ANDERSON KILL

Pennsylvania Insurance Department

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Presentation to the Pennsylvania Insurance Department at July 23, 2014 Public Hearing

Presenters

Daniel J. Healy, Esq.
(202) 416-6547
dhealy@andersonkill.com

Alexander D. Hardiman, Esq.
212-278-1588
ahardiman@andersonkill.com

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Proposed Acquisition

- The Proposed Acquisition of OneBeacon's run-off business, including traditional commercial lines and asbestos and environmental exposure, by Armour is not in the best interests of policyholders, or the companies to be transferred to Armour.
- The Proposed Acquisition will leave the Run-Off Companies being undercapitalized and unable to provide reasonable assurance of coverage.

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The Proposed Acquisition Should Not Be Approved

- Colgate opposes the transaction because it is directly contrary to the interests of policyholders – an issue raised in two sections of the Pennsylvania Law that expressly sets forth the factors the Department must consider.
- The transfer of the Run-Off Companies to Armour increases the likelihood of non-payment of coverage to policyholders to less than normal standards.
- It also increases the likelihood of the Department's regulatory intervention.

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The Proposed Acquisition Should Not Be Approved

- As proposed, the transfer of the Run-Off Companies leaves them less likely to be able to pay coverage timely than normally is expected of insurance companies.
- At least $200 million of additional capital is needed.
- The reinsurance sources referenced by the Applicants are almost entirely exhausted and/or are insufficient to cover the lack of capital.

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The Proposed Acquisition Should Not Be Approved

- Towers Watson and RRC did not assess technical insolvency or surplus adequacy.
- Even accepting all other features of the Towers Watson report:
  - The failure rate is higher than 12%.
  - Failures will be recognized and timely payment potentially interrupted <u>much sooner</u> than indicated in Table 1.
  - Even 12% is a high failure rate.

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Summary of Issues

- Even assuming the facts as presented by the Applicants and Towers Watson, an additional $200 million of capital is needed.
- Based on the Towers Watson report, Potomac's Authorized Control Level of capital is $116 million – *that number was calculated by OneBeacon*.
- Potomac's Company Action Level is $232 million, based on the NAIC Model Act. The required capital for group of Run-Off Companies is higher.
- Towers Watson reports that the entire group of Run-Off Companies will be left with $161,500,000.
- Without additional capital, the Proposed Acquisition – as proposed – will create the need for the Department's immediate involvement.

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Summary of Issues

- Insurance Companies with capital vs. gross liabilities levels like the Run-Off Companies are already under the Department's supervision, *e.g.*, Century Indemnity Company.
- The financial estimates used by Towers Watson are based on unnecessarily old claim information that skews the results, yet still show under-capitalization.
- OneBeacon has systematically removed capital and assets from the Run-Off Companies in preparation for the Proposed Acquisition.
- Armour does not have the necessary financial strength to make up the shortfall in capital.
- There are a number of issues that all point to these conclusions, all of which are grounds for denying approval of the Proposed Acquisition.

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Problems Remain Unaddressed

- Based on limited available information, policyholders have identified significant problems with the Proposed Acquisition.
- The Towers Watson and RRC reports do not answer the financial questions raised and are filled with qualifiers and caveats.
- An earnest interpretation of the Towers Watson report, even with its flaws, is that the report demonstrates the transfer should not be approved.

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OBA Systematically Depleted the Run-Off Companies

- OBIC already has transferred over a billion dollars of assets with a measurable value to Atlantic Specialty.
- OBIC will transfer all of its holdings in Atlantic Specialty upstream to its parent.
- This transfer to OBIG effectively removes what appear to be the vast majority of valuable assets held by the Run-Off Companies prior to their transfer to Armour.

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Under-Capitalized

- Applicants ask the PID to accept unsupported representations: "OBIG is confident it has determined [the Acquired] Companies' liabilities through sophisticated and ongoing actuarial reviews." (June 21 Letter filed with the PID, p. 2.)
- In just 2012, OBIC experienced over $24 million in "unfavorable losses," *i.e.*, losses that are over and above the losses that Applicants planned for and reserved for. (2012 OBIC Annual Statement.)

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Insufficient Reinsurance

- There is no evidence that there is adequate reinsurance for the A&E liabilities.
- The NICO policy is almost entirely depleted, according to publicly available documents.
- The Gen Re policy already has been fully utilized by losses previously ceded by OBIG, not the Run-Off Companies that hold the A&E at issue.

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The New Reports Do Not Provide Answers

- Towers Watson and RRC do not provide the information the Department needs to evaluate whether to approve the transaction – they miss the point.
- Neither TW nor RRC opine on fairness to policyholders.
- The reports ignore ERM and ORSA industry standards.

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Towers & RRC Miss the Point

- Neither report supports the conclusion that the amounts due to policyholders will likely be paid on time.
- An insurance company must have "technical solvency" and avoid "inadequate surplus".
- Otherwise, regulatory action is needed.

