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Insurer Restructuring, Run-off and Resolution

The view from both sides of the Pond

Wednesday 15 May 2019

Welcome

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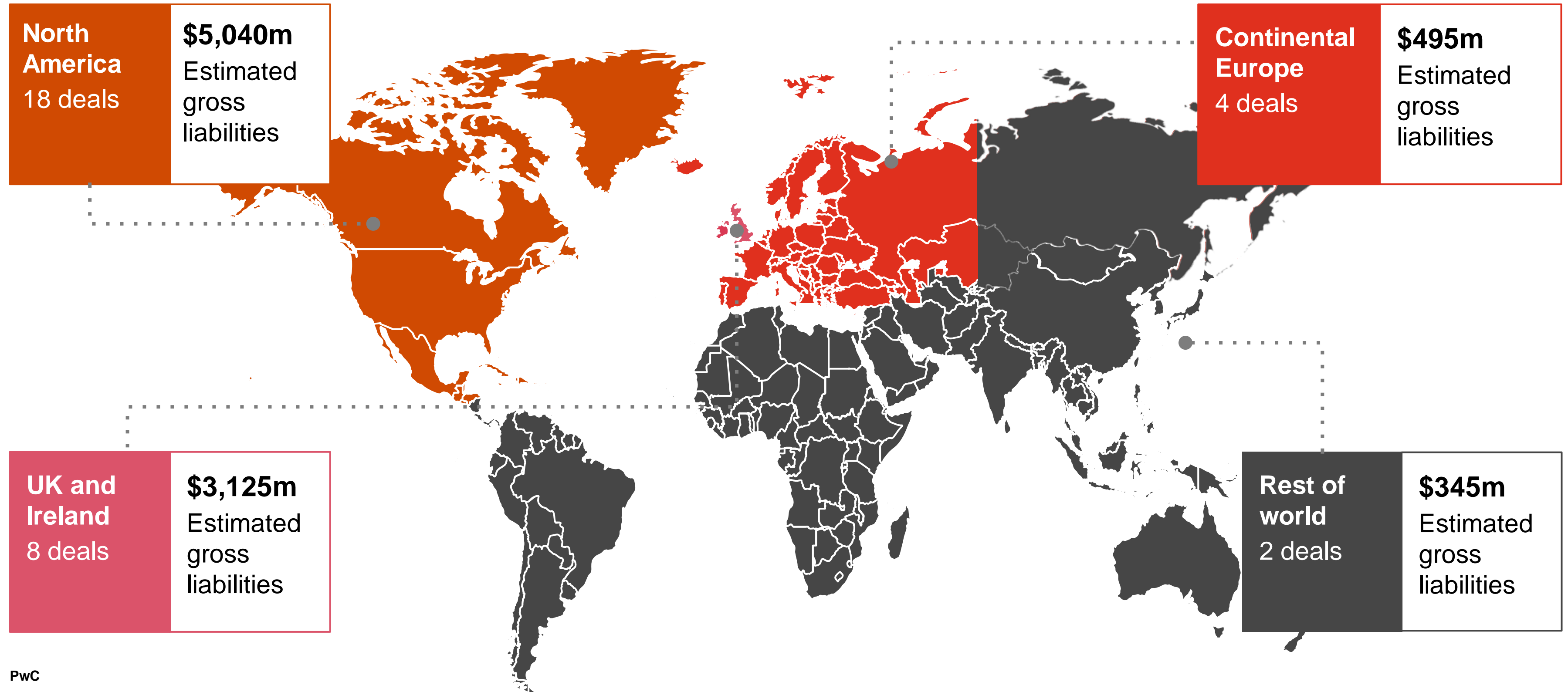
pwc

2018 P&C run-off transactions in numbers



Trends in U.S. Insurance Rehabilitation

Peter Ivanick, Partner
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Summary

- Pre-Financial Crisis Lengthy Rehabilitation/Liquidation Process
- 2007-10 Crisis Causes Regulators to Rethink Rehabilitation
- Restructuring of Troubled Insurers Post-Crisis took Many Forms
- Future of Insurance Insolvency in the US:
  - Life
  - Long Term Care (“LTC”)
  - Health
  - Financial Guaranty

