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July 21, 2014

Via Federal Express and Electronic Mail (without exhibits)

Mr. Stephen Johnson
Bureau of Company Licensing and Financial Analysis
Commonwealth of Pennsylvania
Insurance Department
1345 Strawberry Square
Harrisburg, Pennsylvania 17120

Re: Application for Approval to Acquire Control of OneBeacon Insurance Company and Potomac Insurance Company

Dear Mr. Johnson:

Enclosed, on behalf of the Pennsylvania Manufacturers Association; the 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, is the Expert Report of Jonathan Terrell, for the Department's consideration in the above-referenced matter. Mr. Terrell will be available at the public hearing on Wednesday, July 23 should the Department have any questions.

As always, please do not hesitate to contact us with any questions or concerns.

Respectfully yours,

Paul K. Stockman

Paul K. Stockman

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PROPOSED ACQUISITION OF ONEBEACON INSURANCE COMPANY AND POTOMAC INSURANCE COMPANY

BY

ARMOUR GROUP HOLDINGS LIMITED

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

JULY 21, 2014

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I. INTRODUCTION

Scope of Report

I have been retained by The Pennsylvania Manufacturers Association, Associated Industries of Massachusetts, Belden Inc., Crosby Valve, LLC, ITT Corporation, PolyOne Corporation, The Procter & Gamble Company, 3M Company, United Technologies Corporation, and The William Powell Company (collectively, the "Petitioners") to analyze the proposed sale by OneBeacon Insurance Group LLC ("OBIG") of its operating subsidiaries, OneBeacon Insurance Company ("OBIC") and Potomac Insurance Company ("Potomac") (collectively the "Acquired Companies")[1] to a subsidiary of Armour Group Holdings Limited ("Armour") (the "Proposed Transaction"). I focus in particular on:

- Whether the financial condition of Armour Group might jeopardize the stability of the Acquired Companies and, consequently, impair the interest of its policyholders;
- Whether the proposed acquisition is unfair, unreasonable, and not in the public interest;
- Whether the proposed acquisition is likely to be prejudicial to the insurance buying public; and
- Whether the Proposed Transaction comports with guidelines for analyzing such restructurings established by the National Association of Insurance Commissioners ("NAIC") in its June 1997 White Paper, "Liability-Based Restructuring," and the standards set forth in 40 P.S. § 991.1402.

Executive Summary

Although my conclusions are necessarily limited by the withholding of much of the relevant information concerning the Proposed Transaction, I conclude that:

1. OneBeacon and the insurance industry have materially underestimated long-tail liability exposures -- including asbestos and environmental liabilities -- for many years, and the actuarial reports by Towers Watson and Risk Regulatory Consulting ("RRC") provide no confidence that the Acquired Companies' reserves will be adequate if the Proposed Transaction takes effect.

2. The Acquired Companies will be inadequately capitalized after the sale.

[1] The Proposed Transaction also contemplates that two other operating subsidiaries of OBIC – Employers Fire Insurance Company and OneBeacon America Insurance Company – would be folded into the sale and acquired by Armour Group following redomestication of those entities from Massachusetts to Pennsylvania.

3. OBIG and Armour Group fail to articulate any plausible reason why the Proposed Transaction confers a benefit on policyholders or is necessary to OBIC's continued survival and growth.

4. The skeletal financial condition of Armour Group will jeopardize the stability of the Acquired Companies and prejudice the interests of policyholders.

5. There would be major adverse consequences for regulators, guaranty funds, and policyholders in the event an inadequately capitalized runoff entity ultimately leads to a major insolvency along the lines that this Commonwealth previously experienced with the demise of Reliance Insurance.

6. Recommendations of the NAIC White Paper on how liability-based restructurings should be reviewed with appropriate procedural safeguards have not been followed to date, making it difficult to evaluate the Proposed Transaction and undermining confidence in these proceedings.

Qualifications

I received a Bachelor of Arts degree in 1984 from Newcastle University, and am a Fellow of the Institute of Chartered Accountants in England and Wales. My Curriculum Vitae is attached hereto (Exhibit 1).

I am the founder and President of KCIC, a consulting firm that focuses on providing quantitative, litigation and strategic consulting services to corporate policyholders and their legal counsel, with a particular emphasis on long-tail claims and liabilities. I have almost 30 years of financial services experience gained in London, New York, Paris and Washington DC, and a background that crosses accounting, finance, insurance and banking disciplines.

I have developed a particular expertise in the effects of insurance company reorganizations, including both Loss Portfolio Transfers ("LPTs") and Liability Based Restructurings ("LBRs"). I have been retained as a consultant or expert witness in numerous matters concerning various aspects of LPTs and LBRs. In addition, I regularly perform analysis and give testimony concerning insurance company solvency, economic damages and insurance asset valuation.

Before establishing KCIC 12 years ago, I was an Executive Vice President with Zurich Financial Services, where I worked extensively on the analysis and settlement of long-tail liabilities of The Home Insurance Company in run off. Formerly, I was a Vice President in JP Morgan's Capital Strategy and Quantitative Analysis Group, and spent eight years in public accounting with PricewaterhouseCoopers and Ernst & Young with a focus on the banking and insurance industries.

II. ONEBEACON AND THE INSURANCE INDUSTRY HAVE MATERIALLY UNDERESTIMATED LONG-TAIL LIABILITY EXPOSURES FOR MANY YEARS, AND THE SUMMARY ACTUARIAL REPORTS DISCLOSED TO DATE PROVIDE NO CONFIDENCE THAT THE ACQUIRED COMPANIES' RESERVES WILL BE ADEQUATE TO MEET FUTURE LIABILITIES UNDER OCCURRENCE POLICIES

The Proposed Transaction substitutes a weak group of runoff companies with a weak balance sheet for a financially stronger organization tethered to OBIG's ongoing underwriting operations and income stream. If the Proposed Transaction is consummated, the Acquired Companies will be expelled from the strong and profitable specialty underwriting business of OBIG and consigned to the dramatically weaker resources of Armour's runoff business—with large amounts of capital having been stripped out of OBIC and Potomac in advance of the sale. The long-term disadvantages that this weaker claims-paying structure and reduced surplus will visit on policyholders cannot be offset by the claims of OBIG's and Armour's lawyers that the assets of the Acquired Companies will now be "insulated" from the supposed "risks" associated with OBIG's ongoing businesses.[2]

OBIG's ongoing specialty businesses are comprised largely of short-tail risks, with only a modest interval between the sale of the policies and the onset and payment of claims. This sort of business is considerably easier to price and reserve for, and the risks associated with it are more modest, than the long-tail liability risks taken on by OBIG's predecessors, the Commercial Union and General Accident ("CGU") Companies, who wrote decades of broad-form Comprehensive General Liability ("CGL") and umbrella policies to large corporate policyholders, the bill for which is only now coming due. The long interval between sale and claim payments that characterizes the risks assumed by the CGU Companies – including asbestos, pollution, health hazard, medical malpractice and other long-tail exposures – means that the ultimate cost of such claims is much harder to predict. This partially explains why OBIG specifically, and the property-casualty industry generally, have consistently understated the reserving requirements for such exposures in the past. It is therefore untenable for OBIG's lawyers to suggest that the risks left behind in OBIG's ongoing operations are nearly as volatile and potentially catastrophic as the long-tail risks they propose to dump into a severed runoff vehicle.

Even ignoring the benefits of strong parentage in OBIG and White Mountains Insurance Group, and the limitations of ownership by Armour, a simple comparison between the OBIC 2013 Annual Statement and the Projected Stand Alone Balance Sheet as of June 31, 2014 makes for alarming reading:

- Surplus at December 31, 2013 of approximately $866 million will be reduced to approximately $162 million (and $128 million if an improperly included deferred tax asset is excluded from Surplus).

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[2] OBIG and Armour Response To Substantive Comments of Petitioner-Policyholders, at 8 (filed June 21, 2013) ("OBIG Response").

- Assets of approximately $1,087 million at December 31, 2013 will be reduced to approximately $347 million (only $313 million without the deferred tax asset).

- The healthy Risk Based Capital ("RBC") ratios of 526% at December 31, 2013 will be reduced to 277% (215% adjusting for the deferred tax asset).

In the face of this dramatic reduction in surplus and capital of the Acquired Companies, OBIG nonetheless assures the Department that the Acquired Companies will be in excellent financial shape: "OBIG is confident it has determined those Companies' liabilities through sophisticated and ongoing actuarial reviews"[3]; "OBIG has a sophisticated and ongoing actuarial review process, and its own internal analyses have consistently tested the adequacy of the reserves for the Runoff Companies"[4]; "OBIG estimates that, in order to exhaust this $200 million reserve buffer, the book of runoff business would have to experience a 25% adverse loss development over current case and IBNR reserves, an event it views as highly unlikely."[5]

The reality, however, is quite different. Despite these hortatory assurances about reserve adequacy, the SEC disclosures by OBIG, the statutory reporting by OBIC, and the Towers Watson and RRC actuarial reports demonstrate considerable, material uncertainty about the adequacy of the Acquired Companies' reserves, and are devoid of any conviction that the carried reserves will in fact be adequate to satisfy future claims. This material uncertainty is less significant as long as the Acquired Companies are part of the healthy OBIG underwriting group, because it is always possible for an ongoing insurance enterprise writing stable and predictable coverages – like OBIG's existing specialty businesses – to write its way out of trouble and gradually cure any long-term reserving deficiencies over time. But that approach is disfavored by shareholders, who prefer to forget about the mistakes of the past and focus solely on maximizing future returns. That is the genesis of the Proposed Transaction, which nakedly furthers the interests of White Mountains' shareholders at the expense of honoring commitments to policyholders under discontinued (i.e., unprofitable) lines of CGL business.

<u>The Fundamental Uncertainty of Future Claims</u>

OBIG's 2013 Form 10-K report to the SEC for the year ended December 31, 2013 shows that management has a significantly less sanguine review of reserve adequacy than their lawyers now suggest.

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[3] *Id.* Page 3, ¶2.

[4] *Id.* Page 6, ¶2.

[5] *Id.* Page 24, ¶2.

- "Exposure to asbestos and environmental claims could materially adversely affect our results of operations and financial condition."[6]

- "Estimating our exposure to A&E[7] claims is subject to a high degree of uncertainty and final ultimate loss and LAE could exceed coverage available under our reinsurance arrangements."[8]

- "Our reserves for A&E losses at December 31, 2013 represent management's best estimate of its ultimate liability based on information currently available. However, significant uncertainties, including but not limited to case law developments, medical and clean-up cost increases and industry settlement practices, limit our ability to accurately estimate ultimate liability and we may be subject to A&E losses beyond currently estimated amounts."[9]

- "OneBeacon cannot reasonably estimate at the present time loss reserve additions arising from any such future adverse loss reserve developments and cannot be sure that allocated loss reserves, plus the remaining capacity under the NICO Cover and other reinsurance contracts, will be sufficient to cover additional liability arising from any such adverse loss reserve development."[10]

I suggest that these statements, made in the context of securities filings that must be painstakingly accurate to avoid suits against OBIG and its management, should be afforded more credence in evaluating the Proposed Transaction than rhetorical statements of OBIG's and Armour's lawyers.

These same concerns are repeated in the Towers Watson analysis commissioned by OBIG:

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[6] OneBeacon Insurance Group, Ltd., Form 10-K, for the fiscal year ended December 31, 2013 (Exhibit 2), ITEM 1.A RISK FACTORS, page 20. *Compare* OBIG Response at 6 (touting OBIG's "sophisticated and ongoing actuarial review process" without addressing how much reserve requirements for A&E claims have been understated in the past).

[7] Asbestos and Environmental.

[8] OBIG 2013 Form 10-K, ITEM 1.A. RISK FACTORS, page 20. *Compare* OBIG Response at 3, 22 (touting the "reinsurance protection from highly rated carriers" and the "extensive reinsurance protection [the Acquired Companies] have in place").

[9] OBIG 2013 Form 10-K, Asbestos and Environmental (A&E) Reserves, Page 66, ¶5. *Compare* Towers Watson Stochastic Modeling of Run-Off Business Pro-forma Balance Sheet as of June 30, 2014, Summary Report, at 12 (filed June 10, 2014) (asserting without substantiation that cleanup costs will decrease in the future).

