



December 8, 2014

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

Dear Mr. Johnson,

RRC has reviewed the Update of Stochastic Modeling of Run-Off Business as of June 30, 2014 (submitted by Towers Watson on November 3, 2014). The Towers Watson (Towers) model was updated for the recent reserve roll forward work as well as the additional capital contribution and reduction in management fees amendments to the Form A Filing. RRC also reviewed the November 3, 2014 letter from Cozen O'Connor in response to the Department's October 6, 2014 letter requesting clarification and additional information.

Key RRC Observations from the Updated Stochastic Model:

- The update addresses criticism that data relied upon in Towers' Ground Up Reserve Study is too old.
- Consideration of an additional nine months of payment history is favorable in the aggregate for the One Beacon Run-Off Companies as compared to Towers' projections from the initial analysis.
- Additional capital of \$20.1 million contributed as part of the currently proposed transaction had the most significant effect on the model. Consideration of the recent materially large asbestos settlement had a significant impact on the level of payments assumed in Tower's updated stochastic model, and this also had the effect of reducing the failure rate; however the asbestos settlement occurred subsequent to the rollforward of the Ground Up Reserve Study and was therefore not taken into account in the roll-forward reserves.
- The decrease in management fees, while positive, did not have a material impact on the success or failure rate.
- The updated stochastic model exhibits less uncertainty (i.e. less variance between the mean and most severely stressed scenarios), possibly due to a combination of favorable claim payments, settlement activity, and the passage of time.
- The failure rate projected from the model has decreased from 11.7% to 6.6% over 70 years with the Updated Stochastic Model.

On November 2, 2014, Towers submitted an update of its stochastic modeling of the One Beacon Runoff Companies as of June 30, 2014. This update includes a roll-forward of the central estimate of ultimate losses from the ground up reserve study, using actual payment data through June 30, 2014. In addition, the favorable outcome of a large asbestos settlement, which took place after June 30, 2014, has been reflected in the stochastic modeling. We believe that this updated review sufficiently addresses the issue noted by RRC and by others that the Ground Up Reserve Analysis utilized in the original stochastic model was based on data from December 31, 2012 and previously updated with data through September 30, 2013.

RRC asked Towers about the reduction in failure rate and to what extent the following contributed to it:

- a. Additional \$20.1 million in capital
- b. A materially large asbestos settlement
- c. Other favorable loss development
- d. Reduction in Armour's administrative expense

Towers replied that everything was interrelated but from previous sensitivity testing it had determined that the additional \$20.1 million in capital would be the primary reason for the improved success rate. The asbestos settlement is handled in the stochastic modeling by including a large payment in Year 1 in each of the simulations. Because of the asbestos settlement, there is a positive impact on future projected payments as well as decreased uncertainty in the model. This also affects the estimate of the remaining NICO cover on a paid basis. There is an offsetting speedup of cash outflows but overall the asbestos settlement has a significant impact on improving the success rate. Towers did not think the reduction in administrative expenses had as significant of an impact on the outcome.

#### **Variance in the updated analysis is somewhat less than in the initial version**

The variance (uncertainty) in the updated model has decreased, and Towers attributed it to the asbestos settlement. Compared to other unrelated models of A & E exposure performed by other parties in the past, this model might appear to have less variance. As RRC has noted in its earlier reports, Towers' modeling was based on accepted assumptions and methodologies, meets applicable actuarial standards and practices and provides a reasonable basis for the purpose of determining whether the assets would be adequate under most circumstances to fund the obligations of the One Beacon Companies. RRC has observed that the model does include some severely-stressed scenarios which implicitly include adverse events outside of the historical data. It is important to highlight that the model indicates that approximately 94.6% of the scenarios are successful in the first 30 years and 93.4% for ultimate payout in 70 years. With the current 93.4% success rate, some highly-stressed scenarios succeed; those that fail include the ability for the Run-Off Companies to pay losses for many years into the future.

#### **Alternative Failure Definition**

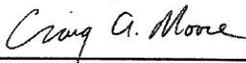
In a letter dated October 6, 2014, the Department asked One Beacon to project alternate versions of failure scenarios to address concerns that the existing definition of failure, which the Department believes is appropriate, is too narrow. One Beacon proposed use of the average of

all failure scenarios (6.6% of the 10,000 scenarios) from the updated stochastic model to examine the timing of extreme-stress failure under an alternative definition of failure. RRC agreed that this was a credible approach. We asked One Beacon to prepare balance sheets for this alternative failure definition: failure is reached when reserves exceed remaining assets. RRC thinks this alternative failure definition provides a meaningful point of comparison to the accepted definition of failure.

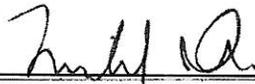
Focusing on the extreme stress scenarios in the Towers' model provides useful input. Using the average of all unsuccessful scenarios in the Towers' Updated Stochastic Model, the reserves of \$276 million exceed invested assets of \$262.9 million in Year 8. One Beacon presented reserve discounting assumptions at 4% and 6% that extend the success period to 13 and 15 years, respectively. In Year 15 the invested assets are estimated at \$137.9 million, thus, even though reserves exceed assets it is expected that claims would still be paid for years. We note that discounting would require approval from the Department and One Beacon is not requesting such approval at this time. In a run-off operation with substantial assets to be paid out over a long period of years, it is not unusual to see allowance of some level of reasonable discounting, but we note that discounting would require approval of the Department, and One Beacon is not requesting such approval at this time.

It should be kept in mind that severe adverse development and extreme stress scenarios exist with or without this transaction. This transaction as currently proposed provides \$101 million in surplus notes which helps mitigate the adverse development and extreme stress cases. It also demonstrates that the Towers' high stress scenarios are not inconsistent with the actuarial points raised by the commenters. RRC believes the Towers' modeling provides sufficient information to make an informed decision on the likelihood of success of the runoff.

Sincerely,  
Risk & Regulatory Consulting, LLC



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