Pre Financial Crisis Rehabilitation Process

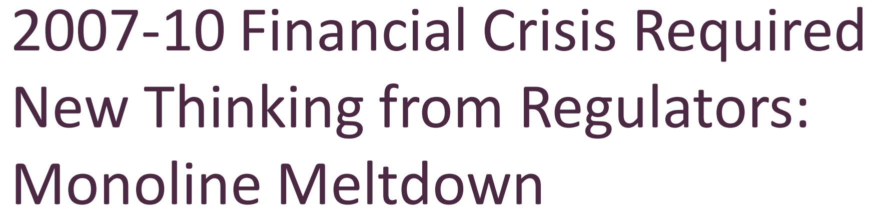
- Prior to the Financial Crisis, insurance companies remained in rehabilitation for decades.

- Few companies ever emerged from Rehabilitation as viable businesses.

    - Most senior employees fired immediately;
    - Middle management retained for three-four month transition;
    - Then company operated by regulator for lengthy and expensive period of time while claims develop and assets are collected;
    - Finally, liquidation;
    - State guaranty funds pay up to limits and reinsurance and other assets are collected;

State Guaranty Funds

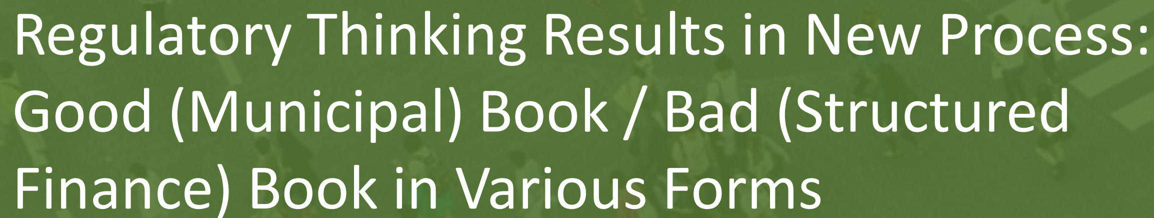
- Each state has enacted laws to create entities (one for life, health and LTC coverage and one for P & C coverage), typically referred to as a "guaranty association".
    - These associations provide "back up" coverage to policyholders in the event that their insurer is liquidated.
    - Policyholders of a liquidating insurer are paid by their state's guaranty association, up to statutory limits (typically $100,000 to $500,000).
    - In order to obtain the funds needed to pay policyholder claims, these associations have statutory authority to levy assessments against member insurers.
- The pre-financial crisis "rehabilitation-followed-by-liquidation" system often included guaranty fund coverage and guaranty associations were large players in the process, as these associations generally had large subrogation claims.



- Financial Crisis resulted in need to restructure monoline insurers (a/k/a financial guaranty insurers).
- Historically, monolines primarily insured municipal bonds.
    - Premiums often paid in full, up front;
    - Municipalities rarely defaulted, thus policy claims rarely asserted.
- Then, in 2000's, to enhance returns, monolines began insuring structured finance obligations (i.e., ABS, RMBS, CDS, CDO).

Background to the Need for New Restructuring Process

- Many monoline-insured structured finance vehicles were hit hard by the 2007-10 financial crisis.
- Massive mark-to-market losses if CDS defaulted.
- Huge losses in investment portfolios.
- POLITICAL PROBLEM FOR STATE REGULATORS: If restructuring of monoline insurer meant liquidation, then the political fallout would be huge because the guarantees of municipal debt purchased by "moms & pops" would be worthless on liquidation or at best paid pennies on the dollar in rehabilitation proceedings that could last 20 to 40 years.



Regulatory Thinking Results in New Process: Good (Municipal) Book / Bad (Structured Finance) Book in Various Forms

- Supervised, negotiated restructuring – ACA
  - Regulators supervised restructuring without petitioning court for formal rehabilitation proceeding.
  - Holders of structured finance policies agreed to settlements of ACA’s CDS obligations, and received most of the equity of the remaining municipal (good) book

Regulatory Thinking Results in New Process: Good (Municipal) Book / Bad (Structured Finance) Book in Various Forms

- Non-negotiated separation of obligations into municipal (good) book, and structured finance (bad) book - MBIA.
  - Supervised by insurance regulator.
  - MBIA and its parent funded an MBIA subsidiary, which assumed MBIA's "good" book; and
  - Holders of structured finance policies litigated for many years, arguing that capitalization of separate subsidiary for municipal book and reinsurance transaction involved massive fraudulent transfers
  - Litigation settled on eve of threatened seizure of company by regulator.