[10] OBIG 2013 Form 10-K, Note 19, Discontinued Operations, Page F-70, ¶4. *Compare* OBIG Response at 8 (asserting that "the Runoff Companies [will have] adequate assets to fund whatever portion of the Companies' reserves is not covered by reinsurance, with a substantial margin for conservatism").

- "Projections of loss and LAE cash flow liabilities are subject to potentially large errors of estimation, since the ultimate disposition of claims incurred prior to the financial statement date, whether reported or not, is subject to the outcome of events that have not yet occurred."[11]

- "The inherent uncertainty associated with projection of loss and expense liabilities is increased when dealing with toxic torts due to the nature of these losses. The technological, judicial, and political climates involving toxic torts such as asbestos and pollution-related claims continue to change, and traditional actuarial methods are not optimal for projecting toxic tort liabilities. As a result, the projection of liabilities for asbestos and pollution claims is subject to a greater uncertainty than would normally be associated with a review of liability estimates for general liability exposures other than major claims. We have conducted our review based on a variety of assumptions that are subject to change and, as much as possible, have taken this uncertainty into consideration. External influences such as court decisions and legislative changes tend to have a greater effect on the uncertainty in major claims liabilities than for other types of loss. In particular, the asbestos litigation environment has experienced significant changes over the last several years. The changes individually and collectively have had and are expected to continue to have a significant effect on the manner in which asbestos claims are asserted and settled. This in turn leads to continued uncertainty in liability estimates as the effects of these changes must be estimated and incorporated into our projections."[12]

In fact, the property/casualty insurance industry has vastly underestimated and under-reserved for asbestos and environmental exposures historically. The NAIC has for many years required special disclosures concerning reserves for asbestos and environmental claims in the statutory filings of all U.S. insurance companies. A.M. Best, the insurance company credit rating agency, has produced a series of special reports, U.S. Asbestos & Environmental Liabilities, which summarize those disclosures for the entire Property & Casualty ("P&C") industry. These reports provide an excellent basis for analyzing trends in industry-wide reserving levels, reserve increases, adverse development, payments, and other measures of reserve adequacy, such as survival ratios. The most recent of these reports, dated October 28, 2013, is attached (Exhibit 3).

From these reports, it can be observed that the P&C industry carried reserves for asbestos and environmental claims of $22.8 billion (net of prospective reinsurance) at December 31, 2001, the year in which White Mountains Insurance Group, Ltd. acquired the CGU Companies (subsequently renamed OneBeacon Insurance Group), who for decades wrote high-risk CGL and umbrella policies for U.S. corporate policyholders.[13]

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[11] Towers Watson Stochastic Modeling Report, at 16.

[12] *Id.* Page 17.

[13] In fact, the Commercial Union Companies were one of the earliest insurers to recognize the inroads that Lloyd's was making in the U.S. market by selling broad-form (continued...)

Since that date, according to the A.M. Best reports, the P&C industry has strengthened its net reserves for asbestos and environmental claims by $44.4 billion or 195% (Exhibit 4). Thus, the industry was nowhere close to being adequately reserved for these classes of exposure as of 2001, only 13 years ago. In other words, based on subsequent reserve increases alone, and with the benefit of hindsight, the industry should have been carrying reserves of $67.2 billion as of December 31, 2001 when it fact it was carrying just $22.8 billion. And since the overwhelming bulk of A&E exposures are concentrated in 30 insurer groups (including OneBeacon, as successor to the CGU Companies), the magnitude of the deficiency is even more glaring than these numbers suggest.

Sophisticated actuarial analysis and optimistic liability projections have characterized the financial statements of the vast majority of the insurance companies that are most heavily exposed to A&E liabilities for many years -- just as they do here. This is not to condemn actuarial science or the professionalism of the actuaries engaged to analyze the Proposed Transaction. It is simply an observation that the actuarial profession historically has gotten the setting of adequate reserves for legacy liabilities spectacularly wrong.[14] Actuarial science, as applied to this category of extremely volatile exposures, has been compared to driving a car entirely by looking in the rear view mirror. However sophisticated the actuarial reviews, their track record provides scant comfort to policyholders being displaced from an otherwise profitable and well capitalized insurance group.

Just as the property/casualty industry in general has historically underestimated its A&E exposures, OBIG has also underestimated its own exposures and reserving requirements. This is well illustrated by examining the exhaustion of the NICO and General Reinsurance Corporation ("GRC") retroactive reinsurance covers entered into when White Mountains acquired the CGU Companies in 2001. The NICO cover provided up to $2.5 billion in retroactive reinsurance protection against asbestos, environmental, and certain other latent exposures under legacy policies.[15] The GRC cover provides up to $570 million against adverse development on non-NICO lines for the accident year 2000 and prior years.[16]

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umbrella liability coverages, and began aggressively selling such open-ended policies in the early 1960s. Much of this coverage is now being called upon to pay A&E liability claims.

14 Just 18 months ago, A.M. Best increased its net ultimate asbestos losses for the P&C industry from $74 billion to $85 billion, another startling increase. *See* Best's Special Report, *Asbestos Loses Persist; A.M. Best Raises Industry's Loss Estimate to $85 Billion* (December 10, 2012).

15 Potomac Insurance Company Annual Statement for the Year 2002, Note 22.F. Retroactive Reinsurance (Exhibit 5).

16 *Id.*

Initial reserves transferred under the NICO cover were $955 million.[17] According to the OBIG 2013 10K, there was $198.3 million unexhausted on an incurred basis as of December 31, 2013.[18] Thus, there has been $1,347 million in adverse net reserve development over the 12 year period from 2001-13, or 141%. This amply illustrates that OBIG's internal and independent actuaries have been incapable of properly reserving for these volatile and expanding classes of liability, notwithstanding their apparent sophistication. If reserve development were to continue at the same average rate of the last 12 years (as will be discussed later in this report, there is every reason to expect continued significant adverse development), the NICO cover would be exhausted within two years on an incurred basis, and the Acquired Companies would be insolvent within four years.

There is a similar story for the GRC cover. Initial reserves transferred under that cover were $170 million. As of December 31, 2013 there was $8 million left unexhausted under the cover on an incurred basis.[19] There has accordingly been $392 million in adverse net reserve development over the same 12 year period, or 231%. There are a number of classes of exposure included within this cover, though Workers Compensation is by far the most significant. These classes of liability exposure are supposedly easier to forecast than the more volatile asbestos and environmental liabilities addressed in the NICO cover, but apparently the OBIG internal and external actuaries were even less successful in adequately forecasting reserve requirements for these classes of claims than they were for asbestos and environmental claims.

The SEC disclosures of OBIG also corroborate OBIG's history of reserve increases for asbestos and environmental liabilities subject to the NICO cover, though it is more difficult to draw firm conclusions for the liabilities associated with the GRC cover. I have summarized these disclosures for the last 10 years from the 10K filings of OBIG (Exhibit 7). As can be seen, material gross reserve increases of $811 million and $489 million took place in 2005 and 2011, respectively. These documents show that OBIG, like most of its brethren, was substantially under-reserved for its legacy liabilities (both NICO and non-NICO lines) at the time the Proposed Transaction was submitted, according to its own expert's estimates.

The Towers Watson analysis gives a range of gross estimates for asbestos and environmental liabilities at two dates, December 31, 2012 and March 31, 2013.

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[17] *Id.* Under the transaction NICO received immediate access to a premium for investment purposes of $1,322 million which it invested for its own benefit.

[18] Page 66.

[19] Potomac Insurance Company Annual Statement for the Year 2013, Note 23.F, Retroactive Reinsurance (Exhibit 6).

Towers Watson[20]	Low	Central	High
March 31, 2013	928	1,218	1,570
December 31, 2012	949	1,239	1,590

As can be seen, at December 31, 2012, where we can match dates, OBIG was carrying gross reserves that were significantly below even the midpoint of the Towers Watson range of estimates.

One Beacon Insurance Group[21]	
December 31, 2013	1,013.9
December 31, 2012	1,162.4

On a net basis, the story is even worse. The Towers Watson analysis gives a range of estimates for net asbestos and environmental liabilities.

Towers Watson[22]	Low	Central	High
March 31, 2013	691	833	1,029
December 31, 2012	707	849	1,045

OBIG's comparable disclosures for its net asbestos and environmental liabilities are as follows:

One Beacon Insurance Company	
December 31, 2013	615.6
December 31, 2012	727.9

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[20] Towers Watson September 9, 2013 Analysis of Unpaid Loss and LAE as of 9/30/2012, 12/31/2012 and 3/31/2013 Summary Report, Roll Forward – NICO Summary Sheet 1.

[21] OneBeacon Insurance Group, Ltd., Form 10-K, December 31, 2013, Note 19 Discontinued Operations.

[22] Towers Watson Analysis of Unpaid Loss and LAE Summary Report, Roll Forward — NICO Summary Sheet 2.

Net of reinsurance, OBIG's carried asbestos and environmental reserves were barely above the low end of the Towers Watson range of estimates.

Flaws in the Towers Watson Report Undermine Its Utility

The numerous limitations and inherent uncertainties described by the authors of the Towers Watson report have been referred to above. In addition, there are numerous causes for concern in the various assumptions set forth in the report.

Towers Watson states that its estimates are suitable for use in a financial reporting context. But the proposed acquisition is not a financial accounting or reporting exercise. It is a wholesale risk transfer of an unstable class of liabilities to a runoff vehicle without the opportunity for further recourse for the affected policyholders if the assets of the Acquired Companies prove to be insufficient to pay claims in the future. A higher standard of assurance should be demanded for the protection of policyholders than "suitable for use in financial reporting contexts."[23]

For its discount rate assumptions, Towers Watson has included the long-term real compound return on US equities as estimated by White Mountain Advisors, apparently without independent consideration of its reasonableness.[24] For its High estimates, Towers Watson uses even higher discount rates without disclosing the underlying assumptions, but equates those high discount rates with projected higher inflation. As a general matter, with certain exceptions, the discounting of loss reserves is prohibited under US accounting rules, both for SEC and statutory reporting. This is because of the inherently speculative nature of the timing of future cash flows and the investment return that can be earned on a matched portfolio of investment assets. Towers Watson's use of significantly discounted loss reserves based on White Mountain Advisors' aspirational investment returns, including a particularly speculative compound return on US equities, is inappropriate as a matter of basic insurance accounting.

While it is not unreasonable to project that inflation will be moderately higher in the next ten years than it was in the preceding decade, history tells us to expect inflation in the tort system, which may be entirely independent of inflation in the general economy.[25] For instance, there has been significant inflation in the average settlement values for asbestos-induced mesothelioma and lung cancer claims in recent years, even while inflation in the general economy has been low. Towers Watson, in their high scenario, not only assumes higher settlement values as a result of general inflation (in fact, settlement values will likely be higher, independent of general inflation), but then also assumes a higher discount rate, because higher inflation in the general economy will

[23] *Id.*, Page 2, ¶1.

[24] *Id.* Page 2, ¶6.

[25] *Id.* Page 3, ¶1.

lead to higher interest rates. Each of these assumptions is questionable, making the present value of their High scenario almost certainly understated.

Towers Watson also notes changes in the organization of the claims operation for non-NICO lines, which is now focused on a run-off strategy with more emphasis on the "settlement" of claims. This statement foreshadows what policyholders may expect if the Proposed Transaction is approved. Based on my own experience implementing a runoff strategy for Home Insurance Company after its profitable businesses were transferred to Zurich, this "settlement" strategy will consist, *inter alia*, of demanding broad policy commutations for settling claims at or below the level at which they are reserved, engaging in protracted coverage litigation with policyholders who are unwilling to surrender their policies, and extracting deeply discounted settlements from weary policyholders who are tired of the litigation shell game. This is the only practical way to manage a runoff entity that has been left with inadequate assets in a division like the one contemplated here. Towers Watson goes on to acknowledge that these strategic changes introduce additional uncertainty.[26]

In the estimation of asbestos exposure, Towers Watson relies entirely on its own "proprietary" asbestos model which has not been made available for independent scrutiny, even to RRC. The Towers Watson analysis is a ground up, exposure based analysis that includes a detailed review of the hundreds of legacy CGU insurance policies with open asbestos and environmental claims.[27] This is a helpful exercise, but Towers Watson relies on it entirely for its asbestos analysis and does not supplement it with traditional actuarial methods, such as market share analysis, adverse development trends or survival ratios. Given the grave limitations of actuarial science as demonstrated by the lamentable history of asbestos reserving, a reasonableness check using several different methods would seem to be in the best interests of policyholders and necessary to properly assess the ramifications of the Proposed Transaction for policyholders. For instance, the 1-year and 3-year survival ratios for the projected asbestos and environmental exposures of the Acquired Companies are far below A.M. Best's benchmarks.[28] [29]

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[26] *Id.* Page 5, ¶4.

