Policyholders Must Object To Insurer Reorganizations

By **Jonathan Terrell** (January 8, 2024)

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I am firmly opposed to insurance company reorganizations of any sort. All of them? OK — I concede there might be a tiny percentage that make sense, but the overwhelming majority of the time, policyholders are left holding the bag with insurance policies that too often pay out only a percentage of what they owe, many years later than when due.

Insurance is regulated at the state level, and every state has an insurance commissioner and a department of insurance. Insurance is a public good because it enables corporations and individuals to manage their risks, but it is highly susceptible to manipulation. This is because premiums typically get paid up front.

Then claims are made, perhaps denied, and perhaps paid, when the policyholder no longer has any leverage. Insurance commissioners exist to protect the insurance-buying public from this unequal power bargain, and they use a variety of regulatory tools in so doing.

Insurance regulators are failing the insurance-buying public as can be seen by the recently reported insolvencies of Arrowood Indemnity Co., the successor to the U.S.-based insurance business of Royal & Sun Alliance, in November 2023, and Bedivere Insurance Co., formerly OneBeacon Insurance Co. and successor to the U.S.-based insurance business of Commercial Union and General Accident, in March 2021.

So, what do I mean by an insurance reorganization? For over 20 years, I have been blogging, testifying against and predicting two main types.

1. The Thinly Capitalized Spinoff

In this species of reorganization, the insurance group goes through a period of internal reorganization to concentrate the worst and most volatile exposures — typically legacy liabilities — into a single company or small subset of companies, while transferring profitable ongoing renewal business out of them. The subset of companies is then sold to a third-party corporation, often a so-called run-off specialist.

Regulatory sign-off is achieved by reliance on highly questionable actuarial reports based on other worldly assumptions that appear to confirm that the entities are adequately capitalized.

In the 2014 OneBeacon regulatory hearings, we learned that their consulting actuaries had run 10,000 simulations that predicted with 93% confidence that every claim would be paid for at least 30 years by the spun-off companies. OneBeacon, now renamed Bedivere, was ordered into liquidation just seven years later in March 2021.

The Delaware Department of Insurance at least created a claims monitor position to ostensibly protect Arrowood policyholders' interests, but the monitor ultimately failed to do much of anything to protect them.

The Arrowood and Bedivere insolvencies are both prime examples of strong and profitable

insurance groups offloading their inconvenient legacy liabilities to the extreme detriment of their insureds.

2. The Loss Portfolio Transfer

Loss portfolio transfers are most often achieved using retroactive reinsurance, which is a complicated financial instrument.

Space here does not allow me to fully explain how this instrument functions, but it should not be confused with prospective reinsurance — a risk-management device all insurance companies use in the ordinary course of business.

Retroactive reinsurance transactions are exceptional and are used to transfer whole books of business rather than manage risk at the more micro level, which is the common use of prospective reinsurance.

The enormous concentration of asbestos-related liabilities at the Berkshire Hathaway subsidiary, National Indemnity Co., was achieved using retroactive reinsurance transactions with numerous other insurance groups, including Equitas Insurance Ltd., American International Group Inc., The Hartford Financial Services Group Inc., CNA Financial Corporation, Liberty Mutual Insurance Group and ACE American Insurance Co.

One of the idiosyncrasies of accounting for retroactive reinsurance is that under generally accepted and statutory financial accounting, the reserves are still reported on the balance sheets of the company that is transferring liability to the counterparty.

A key aspect of these transactions involving National Indemnity is that a different subsidiary, Resolute Management Inc., typically takes over claims handling responsibility, while National Indemnity pays the claims. Although nothing has legally changed between the policyholder and its insurer, it feels like a novation in the claims experience, because a wholly unrelated entity handles and pays claims after the retroactive reinsurance transaction.

The new folks are also quite at liberty to take wholly different coverage positions than the previous claims handlers that may have defined the relationship for many years. It is, after all, the new claims handlers' money. Cynics may say that the opportunity and incentive to act in bad faith is inevitably increased by the use of retroactive reinsurance, too.

Conclusion

Call me old-fashioned if you like, but I believe that once a bargain has been struck between an insurer and a policyholder, for a given insurance contract for an agreed premium, then both parties ought to be bound by it.

Key considerations of the corporation or individual in the market for insurance, assuming the price is right, are the credit strength of the insurer and its claims handling reputation.

When reorganizations occur, albeit without breaking any laws or insurance regulations, they may materially change the creditworthiness of the counterparty, and they may change the entity and philosophy for adjusting and paying the claims.

In sum, the nature of the transaction changes to one that is purely financial, rather than one that also includes reputational risk for the insurer. To my mind, that represents a failure

of public policy.

Yet time and time again, that is exactly what has occurred with the benign connivance of the insurance regulatory community. But enough is enough. This is a call to arms. If you think I am an alarmist, just ask policyholders of RSA, OneBeacon or Home Insurance Co. how much they are enjoying their now-defunct coverage.

When I testified as an expert witness against the RSA and OneBeacon reorganizations, only a handful of policyholders showed up to object.

When retroactive reinsurance deals are announced, policyholders should write their objections to the relevant insurance commissioner. It is time for policyholders to organize and object en masse every time the writing is on the wall.

Insurance commissioners are political appointees, subject to the usual weaknesses and desires of any political appointee. Some may even have the courage to stop objectionable transactions or to strengthen the terms for policyholders.

The federal government has left this vital aspect of our financial system to the states, but the states are failing policyholders. It is time for the insurance-buying public to take action into their own hands.

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Disclosure: The author testified as an expert witness in the RSA and OneBeacon regulatory hearings.

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