FGIC – First Post-financial Crisis, Successful Rehabilitation

- Financial Guaranty Insurance Corporation ("FGIC") was the first financial guaranty insurer to emerge from rehabilitation with restructured policies, able to effectuate a wind-down outside of its rehabilitation proceeding.
    - First, FGIC sold its municipal book and ceased payments on structured finance obligations per regulatory order.
    - New York regulator began formal rehabilitation proceeding, obtained a court order "enjoining" (thereby curing) pre-existing defaults and, thus, preserved FGIC's "control rights" rights under insured-bond transaction documents.
    - Plan restored FGIC to solvency because plan provisions mandated that liabilities never exceed assets.
    - Management team led rehabilitation proceeding.

Segregated Account of Ambac Assurance Corp. ("AAC"): Another Successful Emergence from Rehabilitation

- Rehabilitation of structured finance (bad) book via segregation in 2010 into the "Segregated Account", separate from municipal (good) book, and rehabilitation of Segregated Account.

  - Segregation of bad from good business lines protected AAC's municipal book from contractual events of default and related losses that could have been triggered if all of AAC was seized in a rehabilitation or liquidation proceeding.
  - During proceeding, AAC's management was successful in significantly reducing actual and projected liabilities of the Segregated Account and increasing investment returns.
  - Regulator insisted on a "durable exit", which meant that AAC as a whole (good book and bad book), would have adequate capital to continue operations and pay in full post-Effective Date claims.
  - In January of 2018, the Segregated Account exited rehabilitation and was merged back into AAC.

Key Take Aways

- Empower company's management to mitigate losses through commutations, settlements and restructurings during the proceeding
- Judicial process can restructure policy obligations and restore to solvency.
  - Rehabilitation plans are not subject to policyholder or creditor votes.
  - Court must, however, find that the plan of rehabilitation is "fair and equitable" and eliminates the causes of distress that necessitated rehabilitation.
- Upon court approval of rehabilitation plan, company can exit and plan can be implemented over time by company management outside a proceeding.

Future of Insurance Insolvency
Life insurers and life reinsurers
Long-term care insurers
Health insurers?
Financial Guaranty insurers?

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"They do it differently now"

UK solvent schemes and life insurer liabilities and how we got there

Joe Bannister and Jonathan Russell

May 2019

Overview of talk

- The journey
  - Insolvent and solvent schemes
  - Growth of the M&A market and the use of Part VII and reinsurance
- Management of life insurance liabilities
  - The development of the "retail" scheme as a means for liability management
  - Addressing the Scottish Lion legacy
- Conclusions