[27] *Id.* Page 20.

[28] *See* Best's Special Report, *U.S. Asbestos & Environmental Liabilities*, 2012 Segment Review October 28, 2013. A.M. Bests benchmark is 17 times for asbestos and 13 times environmental (page 11). The overall industry is below this level, at 10.0 and 5.8 respectively in 2012 (with anticipated additional earnings drag as a result of future bolstering of reserves (page 6)). White Mountains Insurance Group (the parent of OBIG) is identified as an insurer that can expect modest earnings drag as a result of under reserving for asbestos and environmental liabilities (page 10). As recently as 2011, Best characterized White Mountains' A&E exposures as a "heavy drag" on earnings with a five-year average of 4.1 points. Best's Special Report, *U.S. Asbestos and Environmental Liabilities Market Review* (Feb. 21, 2011).

OBIG assumes a provision of 7.5% for uncollectible reinsurance to address the possibility that reinsurance contracts may be applied less favorably than assumed in its ceded model. Towers Watson accepts this 7.5% provision at face value, but this is clearly indefensible. According to the 2013 10-K, the Acquired Companies are approximately 38% prospectively reinsured for asbestos exposures. This represents a material asset, the availability and collectability of which is a key element in assessing the viability of the Proposed Transaction. Yet Towers Watson has undertaken no independent work on the proper valuation of that asset. They have instead relied entirely on the OBIG model, used out of date calculations, and even accepted without further inquiry the provision of 7.5% against overly favorable assumptions.

Anyone experienced in the field of reinsurance collections knows that the collection of third-party reinsurance is fraught with disputes, arbitration, and compromises. Given the tenacity with which runoff entities resist claim payments and force discounted settlements, it should come as no small surprise that their reinsurers have adopted similar tactics. Whether invoking *uberrima fides,* claiming that commutations by cedents are *ex gratia* payments, resisting loss allocation decisions, invoking late notice defenses, or arguing that legal expenses are not covered, reinsurers can and do tie up and delay recoveries through years of litigation. They also are less regulated than licensed direct insurers, and are more prone to insolvencies, especially on the other side of the Atlantic. On the face of it, then, 7.5% is an overly optimistic assumption for the needed provision against reinsurance collection.

For their estimation of pollution (environmental) liabilities, Towers Watson, in contrast to their asbestos approach, decided to use a combination of their proprietary waste site simulation model, an aggregate loss development analysis, and a market share approach. Nevertheless, they point out a number of factors that "introduce unusual uncertainty into our estimates" of OBIG's environmental exposure, including judicial trends, potential settlements, the application of coverage terms, the ultimate costs of site remediation, the size of PRP shares and the method of allocation.[30] In other words, they really have no idea what the extent of the Acquired Companies' environmental liabilities will actually turn out to be.

Towers Watson's approach to estimating the prospective reinsurance associated with environmental liabilities is even more questionable than its asbestos approach. They simply assume a 50% net-to-gross ratio based on historic experience and assert without any substantiating data that the 2010 OBIG review will accurately predict the future. There are many reasons why the actual net-to-gross ratio may be materially different than that experienced in the past, especially if a more aggressive buyout strategy is adopted by

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[29] *See* OBIG 2013 10-K, Note 19. Notwithstanding exceptionally low net payments in 2011, the 3-year survival ratios for asbestos and environmental are 9.9 and 4.4, well below A.M. Best benchmarks.

[30] Towers Watson Analysis of Unpaid Loss and LAE, Page 24.

the Acquired Companies, as is typically the case with runoff operations. If that occurs, the number of reinsurance disputes and payment delays will increase substantially.

The Towers Watson projection of cash flows for environmental claims is based on their aggregate loss development projection, but they acknowledge that this could be completely wrong, because single large payments or unusual settlement activity could invalidate their assumptions. That is precisely what happened during the nine-month "true-up" period from December 31, 2012 to September 31, 2013, when only two environmental settlements required a material upward adjustment to reserve estimates.[31]

Significantly, Towers Watson makes no specific allowance at all for the emergence of wholly new areas of mass torts ("OMTs"). This assumption is so unrealistic as to be indefensible. It is a historical fact that new mass torts emerge regularly (e.g., breast implants, tainted blood, construction defects, hand-arm vibrations, various pharmaceutical products, fen phen, Agent Orange). While Towers Watson bases so much of its analysis on history, in this particular assumption, they completely ignore history. What is certain is that there will be new areas of mass tort exposure arising in the future, for which there is no allowance in the reserves of the Acquired Companies, and for which the NICO cover may very well be unavailable. The bottom line impact of just doubling the Towers Watson net estimate of OMTs would be enough to wipe out the proposed capital of OBIC per the Amended Form A.

Finally, Towers Watson relies on historical data, and other quantitative and qualitative information supplied by OBIG, with no more than an unspecified "reasonableness" check. They have simply assumed that the information is complete and accurate, and that they have been provided with all the information relevant to their analysis.[32]

Similar Problems Infect the Towers Watson Stochastic Model

Stochastic modeling is an accepted tool for estimating potential outcomes by allowing random variation in one or more inputs over time. It is also referred to as "Monte Carlo" analysis. It can be contrasted with "deterministic" analysis in which the best estimate for the various inputs in an analysis are deliberately selected, but the range of less likely potential outcomes is not taken into account. In stochastic modeling, for each of the key inputs into an analysis, a random variation is introduced usually based on what has been observed in historical data. The key test in the Towers Watson Stochastic Modeling Report (the "Stochastic Report") is whether or not invested assets in the

[31] RRC Report on Towers Watson Stochastic Modeling, June 20, 2014, Page 15. "We note that this unexpected $10 million activity took place in a relatively short time frame after the completion of the reserve study, and represents a sizable increase in ultimates for a line with a central estimate of unpaid losses of $119.9 million as of March 31, 2013. It is one indication of the unpredictable nature of A & E exposure."

[32] Towers Watson Analysis of Unpaid Loss and LAE, Page 28.

proposed pro-forma balance sheet fall below zero before the last claim is paid. In order to test this question, Towers Watson modeled a series of random variations in the key inputs to their model, and then repeated the process 10,000 times.

The key inputs to the model needed to answer the question of whether invested assets will be sufficient to pay the last claim are not difficult to identify: the return on the invested assets, the amount, frequency and timing of the claims on the legacy policies issued by OneBeacon's predecessors, the amount and timing of reinsurance recoveries under the prospective ceded reinsurance assets, and the amount and timing of recoveries under the retroactive ceded reinsurance assets. As easy as it is to identify inputs, calibrating a stochastic model to produce meaningful results requires significant and debatable exercises of judgment. Whether Towers Watson ran 10,000 simulations or 10 billion makes little difference: the critical point is whether the parameters they set in analyzing the historic data were reasonable, realistic, and a reliable predictor of the future. Stochastic models do not use an arbitrary set of values. Rather it is within the parameters of historical experience that the random variations are introduced.

Towers Watson informs us that as a result of running 10,000 simulations through their model, that there is a >90% chance that the invested assets will be sufficient to pay ALL claims for the next 30 years.[33] This is difficult to accept. While I would certainly concede that there are many combinations of inputs that could lead to success for the first 30 years, to come up with a >90% success rates for entities as thinly capitalized as the proposed runoff companies, and that are subject to the pronounced uncertainties already discussed, defies credulity and is indicative of a flawed and unrealistic calibration of their stochastic model. None of the parties whose interests are most directly impacted by the Proposed Transaction, namely the policyholders, have been afforded the opportunity to review and test the reasonableness of the inputs to the Towers Watson model. Even RRC was not afforded the opportunity to delve into the mysteries of these "proprietary" and "confidential" models.

It must be remembered that all of the limitations and flawed assumptions of the Analysis of Unpaid Loss and LAE also fatally infect the stochastic modeling exercise. These include the unchallenged calculation of the value and collectability of the ceded reinsurance asset by OneBeacon, a failure to take account of the potential emergence of new classes of mass tort liabilities (a prospect that is valued at zero), the bleak history of under reserving of OneBeacon and the insurance industry generally, and the litany of limitations and disclaimers that permeate the Towers Watson report. These are red flags, and they should give pause to any agency considering approval of such a transaction.

Beyond the limitations of the inputs, the Stochastic Report itself contains a number of "otherworldly" assumptions that further detract from its credibility. The first of these concerns the assumption for future asbestos claims inflation. Towers Watson begins with the assumption that "ground up medical inflation" should be applied, then

[33] Towers Watson, Stochastic Modeling Summary Report, Page 5.

reduces it due to the ageing of the claimant population and the assumption that older plaintiffs will be paid less. None of these assumptions bears any resemblance to the reality on the ground.

- Settlement values and medical inflation really have nothing to do with each other in the asbestos world. Settlement values are a function of likely jury awards in the tort system, not changes in the inflation index. The reality on the ground is that there have been significant increases in both jury verdicts and resulting settlement values for mesothelioma and asbestos lung cancer cases.

- While a 40 year old mesothelioma victim might be paid more than a 60 year old, (a 40 year old mesothelioma victim is exceptional) there is no observable difference between settlement values for a 50, 60, 70 or 80 year old.[34] An 80-year old retiree who suffers a lot for a short period of time and was viewed as a good family man easily can be awarded higher damages in a jury trial than a 50-year old with a criminal record who suffered for a longer period.

- A significant number of newer mesothelioma claims are coming from the children of exposed workers, which tends to offset the ageing of the original exposed population.

- Leading pulmonologists are describing at asbestos medical conferences emerging scientific breakthroughs that allow for the medical diagnosis of mesothelioma several years earlier, which has been impossible historically. This will lead to expensive medical treatments for far longer than is currently the case, and will materially increase medical inflation for mesothelioma cases.

- Towers Watson ignores the emerging linkage between lung cancer and asbestos exposure, which is opening a new, enormous class of plaintiff, with potentially high settlement values.

Likewise, the Towers Watson assumption that improvements in remedial technology will offset price inflation for environmental exposures is not substantiated. It is true that during the 1990s, as this class of exposure was shifting into high gear, there were significant improvements in remediation science; but the effectiveness of site cleanups has not been accompanied by a decline in average site remediation costs,[35] partly because the effectiveness of those technologies has led to increasing demands for the most expensive treatments and technologies. The reality on the ground is that cleanup

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[34] I base this observation on a review of over 7,000 settlements for clients of KCIC from 2010 onwards. Over 95% of those settlements were for claimants in their 50s, 60s, 70s and 80s, and there is no observable trend in settlement values in this age range.

[35] U.S. Gov't Accountability Office, GAO-10-380, Superfund EPA's Estimated Costs to Remediate Existing Sites Exceed Current Funding Levels, and More Sites Are Expected to Be Added to the National Priorities List, Figure 6 (Exhibit 8).

costs are increasing, not decreasing, and there are many sites that have yet to be remediated.

The RRC Report on the Towers Watson Analysis of Unpaid Loss and LAE gives little comfort and suggests that the Towers Watson report is based on unrealistic assumptions.

The scope of RRC's mission was to evaluate the report of Towers Watson and hold a number of meetings and telephone calls with Towers Watson and OBIG to increase their understanding of Towers Watson's analysis and conclusions. RRC did not actually test or scrutinize any of the underlying data, nor did they attempt to independently reproduce the results of the Towers Watson report. In fact, even if they had tried to independently verify the results, they would have had to use different models due to the proprietary and undisclosed nature of the models used by Towers Watson.[36] This is an important point. No independent review of the underlying data and financial assumptions by which the economics of the proposed deal can be properly assessed has been performed on behalf of policyholders.

In its review, Towers Watson relies entirely—without any critical assessment—on OBIG's unsubstantiated data, estimates, and many objectionable assumptions outlined above. It is hardly surprising, therefore, that Towers Watson hedges the accuracy of its own projections to such a considerable extent that it could never be criticized, sued, or otherwise taken to task in the event its report is discredited by future events.

