptions are not Flawed.

OneBeacon, through the live testimony of Mr. McDonough and again in its Response, argues that creating a new runoff vehicle divorced from the capital support of an ongoing underwriting business will be beneficial for policyholders faced with long-tail claims, who supposedly will be subject to less risk as a result. For example, we were informed at the hearing that the Proposed Transaction protects those with claims under legacy policies by insulating them from "new" liability risks such as climate change lawsuits, terrorism and hydrofracking. Of course, neither Mr. McDonough nor any other OneBeacon representative attempted to quantify or provide any empirical support for these hypothetical risks, let alone establish that they would be covered under specialty policies currently being underwritten by One Beacon. Instead, the Department is expected to take at face value their assertions that there are looming and unquantifiable risks associated with the ongoing short-tail specialty business; that it is in the interests of legacy policyholders to be out from under those asserted risks; that OneBeacon's management priorities may change as the runoff proceeds; and that future management will be under no legal obligation to add additional capital to the runoff entities. Transcript at 22:17-29:10, 207:12-209:20; OneBeacon Response at 10-12, 15-17, 53-56. The last of these statements, made at the end of a lengthy hearing, appears to be a veiled threat to send one or more of the operating companies bearing legacy A&E liabilities into insolvency if the Proposed Transaction is not approved.

The short answer to these statements is that no insureds or claimants with rights under legacy OneBeacon policies have come out in support of the Proposed Transaction. If in fact the Transaction protected the interests of legacy policyholders rather than leaving them worse off, one would have expected to see at least some of those policyholders rising in support of the jettisoning of legacy liabilities that OneBeacon is pursuing. No such support has emerged, either before or during the July 23 hearing. The concerted opposition to the Proposed Transaction reflects the fact that most policyholders of the existing OneBeacon subsidiaries would infinitely prefer to take their chances with a profitable group that is actually in the insurance business, rather than being consigned to a newly created runoff entity with scant capital resources, a limited track record, and business motivations tied up in minimizing and deferring payments to policyholders.

OneBeacon argues that at some point in the future, if the Proposed Transaction is not approved and the runoff subsidiaries require additional capital, management might want to provide it, but may not be able to for some unstated reason, and in any event would be under no legal obligation to provide it. OneBeacon Response at 53-56. While it is somewhat difficult to discern the point of these ambiguous statements, OneBeacon goes on to argue that there would be no reputational risk to it from failing to support the runoff companies because the objectors have not presented any evidence that such a reputational risk exists. *Id.* at 54.

I challenge OneBeacon to cite a single example in which the publicly traded parent of a group of affiliated insurance companies, with active underwriting operations in progress, *ever* allowed one of its insurance subsidiaries to lapse into insolvency. It simply does not happen, because the reputational consequences to the entire organization would be materially detrimental to the trust that is an essential element of the insurance bargain. For further support of this position I refer to the Declaration of Mr. Jeffrey G. McKinley, CPCU submitted to the Delaware Insurance Department in the proceedings surrounding the Proposed Acquisition of Royal Indemnity Company (Exhibit 14). I submit that OneBeacon's management knows that it can ill afford to allow any insurance subsidiary to tarnish the OneBeacon profile by sending it into insolvency. That is why the preferred strategy for insurance management is the one being proposed here: kick the policyholders out, shunt them into an "independent" runoff vehicle with a new name, allow some time and distance to pass, and then, when the inevitable insolvency occurs, there will be no reputational consequences for the parent.

Recommendations

The Proposed Transaction should be rejected in its present form as severely prejudicial to the interests of policyholders and to the insurance buying public.

If, however, the Department is inclined to approve the Proposed Transaction, then the following conditions would provide some additional protections to policyholders:

1. I concur with the recommendations of FTI Consulting that OneBeacon should be required to contribute at least $530 million in additional capital or $1.6 billion in additional retroactive reinsurance. I further note that this capital infusion is only a fraction of the amount OneBeacon has removed from the runoff companies through prior corporate transactions to support its new "specialty" practice, from which policyholders are supposed to be happy to be

separated. OneBeacon Response at 15, 55. As for reinsurance, if OneBeacon's actuarial certainty is shared by its reinsurance counterparty, such reinsurance should be relatively inexpensive since according to OneBeacon's management and Towers Watson, it is highly unlikely to be drawn upon.

2. The Department should require that a Dividend Retention Plan ("DRP") be established, funded by OneBeacon with an initial contribution of $50 million. In the event that the RBC ratio of the run-off entities falls below 200% in the future, (the initial action level under Pennsylvania law and therefore a good indication of potential problems), the DRP should then contribute capital to the run-off entities to restore the RBC ratios to 200%. Future dividends remitted from any of OneBeacon's subsidiaries to OneBeacon should then be "taxed" at 10% until such time as the Dividend Retention Fund is restored to $50 million. A similar arrangement was previously ordered by the Department in the INA/Century Transaction, and goes some way toward aligning the interests of OneBeacon and its policyholders.

3. The Department should require OneBeacon to guarantee a rate of return on the investment portfolio of the Runoff Entities. As discussed herein, in my Report, and in the submissions of Towers Watson and RRC, the Proposed Transaction is exceptionally dependent for success upon the speculative investment return of the Runoff Entities' investment assets, a significant potion of which will be invested in the highest risk asset class, equities. Instead of transferring this investment risk to policyholders, OBIG should guarantee the investment return in accordance with the undisclosed assumptions made in the base case of the model for a minimum of 20 years. Zurich was required to make this kind of guarantee in connection with the Home Insurance transactions, albeit for a shorter period than what is proposed here (Zurich guaranteed a fixed return of 7.5% for four years).

4. The Department should appoint an independent claims monitor, paid for by OneBeacon, to oversee individual policyholder complaints of unfair claims practices against Armour and its Runoff Entities. The claims monitor should be required to provide periodic reports to the Department addressing, *inter alia*, the number of open unresolved claims by OneBeacon legacy policyholders, the length of time in which such claims for coverage have been outstanding, and the estimated liabilities associated with those unresolved claims. The claims monitor should also be tasked with recommending to the Department procedures for assuring that open claims for coverage of asbestos, environmental and other long-tail liabilities are resolved within a fixed period of time, to deter the incentives that otherwise will exist for Armour and its claims handling agents to delay recognition of valid claims. The claims monitor should be informed in advance of any proposed reinsurance commutations by Armour, and should have the authority to recommend to the Department that it disapprove commutations that do not provide fair value to

the Runoff Entities or are otherwise not in the public interest. The claims monitor would also have authority to institute other measures to assure that claims are processed expeditiously.

5. Armour should be required to submit to the jurisdiction and ongoing supervision of the Department, which should be responsible for approving compensation paid to officers and directors of the Runoff Entities, all management fees paid to Armour, any dividends paid to stockholders and principals of Armour, and commutations of facultative and treaty reinsurance.

Conclusion

I continue to stand by my earlier conclusion that the Proposed Transaction should be rejected in its present form as severely prejudicial to the interests of policyholders and to the insurance buying public, notwithstanding OneBeacon's and Towers Watson's further observations. In the event that the Proposed Transaction is approved, I urge the Department to adopt the protections for policyholders set out above.

SIGNED: JRTerrell

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