A turbulent beginning

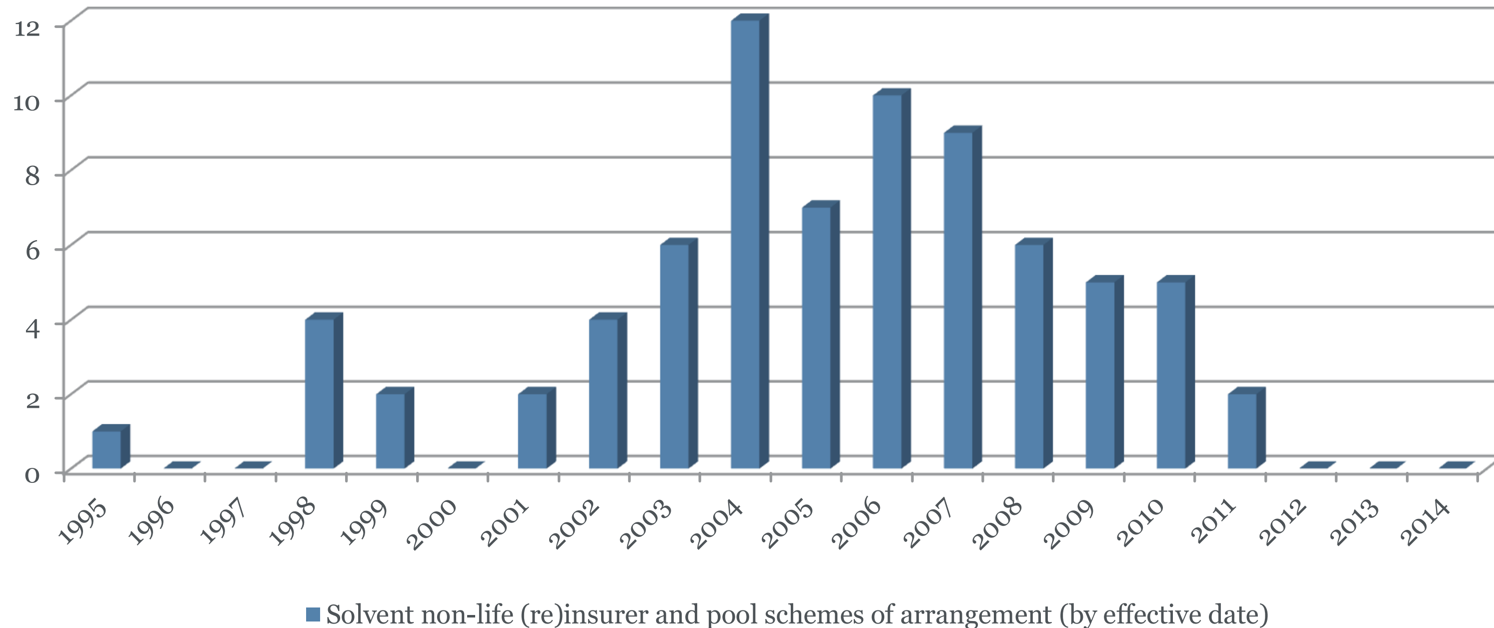
- Natural disasters
  - Hurricanes Andrew and Hugo
  - Exxon Valdez and Piper Alpha
  - Aviation claim (Korean Air, United Airlines and PanAm)
- Industrial injury claims and a wave of asbestos bankruptcies
- Leading to unprecedented pressure in the London insurance market – both Lloyds and corporate

Give us the tools?

- No separate administration/rehabilitation procedure for insurers
- Use of provisional liquidations and "reserving" schemes of arrangement
- 1989/2015:
  - 54 London market insolvencies
  - 36 (72%) ending in reserving schemes
- 2002-2018: many of these schemes converted to "estimation"/cut-off schemes as a means of achieving finality, eg:
  - KWELM
  - Sovereign
  - L&O
  - Orion - a hybrid between an insolvent cut-off scheme and for Qualifying ILU Policyholders

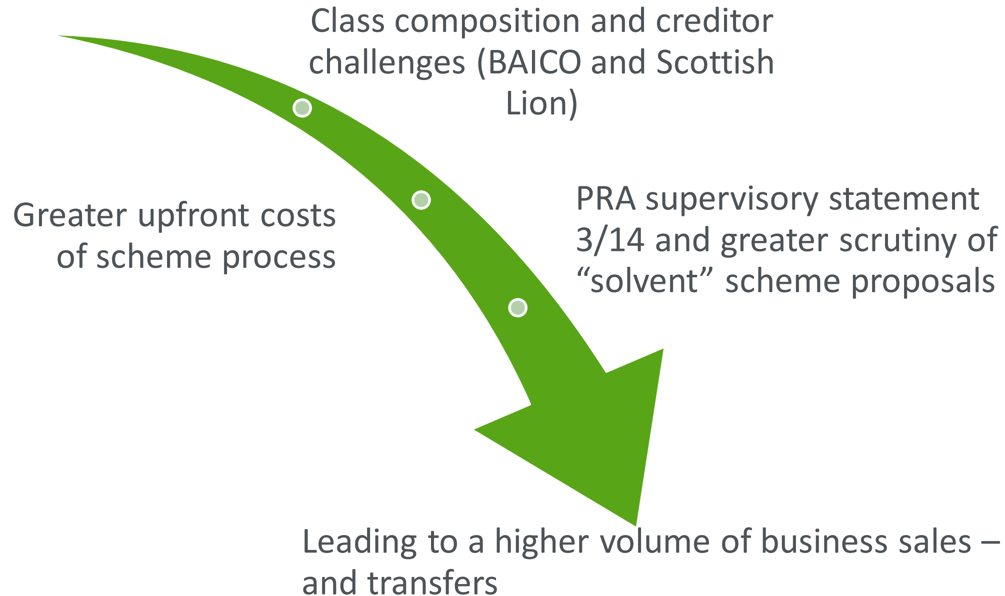
Unlocking value 1995-2011 – the era of the solvent scheme