For its part, RRC's report did not question many of Towers Watson's key assumptions and reliance on unsubstantiated OBIG data points:

- "There are several key assumptions underlying the conclusions in the Reserve Report which we did not review."

- "The scope of our review was limited to reviewing the two reports produced by Towers, and holding numerous meetings and conference calls with Towers and One Beacon in order to increase our understanding of their analyses and conclusions."

- "During this engagement, we relied on a number of reports and exhibits provided to us by Towers Watson and One Beacon. . . . Although we reviewed the various data, analyses, and information provided to us for reasonableness, we have not performed an audit or data verification. We have assumed that the data, analyses and information provided to us was complete and accurate."[37]

[36] Risk and Regulatory Consulting's Report on their review of Towers Watson Report titled "One Beacon Insurance Group LLC, Analysis of Unpaid Loss and LAE as of September 30, 2012, December 31, 2012 and March 31, 2013," Page 5.

[37] *Id.* Page 4-5.

So while RRC at least has been engaged by the Department on behalf of policyholders—i.e. unlike Towers Watson it owes no fealty to OBIG—its independence is of only modest assistance here because it was not asked to conduct an independent review of the underlying data, or an independent quantification of the reliability of the most important financial, legal and actuarial assumptions by which the economics of the proposed transaction can be assessed. Accordingly, by accepting Towers Watson's reliance on the integrity of OBIG's own data, estimates, and assumptions, RRC has effectively deferred to OBIG's own self-interested projections and assumptions.

We learn that during the course of a conference call held to discuss RRC's questions and observations, that "we discussed" or "we questioned," but that no rigorous and independent analysis of Towers Watson's actuarial methodology, financial assumptions, projected claims payout rates, investment returns, or other key variables was actually performed.[38] It is hard to conclude that this "once over lightly," peer review exercise protects the interests of the policyholders who stand to be left holding the bag if the Acquired Companies are insufficiently reserved, inadequately capitalized, and ultimately fail.

Despite observing that "there are numerous caveats in the Towers report" that might diminish its reliability, that Towers Watson's "actuarial central estimates of ultimate losses" did not "encompass all adverse scenarios which might befall One Beacon," that "financial results for insurance companies providing property casualty insurance coverage are subject to certain assumptions about the future and to the occurrence or non-occurrence of future contingent events," and that its "work involved review of analyses prepared by Towers Watson concerning ultimate payments under various scenarios for a book of A & E losses which are highly unpredictable," RRC did not undertake any independent review of a number of Towers' key assumptions or otherwise assess whether and how the many "caveats noted by Towers" and "share[d]" by RRC would compromise the accuracy and conclusions of the Towers Watson report.[39]

RRC did also acknowledged that "traditional actuarial methods often fall short of making reliable predictions of ultimate losses" for "pollution liabilities" as well, and that Towers Watson's "exposure-based method was the lowest estimate of ultimate losses of the three" alternative models.[40] RRC further observed that Towers Watson's report was "based on One Beacon's own loss experience and claim payment patterns, supplemented as needed with industry data." RRC correctly stated, therefore, that the prospective "change in company ownership has the potential to alter the historical payment patterns underlying the loss reserve study. To the extent that this occurs, ultimate losses can be different from those based on historical data."[41]

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[38] *Id.* Page 6.

[39] *Id.* Pages 3-6.

[40] *Id.* Page 4-6, 8.

[41] *Id.* Page 6.

One example RRC cites of a key untested assumption by Towers Watson is the payout pattern of the losses subject to the NICO treaty, which in turn determines when the NICO treaty can be expected to exhaust. RRC tell us (though Towers Watson does not) that the NICO treaty is projected to exhaust in 15 years according to the central estimate. During this period the Towers Watson report projects "a robust investment yield on assets it assumed in this report (a figure supplied by OneBeacon based on its anticipated mix of assets)." As RRC correctly points out, "If either of these conditions (length of time assets are held or average investment yield) were to fall short, the present value of future payments would exceed the discounted liability estimates in the Towers' report, and additional assets could be required to meet liabilities."[42] But these "additional assets" will not be forthcoming from OBIG's active underwriting operations – not even as a backstop – if OBIG has its way.

There are a number of other points to emphasize in RRC's observations:

- The Towers Watson central estimate does project that the NICO cover will eventually exhaust, by approximately $21 million.[43] This should be juxtaposed with the dismissive criticisms of OBIG's lawyers, who assure us that OBIG management considers such a 25% adverse development to be "highly unlikely."[44]

- The Towers Watson High estimate projects that the NICO treaty will be exhausted by approximately $231 million.[45]

- The unrealistic or unexplained assumptions of Towers Watson, discussed earlier in this report, make it entirely likely that the High end of the Towers Watson range will be greatly exceeded. Towers Watson, in the midst of their repeated disclaimers, concedes this possibility (which may be more properly viewed as a likelihood). RRC also concurs that "[t]he possibility exists that the ultimate cost of these claims will exceed the High end of the Towers' range due to the purpose of the High estimate as stated above."[46]

- OneBeacon, and the P&C industry in general, as discussed earlier, has done a lamentable job of reserving adequately for asbestos and other long-tail risks over the last two decades, even after court decisions had established broad coverage for asbestos liabilities under CGL policies. If the average reserve development in the

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[42] *Id.* Page 4.

[43] Towers Watson Analysis of Unpaid Loss and LAE, Page 12, Table 6.

[44] OBIG Response at 24.

[45] Towers Watson Analysis of Unpaid Loss and LAE, Page 12, Table 6.

[46] RRC Review of Towers Watson Report, Page 4.

NICO lines of the last 12 years were to continue in the future, the NICO cover would be – as stated above – exhausted on an incurred basis in two years.

- As the proposed, pro-forma balance shows, very significant amounts of capital will have been stripped out of the Acquired Companies before the Proposed Transaction. Instead of a healthy capital cushion, policyholders will need to rely on (1) a small amount of capital, the sufficiency of which is a function of discounting future cash flows to present value, itself a function of the assumed timing of future claims payments, and (2) the investment mix and return on invested assets laden with equities and high-yield debt instruments. As RRC points out, the "robust" yield anticipated on those invested assets is a major risk factor. Sophisticated investors chasing high returns may well decide to run such risks with appropriate hedging; but one of the main reasons insurers like OBIG are subject to state regulation is to prevent them from subjecting their policyholders to such risks. Cutting policyholders loose from OBIG, its capital structure, and its healthy underwriting activities, and substituting a finite runoff balance sheet, the sufficiency of which is a function of an optimistic and highly speculative set of investment returns and assumed claims payout rates, is severely prejudicial to policyholders.

RRC notes that Towers Watson utilizes an "innovative methodology." RRC correctly notes that actuaries generally use several reserving methods when evaluating asbestos liabilities, but that Towers Watson has only used one for estimating the Acquired Companies' asbestos liabilities: a ground up, exposure-based analysis, which Towers Watson believes is "greatly superior" to traditional actuarial techniques.[47] In fact, traditional actuarial methodologies, such as survival ratios, market share analyses and adverse development trends, indicate that OBIG is well below the levels recommended by trusted industry observers such as A.M. Best.[48]

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.[49] RRC opines that Towers Watson did a "satisfactory job in considering the inherent uncertainty

[47] *Id.* Page 7.

[48] *See* Best's Special Report, *U.S. Asbestos & Environmental Liabilities, 2012 Segment Review*, October 28, 2013.

[49] RRC Review of Towers Watson Analysis of Unpaid Loss and LAE, Summary Report, Pages 7 and 8. RRC also recognized 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 cost of these claims will exceed the high end of Towers' range due to the purpose of the high estimate as stated above."

of asbestos liability."[50] Unfortunately a "satisfactory job" does not provide OBIG policyholders with the kind of assurance they need to get comfortable with being ejected from the group, and relying on a financial model laden with unrealistic and even dangerous assumptions.

RRC again voiced significant concern with the interplay between the timing of claims payments, inflation and investment return:[51]

- RRC notes that the Towers Watson assumed an average investment return of 5.92% during the 15 year period prior to the projected exhaustion of the NICO treaty, which RRC views as high in today's low interest rate environment. We learn from RRC that Towers Watson had been informed by OBIG that 5.92% is the rate they expect to achieve across the Acquired Companies' entire investment portfolio, and that Towers Watson had used that rate without questioning it. For their High scenario, Towers Watson used even higher assumed returns (which were not disclosed but are just as untenable).

- RRC further cautions that adverse development for Workers' Compensation can be for reasons other than general inflation, and that investing in equities is a risky strategy to employ to hedge against such adverse development.

- RRC further cautions that today's inflation rate is very low by historical standards, and medical inflation is subject to potentially large errors of estimation. Towers Watson agreed with this.

With respect the non-NICO lines, Towers Watson did not even conduct an independent stochastic review of this portion "of the runoff book, including some business segments (primarily Workers Compensation involuntary pools)."[52] Moreover, its limited review of Workers' Compensation losses was "subject to assumptions with respect to settlement, mortality, and changing practice in claim handling."[53] RRC did not conduct (because it presumably was not asked to conduct) a critical evaluation of the non-NICO lines, but merely deferred to Towers Watson—who in turn relied solely on OneBeacon's internal data and projections.

Additionally, RRC points out that the diversification factors utilized by Towers Watson for the non-NICO lines -- which are designed to account for the fact that risk does not always add up in a linear fashion (it's raining someplace, but sunny elsewhere) -- are an appropriate statistical method, but that there is a substantial degree of

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[50] *Id.* Page 8.

[51] *Id.* Page 9.

[52] *Id.* Page 6.

[53] *Id.* Page 9.

professional judgment used in their selection.[54] RRC goes on to repeat the same list of six caveats outlined by Towers Watson, which alert us to the fact that the inherent uncertainty associated with the estimates for the non-NICO lines is magnified by a number of other variables.[55] These include:

- Future medical inflation is very difficult to predict.
- Changes in the claim department organization and in case reserving for certain lines, particularly workers' compensation, means that reported development methods and case based methods are less reliable for forecasting purposes than would otherwise be the case.
- Over the last 2 years, greater emphasis has been placed on settling claims. This may distort the paid development patterns.
- Finally, RRC notes that a thorough reserve study should be conducted every two years, and it is nearly time to repeat the work that is currently being cited in support of the Proposed Transaction.

<u>The RRC report on the Towers Watson Stochastic Modeling Project likewise raises significant concerns for policyholders.</u>

RRC concludes in their report that Towers Watson did a "thorough and professional job" in their stochastic modeling. They immediately caution, however, that "considerable uncertainty exists both with respect to the ultimate cost of these liabilities, and the ability of the assets to perform as needed. . . . A&E liabilities may have a particularly wide range of reasonable estimates due to greater uncertainty."[56] "There are significant risks, some contemplated in the stochastic modeling, and some not contemplated, that could result in the exhaustion of the Run-off Companies' assets before all claims are paid."[57] This is hardly a vote of confidence in the financial stability of the Acquired Companies or the runoff operation.

RRC notes the four principal risk factors -- NICO losses, non-NICO losses, equity returns and payout patterns -- and observes that the losses covered by the NICO cession are the most frequent driver of outcome scenarios in which there is a failure to achieve sufficient assets for future claims. RRC also expresses significant misgivings about the potential that the equity-based investment strategy may drive failure.[58]

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[54] *Id.* Page 10.

[55] *Id.* Page 10.

[56] Towers Watson Stochastic Modeling Report, at 16.

[57] *Id.* Page 3.

[58] *Id.* Page 5.