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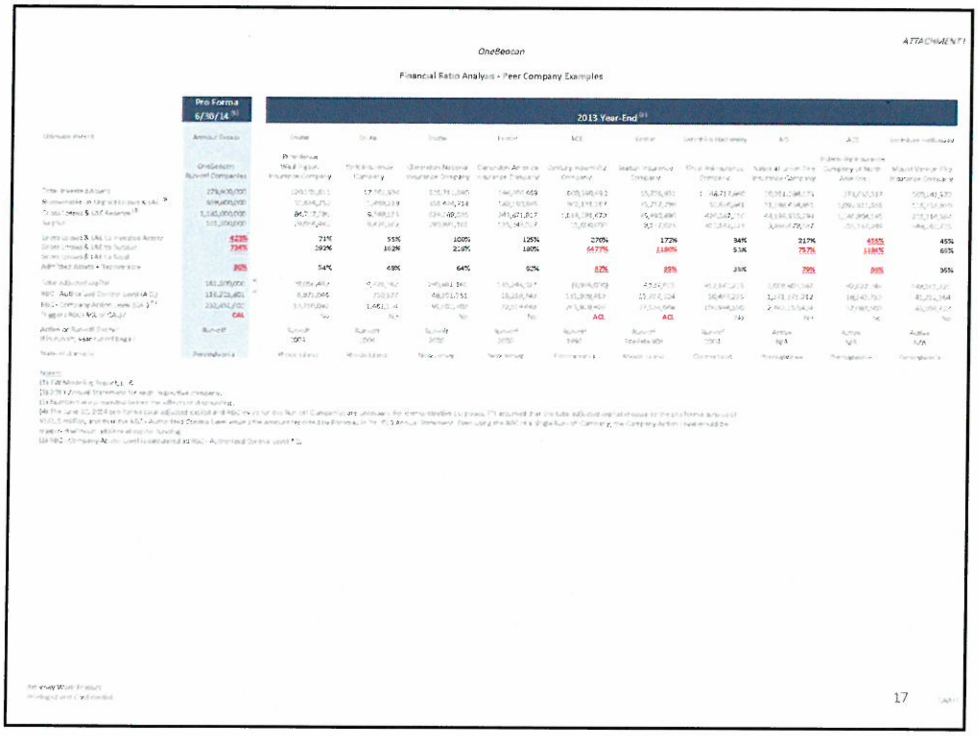
Inadequate Surplus

- Assuming the finding in the reports, Potomac would be subject to regulatory action on day one.
- Surplus must be maintained above "RBC" (risk-based capital) thresholds.
- Even based on the limited available data, $200 million of additional surplus is needed to maintain the 12%/18% failure rate currently projected.
- Towers Watson prepared low, central and high estimates of required reserves. Then it ignored the low and high, meaning it underestimated reserve uncertainty and failure rate.
- The 30 year projection for the 12% failure rate lacks any basis and could be realized sooner.

Technical Insolvency

- If liabilities exceed assets, the company enters technical insolvency and timely payments cease.
- "Near Misses" are failure to timely pay due to technical insolvency, when cash is adequate but reserves predict a cash shortfall.
- "Near Misses" could raise the failure to timely pay to 18% - instead of 12%.
- Towers Watson did not project when the company will be known to be insolvent.
- The projected 12% failure rate will be realized sooner than the 30 year projection that is based on asset depletion.



Capital Requirements & Stress Testing

- Towers Watson only tested cash as a model.
- But it should have generated and tested a Capital Requirements model.
- Towers Watson also failed to perform stress testing, reverse stress testing and sensitivity tests.
- Such tests identify where potential cash and capital problems may be.

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Answers Are Not Provided

- The Towers Watson report does not test and identify the Company Action Level.
- This threshold, evening assuming Towers Watson's findings, will be triggered on the day of closing.

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Industry Standards

- ERMA or ORSA industry standards call for multiple forms of modeling, stress testing, sensitivity testing, etc. NAIC Own Risk and Insolvency Assessment (ORSA) Guidance Manual (March 2014), p.8.
- Standard software performs these tests.
- Risk-Based Capital (RBC) for Insurers Model Act, p. 312-2.

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Known Unknowns

- These are gaps in the information they need to rely upon to advise you and they are filling the gaps with assumptions. The assumptions were made very favorably to the Applicants.

- They noted it because it is important.

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Known Unknowns (cont.)

- Towers excluded "outliers" from its data, meaning "the failure rate may actually be higher than 11.7% ..." (RRC-S Report p.14)

- The risks created by such missing information include that "the models used are not appropriate (model risk)" (Id. p.5)

- It failed to include "modeling of the variability" from lognormal distribution of claims. (Id. p.13)

- The medical inflation models "may vary more from historical data than the model's results indicate." (Id. p.11)

- It offset its medical modeling with favorable rates that "may have the effect of underestimating the true impact of claim severity." (Id. p.11)

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KNOWN UNKNOWNS (cont.)

- RRC: Towers "made judgmental adjustments" to the interest rates, equity returns and BBB defaults and that while such adjustments were "not unreasonable" they were "adding somewhat to the riskiness of the model results." (RRC-S Report p.11)

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Prejudice to Policyholders

- No consideration is given to this question.
- Even RRC concludes only that "the Run-off Companies are likely to meet their obligations even when under considerable stress." (RRC-S Report, p. 16)
- "Considerable stress" is not defined, at all.

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Old Reserve Data

- OneBeacon should have quarterly reserve data, but Towers Watson used approximations based on reserve data from nearly two years ago.
- OneBeacon admits having to adjust that data due to "unexpected claim activity," but Towers deems that data "should be adequate."
- Why not get the real answers?

Why It Matters

- Based on the limited publicly available information, it appears that the Run-Off Companies' total anticipated unpaid losses net of reinsurance will lead to their liabilities exceeding their assets sooner than predicted.
- This means the Run-Off Companies will fail.

Thank You

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