- Finality -v- "pass the parcel"
- Solvent schemes – 1997 to 2010 – 71; 2010-2015 - 5

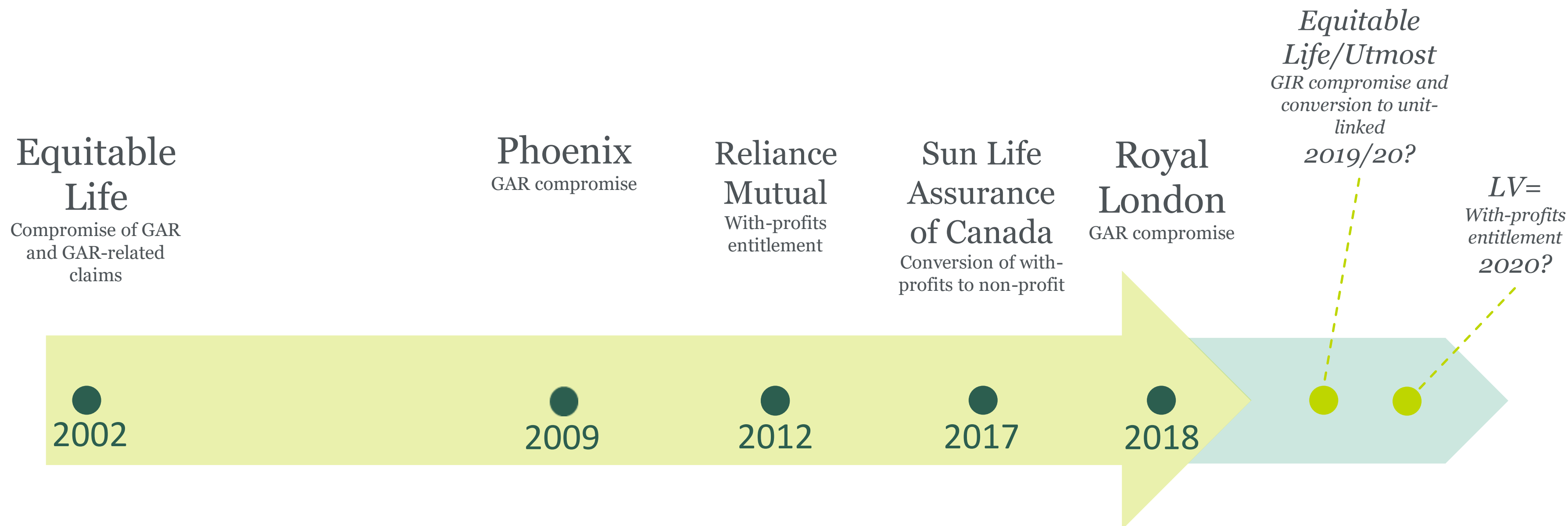


Unlocking value 1995-2011 (cont'd)

- Why the decline in the use of schemes?



Development of the solvent life scheme



Comparison with non-life schemes

Nature of the compromise

- Not a compulsory commutation
- Increased use of an opt-out?

Regulator attitude

- PRA – Supervisory Statement 3/14
- FCA – no guidance, but note statutory consumer protection objective