RRC further notes that asbestos and environmental losses are the main lines of exposure ceded under the NICO treaty, and that adverse development in this book is the most likely cause of failure. RRC criticizes the Towers Watson methods for not attempting to quantify entirely new contingencies that are not part of the historical record. They note that new causes of action and adverse court decisions may produce additional significant A & E losses in the future (as Towers acknowledges), and that the extent of emerging A & E losses has continued to surprise the insurance community.[59] In yet another material qualification, RRC emphasizes that "[w]e are unable to predict the future of A &E losses, but if history is any guide, it would be prudent to expect further adverse development. If in fact there is a 'third wave' of asbestos claims, this may well be considered a change in the litigation environment not explicitly incorporated in the modeling."[60]

RRC also expresses significant concerns about the investment strategy, and in particular the 15% of invested assets which will be invested in equities (down from a high-wire 46% in prior models). The rather heavy emphasis on equity and junk bond investments to sustain the runoff operation in the future is another red flag, and distinguishes this Proposed Transaction from the investment portfolios of ongoing insurance companies, and even other runoff companies. RRC notes that in an earlier version of the model, equities made up 26% of the asset mix, rising to 46% after five years, and that an assumed 8.5 % return on equities has been incorporated for the first 15 years of the model. There is no basis for such an optimistic assumption, especially given the significant (and unsustainable) run up in share values for the major stock indices that has occurred in the last 4 years.[61] As noted elsewhere, this reliance on a speculative future rate of return on equities and higher-risk bonds is a major risk factor for policyholders. Additionally, the way in which OBIG and Towers Watson have experimented with the equity mix suggests that they are trying to justify predetermined investment yields and are more focused on what OBIG can get away with than providing the tangible security that policyholders need.

<u>The reality on the ground is that there is no end in sight to the asbestos problem for defendant companies.</u>

Those of us who spend our days working with defendant companies in managing their asbestos claims and their insurance assets know that the reality on the ground is that there is no end in sight. On the contrary, things are only getting worse.

The plaintiffs' bar is exceptionally well funded, and is prepared to take cases to trial, even with flimsy evidence. They are also prepared to take some losses, because they

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[59] *Id.* Page 4.

[60] *Id.* Page 13.

[61] Standard & Poor's 500 Index History, available at https://go.standard.com/annuities/eforms/13038.pdf; Dow Jones Industrial Average Index History, available at http://finance.yahoo.com/echarts?s=%5Edji+interactive.

know from experience that occasional losses will be more than offset by large, favorable verdicts and settlements. Settlement and defense costs for mesothelioma cases are higher than ever. New companies and sectors are constantly being targeted. The new medical linkages between lung cancer and asbestos exposure open up new, dangerous populations of claimants. Earlier diagnosis of mesothelioma makes longer and more expensive treatment the norm. Multi-generational claims are increasingly common and make the original Nicholson-Selikoff curve no longer predictive.

III. THE ACQUIRED COMPANIES WILL BE INADEQUATELY CAPITALIZED.

The adequacy of the Acquired Companies' capital base must be considered in light of the finality of the Proposed Transaction. Towers Watson, in the Purpose and Scope section of its September 9, 2013 report, explains the limitations of its analysis. "The range of estimates is intended to encompass a range of reasonable estimates of the actuarial central estimate. We have not equated this range with a specific confidence interval. We consider the actuarial central estimate, and the range of estimates presented here suitable for use in *financial reporting contexts*."[62]

But the situation at hand is fundamentally not a financial reporting exercise; it is a wholesale restructuring of long-tail liability risks under decades of broad-form insurance policies, the effect of which will be to hive off OBIG's ongoing underwriting operations and income stream from the risks posed by legacy policies, while leaving their policyholders with recourse against a runoff bank account with significantly reduced assets. Financial reporting must be viewed through the prism of what is material to the users of the financial statements, taken as a whole. The finality of the Proposed Transaction for policyholders who will have no further recourse to the capital generating activities of OBIG underscores that what is material to a policyholder is quite different than the ordinary standard of materiality that would be applied in a financial reporting context.

We are also left wondering why Towers Watson declined to offer any confidence intervals for the range of their estimates. How confident are they that the actual experience will be within, say, one standard deviation of their central estimate? How confident are they that the actual experience will be within the range of their low and High estimates? What percentage confidence do they have that the actual experience will be above their High estimate? Their sophisticated actuarial techniques and proprietary models are surely capable of providing such analysis.

OBIG and Armour attempt to put the onus on the Department to identify the required level of additional capital to support the Proposed Transaction, but the onus should be on them. The OBIG/Armour Response to the Petition to Intervene (filed June 21, 2013) repeatedly asserts that the Acquired Companies will be adequately capitalized,

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[62] RRC Review of Towers Watson Analysis of Unpaid Loss and LAE, Summary Report, Page 2.

but that there is nothing to worry about because "the SPA provides for additional contributions of capital by OBIG, in the event that the Department should determine that the Runoff Companies require additional capitalization."[63] As discussed below, the Financial Projections attached to the amended Form A assume that the full amount of additional capital allowed under the SPA will be contributed, but even under that scenario, the Acquired Companies will be manifestly under-capitalized.

<u>The capital projections for the Acquired Companies are based upon unrealistic assumptions.</u>

Capital Adequacy

The opening pro forma balance sheets for the Acquired Companies are presented as an exhibit to Amendment 1 to Form A, along with projections through December 2019. A few high level assumptions are also disclosed in notes to the Financial Projections. The proposed pro forma balance sheets as of June 30, 2014, December 31, 2014 and December 31, 2019 are reproduced below.

One Beacon Insurance Company
Financial Projections – Balance Sheet

Assets	Jun - 14	Dec - 14	Dec - 19
Cash and investments	226.4	210.0	65.2
Investment in subsidiaries	42.8	40.5	29.2
Receivables	19.7	14.8	-
Funds held assets	1.8	1.4	-
Other assets (including net deferred taxes	45.9	11.9	-
Assets	336.6	278.5	94.4
Liabilities, Surplus and Other Funds			
Net Loss and LAE reserves	156.5	134.8	38.8
Funds held liabilities	7.7	5.8	-
Other liabilities	21.5	16.6	-
Liabilities	185.7	157.2	38.8
Surplus notes	80.9	80.9	38.3
Other capital and surplus	70.0	40.4	17.3
Surplus	150.9	121.3	55.6

The first observation concerning these projections is that there is a precipitous reduction in capital during the first six months, which is a result of deferred tax assets accrued at June 2014 being written off. The accounting rules for carrying a deferred tax

[63] OBIG Response, Page 26.

asset are strict, and a company must be able to demonstrate the likelihood of future taxable income against which the deferred tax assets can be offset in order to carry it on the balance sheet. It is highly unlikely that a run-off entity is going to be able to demonstrate the required levels of taxable income to justify carrying the assets. Just why this worthless asset is carried on the opening balance sheet and included in the calculation of opening surplus is not explained. Nor do the Notes to the Financial Projections, describing this entry as the accrual of a deferred tax liability rather than the writing off of a deferred tax asset, provide any coherent justification for padding surplus in this manner. In any event, Opening Surplus, when adjusted for the write-off of the deferred tax assets, should be approximately $34 million lower, or approximately $127.5 million rather than $161.5 million.

Surplus is a regulatory concept referring to the amount by which "admitted" assets exceed liabilities. It is roughly analogous to stockholders equity in a set of SEC financial statements. It represents the cushion, or margin for error, that protects policyholders from adverse developments, in particular the risk that claim reserves may need to be increased. Once surplus deteriorates below zero, the insurance company is insolvent.

The opening consolidated surplus of $161.5 million (or $127.5 million if adjusted for deferred taxes) stands in marked contrast to the capital levels providing a cushion to policyholders before the Proposed Transaction. At December 31, 2013, OBIC had a Surplus of $866 million. Going back just five years, OBIC's surplus was even greater, standing at $1,354 million as of December 31, 2009.[64] While OBIG's lawyers deny it, OBIG has in fact treated itself to enormous dividends, systematically stripping OBIC of its capital over the last five years. Capital from OBIC has been streamed upward to OBIG through dividends to the tune of $983 million over the last five years.[65] Without the up streaming of that capital, OBIC would have had Surplus of $1,849 million at December 31, 2013 (983 + 866).

One of the key tools used by insurance regulators to assess the adequacy of an insurance company's capital is the concept of Risk Based Capital. This tool, usually expressed as a ratio of Surplus to Mandatory Control Level Risk-Based Capital, enables regulators to tie the capital (statutory surplus) of an insurance company to its size and risk profile, and establish trigger points for regulatory action. The system was created by the NAIC and is uniformly used by state insurance regulators. Five regulatory outcomes are determined by the calculated ratio. These range from where the ratio is > 200%, (No Action), to <70% (Mandatory Control).

Reviewing the financial projections, we are immediately alerted to the insufficiency of OBIC's capital based on the risk-based capital ratios. The stand-alone

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[64] OneBeacon Insurance Company Annual Statement for the year 2013, Five-Year Historical Data, Page 17 (Exhibit 6).

[65] *Id.* Page 18.

OBIC balance sheet projects a RBC ratio of 277% and surplus of $150.9 million. Simple arithmetic allows us to calculate the mandatory control level as $54.5 million (15.9/2.77). However, if we adjust Surplus for the deferred tax assets that were improperly included to $116.9 million ($150.9 – 34.0), the RBC ratio falls immediately to 215%, barely above the authorized control level.

Again, this is in marked contrast to the RBC ratios protecting policyholders before the Proposed Transaction. The RBC ratio for OBIC at December 31, 2013 was 526%. At December 31, 2009 it was 724%. If the up streamed capital were to be added back to surplus at December 31, 2013, the RBC ratio would have been 1,127%.

Reserve Adequacy

The Net Loss and LAE reserves on the opening OBIC balance sheet are $156.5 million. The "Net" part of the calculus is really net of a lot of things, and this number needs to be deconstructed and grossed up in order to illustrate the enormous risks behind it. It is misleading to simply compare $156.5 million with opening surplus.

March 31, 2013 is the most recent date on which Towers Watson presents estimates for both NICO and non-NICO lines in its reports. The Towers Watson gross Central and High estimates for the NICO lines at March 31, 2013 are $1,387 million and $1,794 million respectively.[66] Their gross Central and High estimates for the Non-NICO lines at March 31, 2013 are $765 million and $914 million respectively.[67] Their gross, combined Central and High estimates for both NICO and Non-NICO lines are therefore $2,152 million and $2,708 million, respectively. Baked into these estimates, and the $156.5 million "net" reserves on the pro forma balance sheet, are a series of assumptions, any one of which could be material to the adequacy of the stated reserves and Surplus.

We are told that Towers Watson used the Central estimate as the base assumption for their Stochastic Model. I will therefore use those same Central estimates for illustrative purposes. The combined, Central gross estimate may be reconciled to the $156.6 million on the pro-forma balance sheet as follows.

A. March 31, 2013 Gross Combined NICO and Non-NICO Central Estimate	$2,152
B. Roll Forward to June 30, 2014	Not disclosed
C. Diversification Adjustment	Not disclosed
D. Less Ceded Reinsurance	Not disclosed
E. Less Retroactive Reinsurance	Not disclosed

[66] Towers Watson Analysis of Unpaid Loss and LAE Summary Report. Roll Forward – NICO Summary Sheet 1.

[67] *Id.* Table 4.

F. Unallocated Loss Adjustment Expense	Not disclosed
G. Discount for Time Value of Money	Not disclosed

Net Loss and LAE reserves per pro-forma balance sheet	$ 156

To begin with the obvious point, $156.5 million is a small number relative to $2,152 million. It is an even smaller number relative to the High estimate of $2,798 million. To find our way from the high numbers to the low ones requires several steps, each one laden with assumptions, any one of which could lead to the smaller surplus number becoming materially larger, to the point that capital is inadequate.

Gross reserve adequacy. For the reasons discussed in more detail above, there is no assurance that the Towers Watson Central estimates are adequate to account for future claims. There is no assurance that their High estimates are either. The Towers Watson reports are so riddled with disclaimers that it appears they have little confidence in these estimates either. Rather, the history of deficient long-tail reserving practices by OBIG and its competitors indicates that A&E reserves will need to be far higher. Based on the average development over the last 12 years, the NICO cover will exhaust in less than two years on an incurred basis. Towers Watson also does not account at all for the prospect of new classes of mass tort exposure, and makes unrealistic assumptions about future inflation trends. The Towers Watson models are proprietary, have not been disclosed, and RRC has not undertaken any original work on the underlying data and assumptions baked into those models.

Roll Forward. It is now almost two years since the date of the original actuarial work by Towers Watson, a long time in the life of an insurance company. RRC repeatedly notes the importance of keeping the reviews up to date. Towers Watson itself noted unusual claims settlement activity in their environmental roll forward (which encompasses data from only a six-month period from September 2012 through March 2013) that caused complications and negative adjustments to their environmental analysis. RRC referred to this as an "unexpected" and "sizable" increase in exposure for such a short period, and viewed it as another "indication of the unpredictable nature of A&E exposure."[68] Indeed.

