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Scrutiny of the bounty

Pamela H Woldow, practice leader, forensic accounting and litigation services at Smart and Associates LLP, offers an insight into steering a company through a US solvent run-off.

The decision of a solvent insurance company to abandon an unprofitable insurance line, or even cease operation altogether, triggers a radical business transition burdened by extraordinary strategic, tactical, operational and fiduciary pressures. As the focal point for diverse management, economic, regulatory and personal interests, a solvent run-off can come to look very much like a battle for control of a treasure galleon loaded with a vast variety of riches: cash, barrels of reserves, treasure chests full of premium payments, investment proceeds and reinsurance treaties.

Business as unusual

For executive management, the decision to undertake a solvent run-off cannot be a routine business-as-usual decision. Underestimating the significance and complexity of a shift to an active run-off mode is one of the biggest and most common misjudgments an insurance company can make. In effect, management must shift to an entirely different conception of the company and its future.

While a solvent run-off is not a hurricane-like liquidation, it is not automatically smooth sailing, either, and many a ship laden with bounty ends up at the bottom. The treasure ship's captains face many simultaneous challenges. Under intense time pressure, they must be masters and commanders of run-off strategy. They must keep a vigilant eye on the barometer of investments and cash flows. They have to focus on claims management as never before. They need to keep the ship's IT systems and operational infrastructure shipshape. They have to keep the crew happy or risk mutiny. And, of course, they must sustain a delicate working balance with their reinsurers. The stakes are high, and the risks of ineffective planning and management higher still.

The menu of run-off strategies

When contemplating a solvent run-off, management confronts a variety of possible exit options: portfolio transfer, sale to a third party, policy buybacks, reinsurance collection/commutation strategies and even running off the business to its eventual conclusion. Management may want to close up shop quickly and consider reacquiring as many policies as possible in order to lower the number of outstanding policyholders, and it may also consider buying out any future claims using cash on hand. With a portfolio transfer or outright sale management can get out quickly, but the value of the bounty takes a beating and most of the crew goes down with the ship. Alternatively, the company can finance a run-off through reinsurance commutation and aggressive collections and still wind things up pretty quickly. Alternatively, management can decide on a long-tail run-off, which preserves jobs and provides continued executive control for the longer run. Every option affects whether the ship floats or sinks, how fast or slow it is sailed and whether it journeys safely in deep water or struggles to stay off the shores.

Managing external forces and constituencies

There are, of course, constraints on management's options and the timing of the run-off. Management must turn its gaze away from developing long-term business and relationships and instead focus on immediate asset collection and preservation. This is because in light of their fiduciary responsibilities, the company's executives must ensure – first and foremost – that existing value is preserved and that steps are taken to enhance value during the run-off.

As long as the company remains solvent, regulators have only broad oversight authority and not the plenary powers state insurance departments assume in liquidations. But because regulators' paramount priority is to protect the interests of claimants and policyholders, regulators will keep a keen weather eye on solvency. Management's initial priority therefore must be to protect the bounty: to review the asset mix, review the adequacy of reinsurance, categorise claims and liabilities realistically and get aggressive with asset recoveries.

While self-interest might tempt management to prolong the run-off process and prolong its own employment tenure, shareholders and other stakeholders are unlikely to accept such a strategy passively. To keep them satisfied, run-off strategy must create strong incentives for all players to bring the run-off to an efficient and expeditious conclusion without encouraging a rush for the lifeboats or a feeding frenzy. Vendors, lenders and contractors also are likely to be highly evident and highly vocal. When it comes to collections or extending credit, external parties may suddenly develop a pronounced near-sightedness

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because the distant horizon just isn't relevant anymore.

Once the run-off starts, relationships with reinsurers will change fundamentally. Management's strategic focus may concentrate on collecting what typically is the largest asset of the company - reinsurance. When reinsurers learn that there will be no future flow of business and no continuing long-term relationship to foster and respect, they will likely place a stronger emphasis on their own short term financial interests. Relationships between insurer and reinsurer may become strained unless management exercises an adroit whip-hand when attempting to access the bounty of the reinsurance treaties.

Looking inward at people and processes

A solvent run-off also must focus on internal processes and on the people who must implement them. Management must constantly balance the need to control costs against the maintenance of adequate resources. A company's liquidity ratio begins to deteriorate the moment it goes into run-off, so it is critical that all available funds be invested in a way that both maximises returns and sustains the liquidity needed to settle and pay claims. Asset recoveries must be managed aggressively and must be converted to cash as quickly as possible. In addition to cash collection, management must simultaneously pursue set-off, debt sale and assignment strategies. Most run-off strategies include a strong focus on commutation, so management must come up with powerful incentives for commuting the most volatile reserves.

Managing information and controlling costs

In a run-off, costs are unlikely to diminish as quickly as revenues, so it is essential that management take all possible steps to minimise claims settlement costs. Although an uninterrupted flow of timely and accurate information is essential, run-off managers often underappreciate the need for sophisticated information management. The run-off process requires intense reliance on IT systems and capabilities, and this is the time to make sure information technology, processes and procedures are optimised. Poor quality data, including poor legacy or historical data, seriously impacts the efficiency of a run-off. Crucial underwriting information must be preserved to maintain an historical frame of reference.

New procedures must be implemented to compel TPAs to provide timely and accurate claims processing information. Otherwise, dramatic "friction losses" may occur that may not be readily evident to internal management. Management may be reluctant to make an investment of time and money in both technology and vigilant new control processes when things are going to wind down anyway, but scrimping on technology and information management at this point is a false economy.

The people perspective: capabilities and incentives

Competent, motivated employees are a treasure during a solvent run-off, and the deck crew cannot be taken for granted, either during the commencement or duration of a run-off. At the outset, management must immediately assess which players have the most critical knowledge and experience. This is no time to plug inexperienced players into critical roles.

Retention is likely to be a major issue: in the face of the uncertainty a run-off creates, trust and morale issues loom large. Human resources experts must be included in strategic and tactical planning, because as never before, HR planning and policy are essential keys to employee motivation, career planning, training and development in order to retain critical employees. From senior management on down, new performance goals and objectives must be developed, and compensation must be keyed tightly to those measures. Employee retention is particularly important in the claims area: rewards and incentives must be structured to motivate claims staff to achieve results that release capital in the shortest possible amount of time.

Smooth sailing...or stormy seas?

A successful voyage through a solvent run-off requires management to recognise and balance a complex array of forces, factors and considerations – short term and long term, internal and external, human and procedural, financial and operational, friendly and potentially hostile. To ignore any of these forces is to risk the entire bounty; to fashion them into a coherent, effective strategy represents a true triumph of seamanship.

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