Independent review

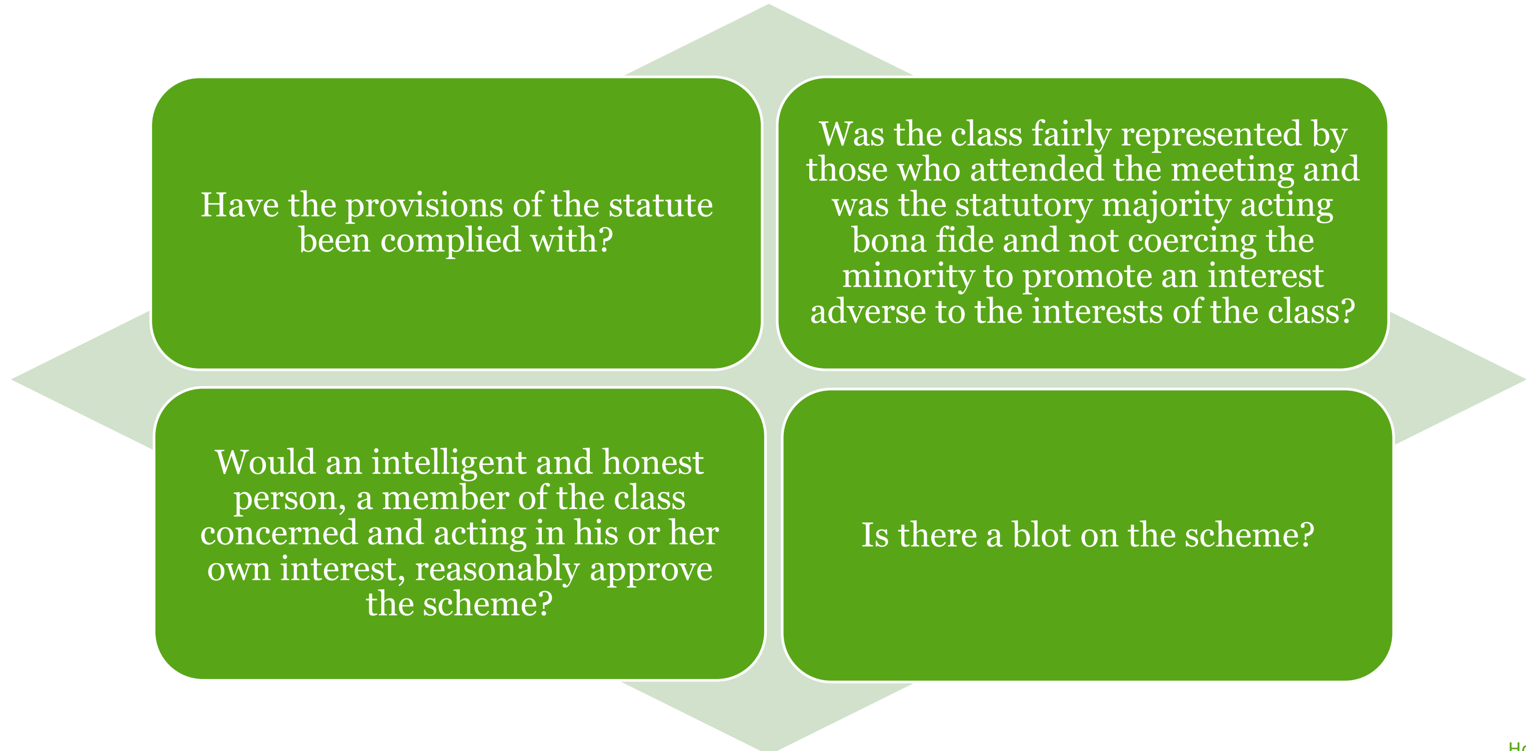
- Appointment of an independent actuary to assess the fairness of the scheme and report to the Court
- Use of fairness criteria

Court's attitude?

- A pragmatic gatekeeper?

The Court’s criteria

- Four elements for the Court to consider at the Sanction Hearing (*Re TDG*):



Addressing the *Scottish Lion* legacy

- Scottish Lion (2009)
  - Lord Glennie: common thread with solvent schemes – "a problem requiring a solution"
  - Rejected by Inner House: "not... a precondition to the sanctioning of a scheme, whether solvent or otherwise"
- Phoenix (2009)
  - Informed and honest man test satisfied
  - Right to opt-out meant there was "no question of underlying compulsion"
- Royal London (2018)
  - Opt-out <u>not</u> a complete solution
  - Concern for non-respondents:
    - Can the Court be satisfied vote at meeting represents the interest of those who have not engaged?
    - To the extent there is any remaining risk that some policyholders unwittingly bound, is this "an appropriate case for creditor rule"?

Why was Royal London an appropriate case?

- Access to Pension Freedoms
- Financial terms only possible in context of collective process
- Benefits to a wide group of policyholders, not just the company/shareholders
- Use of scheme avoided potential Equality Act issues
- Special arrangements for goneaways
- Quality of engagement and publicity

Conclusions

- Where does this leave the resolution of UK life insurers (both life and non-life)?
  - Lower risk of insolvency in a Solvency II world?
  - Challenges with achieving finality in a non-life context – can these be overcome?
  - Developing use of life schemes
- How does this compare with the US?

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