Diversification adjustment. This is recognition that risks do not add up in a linear fashion. While this is a valid adjustment, Towers Watson and RRC acknowledge it is highly judgmental, which is another way of saying it is subjective.

Ceded Reinsurance. OBIC has a very significant ceded (prospective) reinsurance asset. Based on 2013 disclosures, it is approximately 39% reinsured for its asbestos and environmental lines. Neither Towers Watson nor RRC did any independent work on the accuracy or collectability of this material asset. Instead, they accepted, unchallenged,

[68] RRC Summary Report of Stochastic Modeling, Page 15.

output from OBIG's own ceded model undertaken in 2010. This is a major weakness in the OBIG/Armour story line. Anyone who practices in the area of reinsurance knows that reinsurance is, if anything, harder to collect that direct insurance. It is fraught with disputes, insolvencies, write-offs and compromises, most of which take place under the radar in confidential arbitration forums. The reinsurance coverage positions built into the OBIG model – which have been accepted uncritically and subjected to no independent review -- have the potential to seriously overstate the size and collectability of the ceded reinsurance asset.

Retroactive reinsurance. The Gen Re cover is almost exhausted, and the NICO treaty has less than $200 million left on an incurred basis. The opening pro forma balance sheets include no provision for the NICO lines because the NICO treaty is not exhausted. In fact, the Towers Watson Central estimate does not forecast that the NICO treaty will exhaust for 15 years on a paid basis. For the reason alluded to earlier, this is unrealistic.

Time Value of Money. There are two elements to the calculation of the discount for TVM: timing of cash flows and the discount rate. Both elements give cause for concern here. First, Towers Watson's unfettered assumption that payout patterns in the future will resemble those in the past requires significant further challenge and analysis.[69] Second, and as critiqued by RRC, Towers Watson has simply adopted the robust investment earnings assumed by OneBeacon in their aggressively constructed investment portfolio, including optimistic assumptions about future equity yields. If either one of these high risk assumptions is incorrect, it has the ability to derail the entire model and mask impending failure.

Repayment of Surplus Notes

The proponents of the Proposed Transaction are so confident in their financial projections that they estimate that the Surplus Notes will begin to be repaid in 2018. The opening balance sheet assumes that the maximum Surplus Notes contribution under the amended SPA will in fact be made.[70] So to be clear, the thinly capitalized runoff entity being proposed by OBIG and Armour is as good as it is going to get. OBIG and Armour appear to have no intention of committing more capital than the modest amount reflected in the pro forma balance sheet, and apparently will abandon the transaction if the Department requires injection of additional capital. Even at the current thin levels, OBIG and Armour expect to begin reducing capital just four years into a multi-decade runoff,

[69] Resolute administers the NICO-led claims, and has been very aggressive in contesting coverage, generating a large number of litigated disputes between the OBIG subsidiaries and their policyholders. As these cases work their way toward trials, replete with bad faith and other extra-contractual claims, they inevitably will yield higher payouts in settlements or adverse verdicts. The $60 million recovery projected by Petitioner Olin Corporation relating to only five environmental sites in the wake of a recent jury verdict may be the tip of a very large iceberg.

[70] Amendment No. 1 to Form A, Exhibit Forecast, Notes to Financial Projections.

more than 10 years before the NICO treaty is even projected to exhaust on a paid basis by Towers Watson. Nothing could be more illustrative of both the lack of realism underlying the Proposed Transaction.

Settlement Strategy

As previously stated, the opening pro forma balance sheet only includes net reserves for the non-NICO lines. The NICO lines are entirely off the balance sheet. We are told by Towers Watson that one of the difficulties they had in their forecasts was the "regime change" in the claims department for the non-NICO lines, as a result of which, a "settlement strategy" was adopted. "Settlement strategy" is a euphemism for buyout or forced commutation strategy, and it is a typical stratagem pursued runoff companies who threaten their policyholders with impending insolvency to induce panicked commutations. Essentially, instead of paying adjusted claims as they fall due, the insurer seeks to delay recognition of claims and ultimately pay a severely discounted lump sum to terminate the relationship.[71]

The continuation of this strategy is seen in the financial projections. The reserves for Loss and LAE of $156.5 million at June 30, 2014 are forecast to more than halve in 30 months, to just $76.2 million by December 31, 2016, and are further reduced to $38.8 million by December 31, 2019. That is quite an aggressive commutation strategy, and defies any realistic possibility of what can actually be achieved for such a large book of business in such a compressed time frame.

Risk Based Capital

The corollary of the predicted success of Armour's settlement strategy is its ability to deploy investments to produce robust assumed investment returns. Using these assumptions, RBC for the Acquired Companies is projected to rise from 277% at June 30, 2014 to 428% at December 2017. During this this period, net loss reserves are projected to decrease by 61%, but cash and invested assets by just 39%. Key to the success is a combination of cheap commutations of the non-NICO book, and hanging onto investments which will be advantageously invested.

IV. OBIG AND THE ARMOUR GROUP HAVE BEEN UNABLE TO ARTICULATE A PLAUSIBLE REASON WHY THE PROPOSED TRANSACTION CONFERS A BENEFIT ON POLICYHOLDERS.

The June 21, 2013 Response submitted by the lawyers for OBIG and the Armour Group recites a litany of implausible justifications for the Proposed Transaction, including:

[71] Such runoff-driven commutations inevitably yield disparate treatment of similarly situated policyholder creditors, rather than the equal treatment that they must receive in a regulated insolvency proceeding.

- There are "inefficiencies" inherent in the combination of runoff and active specialty underwriting businesses.

- As a result, there were management challenges presented by having to deal simultaneously with the "new" OBIG and the historical runoff book.

- It complicated accounting and reporting.

- The runoff businesses required a different kind of expertise than the specialty businesses.

- It created difficulties in recruiting and retaining employees with the right expertise.

- Discontinued operations are a distraction from the core business.

- Each of the operations can be managed with singular focus, and without potentially conflicting goals.

This is the most cynical and opportunistic set of attempted justifications I have seen for a restructuring whose sole actual purpose is to boost OBIG's results and White Mountains' share values by shedding troublesome A&E liabilities while legacy policyholders are left with the leavings. In the case of other LBRs, there has at least been some regulatory imperative that necessitated the restructuring: for example, the loss of ratings in the case of INA and Home that in practice would have ended their ability to underwrite blue-chip accounts and left legacy policyholders far worse off; or in the case of Royal/Arrowood, an overseas parent beyond the reach of U.S. regulators that was willing to walk away from its U.S. operating subsidiaries if the sale to a U.S. management-led runoff group was not approved.

No evidence is offered in the OBIG Response about the alleged "inefficiencies," "management challenges," "potentially conflicting goals," "distraction" or "lack of focus" supposedly requiring this transaction, or why any of this is protective of the policyholders who are being abandoned by OBIG. What is clear – and what the Department presumably must recognize -- is that the legacy liabilities are a financial inconvenience to OBIG and a drag on its future earnings and on the stock price of White Mountains. No one can seriously argue that there is any other reason for the Proposed Transaction, and it is implausible to suggest that the Transaction is protective of policyholders in any way.

No one disputes that OBIG and White Mountains would be more attractive companies without their legacy liabilities. No one doubts that most lawyers and doctors would prefer not to be burdened by their student loans, which have to be paid off over many years, and create a drag on the professionals' ability to acquire assets. But the loans were a part of the price that was paid to achieve their professional qualifications, and provide an earnings stream for life. Insurance companies, like any other business, must live with their mistakes and miscalculations as well as their successes.

Similarly, the legacy liabilities of the CGU Companies that White Mountains accepted were part of the price it paid to acquire those American companies, which in turn gave them the resources and capability to develop a successful specialty underwriting business. What is at issue here is not whether the Proposed Transaction is economically beneficial for OBIG, White Mountains and their shareholders; they would not have pursued it if it did not confer substantial advantages on them. Rather, the issue for the Department is whether the Proposed Transaction is in the interests of OBIG's policyholders, and it manifestly is not.

While I have not reviewed the NICO-OBIG treaty in any detail, I have reviewed many other retroactive reinsurance deals between NICO and other insurance groups involving the cession of A&E liabilities. These treaties always include a claims administration agreement in which NICO's subsidiary Resolute assumes complete control over all facets of the runoff, including control of all claims handling decisions, settlement and trial decisions, collection of third-party reinsurance, and management of coverage litigation. All of these functions are undertaken using Resolute people, at Resolute's expense. OBIG's operating subsidiaries (OBIC, Potomac, Employers Fire and OneBeacon America) have very little in the way of claims resources assigned to these legacy liabilities, and their residual role is limited to having occasional meetings with Resolute to "monitor" Resolute's activities. One is left wondering what distraction the management of these NICO lines could possibly present to OBIG when they are controlled by NICO and Resolute with nearly complete autonomy, and will be for some time to come.

V. THE FINANCIAL CONDITION OF THE ARMOUR GROUP WILL JEOPARDIZE THE STABILITY OF THE ACQUIRED COMPANIES AND PREJUDICE THE INTERESTS OF ITS POLICYHOLDERS

The financial condition of the Armour Group cannot compare with the strength and stability of OBIG. The Proposed Transaction will change the ultimate parentage of OBIC and Potomac from OBIG to Armour Group Holdings Limited, a Bermuda domiciled company. Very limited financial statements have been made available concerning the financial condition of Armour, but they make for a striking comparison with OBIG.

Armour is a privately held company. The 2011 Financial Statements provided by the Department disclose Total Assets of $9.2 million, Stockholders Equity of $5.8 million, Total Income of $16.9 million and Ordinary Income of $0.1 million. After taking account of "Other" income and expense, Armour had an overall loss of $0.3 million in 2011 ($0.9 million in 2010). It is a meager set of financial statements to put it mildly. Not surprisingly, A.M. Best does not assign Armour a credit rating.

In contrast, OBIG is rated "A" by A.M. Best. It is a successful specialty underwriter, significantly exceeding industry composite profitability levels, with a combined ratio under 100 in most years. OBIG had premium income of over $1 billion in 2013, and Surplus of approximately $866 million. Were OBIC to remain within OBIG, and in the event that additional capital infusions were required for the Acquired

Companies to remain solvent, there would be ample available capital to be contributed by OBIG and White Mountains, which have ongoing income-generating and dividend streams. There would also be the incentive to provide it, because insurance groups never let their subsidiary insurers lapse into insolvency. The reputational consequences are too serious.

If the Proposed Transaction is approved, there will be no additional capital if needed. Armour does not have any spare capital, and it does not have the incentive to invest it, even if it had it. In this crucial respect, the Proposed Transaction departs markedly from the Department's prior approval of the division of Insurance Company of North America ("INA") into an ongoing underwriting business and a runoff entity, the latter of which is now known as Century Indemnity Company ("Century"). While Century continues to struggle with a deficient capital structure, it remains part of the ACE Insurance Group, a large, well-capitalized insurance and financial services conglomerate that is more than capable of re-capitalizing Century as necessary to sustain its runoff operations. In contrast, Armour's minimal assets render it wholly incapable of providing any capital support for the Acquired Companies once they are de-coupled from OBIG. For these reasons, the financial condition of Armour will jeopardize the financial stability of the Acquired Companies and prejudice the interests of policyholders.

Furthermore, the economics and motivations are different for insurance companies in run off compared with insurance companies engaged in active underwriting. Insurance companies that are actively underwriting are unlikely to adjust claims with the level of aggressive denials typically seen from run off companies, because insurance is a competitive market and their policyholders will eventually look elsewhere for coverage. Managers of run off companies have no such modifying influences on their claims adjusting instincts, which are charitably described as tight-fisted and indeed confrontational. To the contrary, their incentives are to conserve the runoff entity's limited assets long enough to obtain the contingent management fees that are often a central feature of runoff compensation. The way to do that is to resolve claims as cheaply as possible by resisting coverage as long as possible.

This is why run off companies demand "finality" in the form of policy buyouts and commutations as the price for resolving a subset of contested claims. The broader the release management obtains for resolving contested claims, the more likely the cost of the settlements will be below the level of reserves, thus protecting their small surplus. This process has already begun for the Acquired Companies' non-NICO lines.

Claims negotiators also seek to leverage the impaired financial condition of the runoff entity as much as possible to achieve more aggressive deals with policyholders. Runoff managers then attempt a similar commutation strategy with ceded reinsurance. This is partly to minimize the high costs of administering the collection of ceded reinsurance, but mainly to provide a steady stream of new cash into the entity. The consequences commuting an endlessly flexible asset, reinsurance, for cash, do not come to a head for a number of years, but eventually the bill becomes overdue and cannot be paid. In the meantime, costs are severely controlled, cheaper counsel substituted where possible, employment benefits curtailed, non-core assets sold, all in order to maximize the cash flow of the run off and keep it afloat. Meanwhile, the core promise underlying the insurance bargain -- that valid claims will be paid promptly and in full -- is simply dishonored.

<u>There is a history of failure to protect the interests of policyholders in LBRs of this kind.</u>

If history is any guide, there is a substantial likelihood that the Proposed Transaction will fail. I discuss briefly below two recent LBRs and their ultimate effect on policyholders, which has been uniformly negative. Moreover, they provide additional evidence (if any were needed) that the actuarial estimates on which regulators often have relied in approving these transactions were and are substantially flawed.

The Home Insurance Company

The Home Insurance Company ("Home") was incorporated in New York on March 3, 1853. Prior to going into run-off, its primary business was writing commercial property and casualty insurance. In the 1960s and 1970s, Home tried to overcome a series of management failures by writing large amounts of high-risk umbrella liability insurance for Fortune 1000 companies. By 1993, Home wrote $1.6 billion in net premiums and had over $10 billion in assets, but was burdened with a mountain of long-tail claims exposures that ultimately proved to be its undoing.[72]

On June 12, 1995, Zurich Insurance Group ("Zurich Insurance"), one of the world's leading insurance and financial services organizations, acquired approximately $1 billion of Home's renewal business, including most of its blue-chip accounts and experienced underwriting personnel.[73] The acquisition split Home's business into two entities: an active pool for new business under the aegis of Zurich American Insurance Group, and an inactive pool of discontinued, A&E-dominated lines named The Home Insurance Company. Home was then placed into run-off while existing liabilities were extinguished.

The acquisition allowed Zurich Insurance to keep the most profitable segments of Home's business and relegate the undesirable business into a run-off operation. This gave Zurich the ability to continue to service the most lucrative business units while offering limited protection to the remaining policyholders, many of whom sought coverage for asbestos, environmental and other long-tail exposures under Home's volatile historical umbrella book.

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[72] Meg Fletcher & Gavin Souter, *Zurich May Beef Up Home Offer Regulators, Insurers Press For More Policyholder Protection*, Business Insurance, February 2, 1995 at ¶17 & 19, available at LexisNexis (Exhibit 11).

[73] Gavin Souter, *Home Deal's Critics Speak Out, Regulators To Hear Arguments To Block Zurich Plan*, Business Insurance, April 3, 1995 at ¶¶10-11, available at LexisNexis (Exhibit 12).

The deal ultimately included an excess-of-loss reinsurance program that provided $1.59 billion of reinsurance protection, a minimum net fixed return on Home's investment portfolio of 7.5% guaranteed for up to four years by a Zurich Insurance subsidiary, and an external funding mechanism that would ensure that Home would meet its dividend obligations to bondholders for at least two years.[74]

There were opponents of the transaction who argued that Zurich Insurance should acquire, and be responsible for, all of Home's business because of the concern that Home would be unable to cover existing and future liabilities. In response, Rolf Hueppi, Zurich Insurance chairman and CEO, stated that he believed the existing funds would be sufficient, asserting "We have quite a significant bet on the fact that there will be sufficient funds in The Home Insurance Co. to satisfy the liabilities over time."[75] To get the deal approved, Zurich increased its original offer on the excess-of-loss reinsurance program from $590 million to the final transaction amount of $1.59 billion.[76]

Despite these additional protective steps (which far exceed what OBIG is proposing here), by year-end 1996, Home's adjusted capital was less than the mandatory control level of risk-based capital, enabling state regulators to begin supervision. In March 1997, just two years after the transaction with Zurich Insurance, the company was placed under formal supervision by the New Hampshire Insurance Department. On March 5, 2003, an Order of Rehabilitation was sought by the Insurance Commissioner and on June 13, 2003 an Order of Liquidation was issued. Within eight years of the transaction, despite assurances to the contrary by Zurich and a parade of actuaries, Home was insolvent. Meanwhile, Zurich American Insurance Company, a member of Zurich Insurance Group, is a healthy and viable carrier with an A.M. Best rating of A+ (Superior).

Policyholders consigned to the Home run-off were left with coverage of greatly impaired value, and many are now standing in line with Home's other unsecured creditors as the liquidation proceeding enters its second decade.

Royal and Sun Alliance USA/Arrowood

Royal and SunAlliance USA was an insurance pool, led by Royal Indemnity Company ("RIC") and Royal Surplus Lines Insurance Company (collectively "RSAUSA"), that encompassed the U.S. insurance entities of Royal & SunAlliance

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[74] Gavin Souter, *Zurich CEO Denies Obligation to Home; Hueppi Sees Duty to Current Policies, Not to Policies Zurich Didn't Renew*, Business Insurance, September 25, 1995 ("Zurich CEO") at ¶¶9-11, available at LexisNexis (Exhibit 13); *see also* Gavin Souter, *Zurich Sweetens Its Offer For Home*, Business Insurance, February 13, 1995 at ¶11, available at LexisNexis (Exhibit 14).

[75] Zurich CEO, Business Insurance, at ¶14.

[76] *Zurich Sweetens Its Offer For Home*, Business Insurance (Exhibit 14)

Insurance Group plc ("RSAUK").[77] RSAUK is a leading multinational general insurer that traces its roots to London with the founding of The Sun Fire Office in 1710. The company expanded, including into the United States, through various transactions over subsequent centuries, including one that resulted in the formation of RIC. In 1996, the UK-based SunAlliance Group plc acquired Royal Insurance Holdings plc and took the name Royal and SunAlliance.[78]

In 2006, RSAUK decided that to become more profitable, it needed to rid itself of the asbestos, environmental and other long-tail risks associated with the legacy policies written by its U.S. operating companies. To accomplish this objective, RSAUK proposed to exit the U.S. market altogether and to sell RSAUSA to Arrowpoint Capital Corporation ("ACC"), a runoff entity that would be controlled by former RSAUSA's managers. RSAUK did not attempt to hide its intention of achieving a "clean exit" from the U.S. market and its liabilities there. As Andy Haste, RSAUK's CEO, commented, "Today's announcement is a significant step for the Group. The sale of the US operation is the right deal for our shareholders and US policyholders. The transaction will bring certainty and finality and delivers on our objective of a clean exit from the US."[79] The press release went on to say that "the Group has given minimal representations and warranties and the transaction represents a clean exit from the US."[80]

The proposal was submitted to the Delaware Department of Insurance (where the U.S. subsidiaries were domiciled) for review and approval, and an extensive effort was undertaken by policyholders to block it or improve the terms. A main argument was that RSAUSA was already financially vulnerable and that losing the support of its U.K. parent and worldwide underwriting operations would inevitably end in its insolvency and impair the interests of thousands of U.S. policyholders. Concerns were also raised that RSAUK was not putting enough capital into RSAUSA (although it was not depleting the capital like OBIG is here) and that the motivations of the Arrowpoint team were unclear due to lack of disclosure.

Neutral analysts were generally in agreement that the proposed deal was a positive step for RSAUK and problematic for RSAUSA policyholders. In response to the deal, A.M. Best placed RSAUK on review for a possible ratings upgrade, asserting that "the review will most likely result in an affirmation or upgrade of [RSAUK's] existing ratings."[81] The ratings agency maintained that the transaction will likely "result in a

[77] Best's Insurance Reports - Property Casualty, US, 2006 Edition (2005 Annual Data, Version 2006.1), Royal & SunAlliance USA Insurance Pool (Exhibit 15).

[78] *Id.*

[79] *R&SA Sells U.S. Business to Arrowpoint Capital; Terminates Stock Listing,* Insurance Journal, Sept. 28, 2006 at ¶4.

[80] *Id.* ¶8.

[81] Press Release, A.M. Best Company, A.M. Best Places Ratings of Royal & Sun Alliance Under Review With Positive Implications, September 28, 2006 at ¶4 (Exhibit 16).

reduction in potential volatility" for RSAUK and that the Group's U.S. exposure will be "largely limited to timing risk relating to the Adverse Development Cover] and the maintenance of existing Letter of Credit facilities." At the same time, A.M. Best placed RSAUSA's rating under review with developing implications.[82] Such a move by A.M. Best usually signals that the agency is worried about the financial condition of the insurer, and often culminates in ratings downgrades.

Standard & Poor's stated that the deal was a positive move for RSAUK.[83] Moody's said that any upgrade would be dependent upon the successful completion of the sale, noting that the deal will "largely eliminate the Group's future exposure to the US operations, which have produced significant underwriting losses in recent years and have weighed on the Group's ratings."[84] The U.K. stock market also responded positively, as evidenced by the fact that the group's stock price rose immediately after disclosure of the impending sale.

Some analysts were "surprised at the cost of exiting [RSAUK's] U.S. unit."[85] After accounting for the loss of the U.S. asset, capital contributions, legal fees, and present value of the deferred consideration owed by ACC, the after tax loss to RSAUK was estimated to be £433 million ($826.3 million[86]).[87] Thus, RSAUK was willing to pay in excess of $800 million to eliminate its exposure to, and responsibility for, the long-tail liabilities it faced in the U.S.

In 2007, after lengthy hearings and appeals, the Delaware Insurance Department approved the sale of RSAUSA to ACC, largely because RSAUK was exiting the U.S. market altogether and stated that it would walk away from the U.S. operations if the price tag was too steep. However, the Department still imposed a number of additional conditions:

- RSAUK made another capital contribution to ACC of $287.5 million.[88]

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[82] Press Release, A.M. Best Company, *A.M. Best Places Ratings of Royal & SunAlliance USA Under Review With Developing Implications*, September 28, 2006 at ¶5-6 (Exhibit 17).

[83] *Royal & Sun Offloads U.S. Unit*, Reuters Business News, September 28, 2006 ("Royal & Sun Offloads") at ¶17, available at LexisNexis (Exhibit 18).

[84] *RSA Credit Rating Placed On Review By Moody's; Upgrade 'Possible'*, AFX News Limited, September 28, 2006 at ¶4, available at LexisNexis (Exhibit 19).

[85] *Royal & Sun Offloads* at ¶7.

[86] Assuming an exchange rate of £1 = $ 1.91, the November 2, 2006.

[87] RSA Press Releases, *Sale of US Operation and Termination of Group SEC Registration*, Sept. 28, 2006 at Page 8-9.

[88] *Id.* Page 8.

- A $1.225 billion Adverse Development Cover ("ADC") agreement remained available to RSAUSA, although it was said to be at its limit, i.e. of no economic value to policyholders.[89]

- RSAUK offered a limited-use Letter of Credit ("LOC") of a value not to exceed $150 million, but the value would decline by up to $50 million a year beginning two years after the transaction if certain financial thresholds were met.

- RSAUK eliminated a $279 million indebtedness held by RIC's US parent.

- ACC would not be permitted to pay out any dividends or increase management compensation without approval from the Delaware Insurance Department.

- A Claims Monitor was put in place to ensure appropriate claims handling and payment by ACC with monthly reporting to the Commissioner.

Despite these additional protections, RSAUSA's financial surplus has deteriorated rapidly in runoff, with policyholder surplus dropping from approximately $1.5 billion in 2003 to less than $900 million in 2005.[90] The slide has continued since the sale in 2007. As of December 31, 2007, Surplus was approximately $450 million[91] and has since deteriorated by 44% to approximately $250 million at year-end 2013.[92] Policyholders of RSAUSA are in a significantly more precarious position today than they were at the time the sale was approved.

<u>This transaction incorporates none of the protections for policyholders found in other LBRs in the event that the actuaries and OBIG are wrong.</u>

In light of OBIG's assurances that that the Acquired Companies will be amply capitalized, with plenty of reinsurance and reserves, it should have no difficulty agreeing to residual protections for policyholders that are reflective of that confidence.

Buy additional NICO protection. If OBIG is confident that its "sophisticated" actuarial techniques are reliable and that the remaining NICO cover is sufficient for at least the next 15 years, OBIG should be able to buy an excess NICO reinsurance policy very cheaply. For example, an additional $1.5 billion NICO cover would provide a meaningful margin of error for the benefit of policyholders. If OBIG is right about the stability of the Acquired Companies, should be able to convince the financial analysts at NICO that providing additional retroactive reinsurance is a win-win proposition for both OBIG and NICO.

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[89] *Id.* Page 8.

[90] A.M. Best Report 2006 (Exhibit 15).

[91] Best's Insurance Reports - Property Casualty, US, 2010 Edition (2010 9-Month Supplement, Version 2010.3), Arrowood Indemnity Company (Exhibit 20).

[92] AMB Credit Report 2014, Arrowood Indemnity Company (Exhibit 21)

Dividend Retention Plan. If OBIG is confident that the Acquired Companies are adequately capitalized, then in addition to the Surplus Notes it is willing to contribute (which burden the runoff entities with interest payments), OBIG and its publicly traded parent should put in place a dividend retention plan. The plan should be initially funded at $50 million, and this amount should be contributed to surplus and increased as necessary to keep the Target Capital Ratio at or above 200%. In the event that the initial retained dividend amount is depleted, it should be replenished from any dividends declared to OBIG or White Mountains.

Armour monitoring function. If Armour is such a great fit, then it should not object to having its own performance, as well as Trebuchet's, monitored by the Department. In particular:

- The Department should approve or veto management compensation, including any contingent commissions, on an annual basis.
- The Department should approve any commutations of reinsurance to assure that fire sales are avoided.
- The Department should appoint an independent Claims Monitor at expense of Armour, just as the Delaware Insurance Department did with respect to the Royal transaction. The Claims Monitor would report to the Department, but would have broad discretion to act independently to protect policyholders faced with unfair claims practices by the Acquired Companies and their management.
- The Claims Monitor should have the authority to receive and act upon policyholder complaints, and to schedule mediations.
- The Claims Monitor also should be authorized to establish and oversee alternative dispute resolution forums for disputed policyholder claims, and to assess legal fees and costs against the losing party.

VI. THE RELIANCE INSURANCE COMPANY INSOLVENCY PROVIDES A SOBERING EXAMPLE OF THE FLIMSINESS OF ACTUARIAL SCIENCE AND THE CONSEQUENCES FOR REGULATORS, GUARANTY FUNDS, AND POLICYHOLDERS OF A MAJOR INSOLVENCY.

Reliance Insurance Company failed with remarkable speed. Looking back with the benefit of hindsight, there were warning signs along the way but no one looking at available facts would have then-concluded that Reliance would become the largest insurance insolvency in U.S. history.

In 1998, the stock price of its parent company was at a record high and for the same year Reliance reported $1.7 billion in statutory surplus.[93] The company enjoyed an A- (Excellent) rating from A.M. Best Company, which not only maintained this rating until June 2000 but contemplated raising the rating further. A.M. Best was not alone, with Standard & Poor's issuing its own A (Strong) rating on the company.[94]

Reliance nonetheless crumbled quickly. The company's finances deteriorated rapidly due to a variety of commercial and management failures, not the least of which was its disastrous involvement in a reinsurance program that cost over $170 million and significant A&E and construction defect losses.[95] A.M. Best warned that Reliance's rating was under review for a downgrade, setting off a chain reaction that is difficult to reverse once it is set in motion. The threat of a downgrade caused brokers to steer their policyholder clients away from Reliance, hurting its finances, and A.M. Best followed through on its threat in June 2000 with the first of several ratings downgrades. This action pushed more policyholders to abandon Reliance and it hurt the company's plan to raise money through bond sales.[96]

Just over two years after reporting its robust 1998 results, Reliance was placed under rehabilitation by the Pennsylvania Insurance Department with liquidation proceedings following less than six months later.[97]

In some respects, that is just the beginning of the story. The liquidation order put into motion the involvement of state insurance guaranty funds to play their statutory backstop role in the payment of claims brought by Reliance policyholders. These funds have paid **$3 billion** in Reliance-related claims, costs that are ultimately borne by policyholders through higher insurance premiums or surcharges and by taxpayers through tax offsets claimed by insurers on used guaranty money.[98]

There are also the costs incurred by state insurance departments to manage the liquidation runoff, identify funds for paying claims, handle lawsuits (both defending and prosecuting), and other administrative matters. These costs, in terms of both time and money, are very significant. In the first few years after the liquidation order for Reliance, the Pennsylvania Insurance Department incurred several hundred million dollars on

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[93] Philadelphia Inquirer Article, *Reliance Insurance Company*, May 24, 2001, at ¶25 (Exhibit 22).

[94] Philadelphia Inquirer Article, *Saul P. Steinberg and Reliance Insurance Company*, December 10, 2012 (Exhibit 23).

[95] A.M. Best's Credit Report 2014, Arrowood Indemnity Company (Exhibit 21).

[96] Philadelphia Inquirer Article, *Saul P. Steinberg and Reliance Insurance Company*, December 10, 2012 (Exhibit 23).

[97] New York Liquidation Bureau Report, Reliance Insurance Company (Exhibit 24).

[98] Property Casualty 360, *Guaranty Funds solid in spite of shadow insolvency*, April 30, 2009 (Exhibit 25).

everything from rent and operating expenses to lawyers and accountants. Pennsylvania, which has dealt with a number of insolvencies over the years, has also spent considerable time and money identifying and selling Reliance assets around the world to raise funds and offset some of its costs as well as those incurred by the Commonwealth guaranty fund.[99]

While Pennsylvania may have borne the largest share of the costs associated with the Reliance liquidation, many other states have similarly been impacted as they also have obligations through their guaranty funds to Reliance policyholders in states where Reliance was licensed.[100]

In short, the costs of dealing with an insurer insolvency are extremely high and are ultimately absorbed by a wide range of parties. The policyholders are left with unpaid claims, partial-paid claims, and long-lead times for reimbursement. Other solvent insurers are required to replenish the guaranty funds, and pass some of those costs onto insurance buyers through premium increases. Taxpayers are impacted by lower tax revenue than otherwise would be the case.[101] States are responsible for managing the insolvent estate and all matters related thereto, at considerable direct expenses. In light of the massive and widespread costs of administering insurer insolvencies, which impact many sectors of our economy, it is imperative that the Department exhaustively analyze "dump and run" restructurings like the Proposed Transaction, and not permit a healthy insurance operation like OBIG to walk away from legacy underwriting mistakes by unloading potentially massive liabilities to an inadequately capitalized runoff vehicle that will eventually become a ward of the state. Has the Department satisfied itself that this scenario will not occur, and that all appropriate safeguards have been implemented to prevent it? OBIG and its parent should not be given a pass at the expense of policyholders and the public interest.

VII. THE NAIC HAS SET CLEAR BEST PRACTICES FOR THE EVALUATION OF SUCH EXTRAORDINARY TRANSACTIONS THAT HAVE NOT BEEN FOLLOWED HERE

The June 1997 NAIC White Paper "Liability-Based Restructuring" (Exhibit 29) provides authoritative background and guidance to regulators in the evaluation of transactions such as the proposed sale of the Acquired Companies to Armour Group.

Although published 17 years ago, the White Paper is surprisingly on point with the Proposed Transaction. Indeed, language in the opening paragraph of the White Paper

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99 Philadelphia Inquirer Article, *Failed insurance firm still gobbling up money Pa. lists expenses of $250 million in two year'*, August 11, 2003 (Exhibit 26).

100 Insurance Journal, *Reliance Insurance 1817 – 2011 – R.I.P., July 23, 2001* (Exhibit 27).

101 National Conference of Insurance Guaranty Funds, Property and Casualty, *Guaranty Funds FAQ* (Exhibit 28).

could have been written with this specific transaction in mind: "The most common specific examples of restructuring during the past several years have been liability-based restructurings (LBRs) of insurance operations into discontinued and on-going operations, primarily because of material exposures to asbestos, pollution and health hazard (APH) claims and other long-tail liabilities."

Although the White Paper does not take a position, for or against LBRs, it makes it clear that LBRs are "extraordinary transactions" that must be carefully scrutinized. (Section I). "Conceptually, an LBR is an extraordinary transaction, or series of transactions, in which one or more affiliated insurance companies wholly or partially, isolate their existing insurance obligations from their on-going insurance operations. The notion of isolation is one of substantive change that creates a legal separation, such that policyholders and other creditors holding the isolated existing insurance obligations have limited or no financial recourse for their direct satisfaction against the on-going insurance operations."

The White Paper acknowledges that there may be certain advantages to an LBR, including the enhancement of shareholder value. But it is equally clear in describing the potentially significant disadvantages of an LBR, every one of which is fully present in the Proposed Acquisition: "On the other hand, underfunded LBRs may reduce the likelihood certain policyholder claims will be paid by the insurer. In addition, LBRs may be difficult to structure equitably due to the uncertainty associated with estimating APH liabilities, may pose questions related to policyholder participation and guaranty fund coverage in the event a restructured entity fails, and may have a negative impact on the public trust in the property and casualty insurance industry and effectiveness of insurance regulation." (Section III). It goes on to explain that every LBR will present both advantages and disadvantages that the regulatory process must carefully weigh in the light of applicable law and the impact upon policyholders: "An advantage to future policyholders (availability and affordability) may arise from a disadvantage to existing and prior policyholders (reduced likelihood of having their claims paid)."

The White Paper also contemplates that interested parties should be allowed to present evidence, call witnesses and cross-examine the witnesses of other parties (Section V.B.), to assure that the regulator's ultimate decision is a fully informed one. It concludes with 12 recommendations (Section VII) including:

- The LBR applicant has the burden of justifying the LBR to the regulatory authority. The regulatory authority should not approve a proposed LBR if the transaction is likely to jeopardize the financial stability of the insurers, prejudice the interests of policyholders or be unfair or unreasonable to policyholders.

- If the effect of the LBR is to extinguish a going concern insurer's obligations to its policyholders, consent of the policyholders should be required. Such transactions have the same effect on policyholders as a novation and therefore should satisfy the procedural and legal requirements of a novation.

- Policyholders should have an opportunity for direct participation in the LBR approval process, meaningful access to information about the LBR, and a public hearing that affords them an opportunity to be heard. *Meaningful access to information necessarily requires that policyholders be given access to information that may be sensitive and proprietary.* The competing interests of the policyholders and the insurer in this regard should be balanced with appropriate measures such as protective orders and confidentiality agreements to allow policyholders access to such information while protecting the insurer's interests in confidentiality.

- The review of all financial aspects of a proposed LBR must culminate in a determination of the adequacy of capital and surplus.

- A key regulatory consideration in evaluating an LBR is whether there will be an on-going parental or affiliate involvement with the restructured insurer after the completion of the LBR.

Clearly, these recommendations have not been followed to date in connection with the consideration of the Proposed Transaction. Although it is uncertain what presentation, if any, OBIG and Armour Group will make at the "public informational hearing" on July 23, the Department has withheld as confidential the fundamental data underlying OBIG's and Towers Watson's actuarial conclusions. It is therefore difficult, if not impossible, for policyholders – those most affected by these proceedings – to offer informed comments and participate meaningfully in the review process. In a very real sense, policyholders remain on the outside looking in – and that is not what the NAIC White Paper contemplates.

VIII. CONCLUSION AND RESERVATION

For the reasons given above and based on the limited data made available to date, I conclude that the Proposed Transaction is severely prejudicial to the interests of policyholders and to the insurance buying public and should be rejected in its present form. The actuarial work undertaken by Towers Watson and RRC does not provide the assurances that ought to be required with respect to the adequacy of the Acquired Companies' reserves. The marginal capitalization of the Acquired Companies under the Proposed Transaction is insufficient to protect policyholders, and in no way compensates for their ejection from a stable, well capitalized, profitable insurance group. Finally, OBIG and Armour have been unable to articulate a single, plausible reason as to how the Proposed Transaction benefits policyholders.

I also reserve the right to supplement or amend these opinions if and when the Department makes additional data available. As of this report, I have been unable to examine the underlying data or methods of analysis that OBIG or Towers Watson used to evaluate the Proposed Transaction and am therefore limited in the conclusions I can draw. Consistent with the NAIC guidelines, the Department should make all relevant financial and actuarial data available, even if under a confidentiality agreement, to interested parties so they can engage in a thorough and independent examination of the underpinnings of the Proposed Transaction.

SIGNED: ______________________

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DATE: July 21, 2014.