CLAIM ESTIMATION/ACCELERATION
NO RETREAT – NO SURRENDER

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I. INTRODUCTION

There are certain issues that arise in the journey of life that strike a chord so dear to an individual or a group that they will advocate their position to the bitter end – reminiscent of the Bruce Springstein song – No Retreat No Surrender. In the reinsurance world - the concept of claim estimation/acceleration is one such issue.

The battles over claim estimation/acceleration began in the mid-1990s when receivers were looking for new methods to effect earlier estate closure. While the issue has certainly not been resolved, no new attempts at claim estimation/acceleration have materialized in the last several years.

II. OVERVIEW OF PAST ATTEMPTS

It is useful at this point, to renew the scorecard with respect to claim estimation/acceleration initiatives:

- NAIC adopts § 41.C(3) of the Insurers Rehabilitation and Liquidation Model Act which permits claim estimation (no specific reference to acceleration of reinsurance recoveries);
- RAA is successful in blocking several states' adoption of the NAIC model;
- Connecticut adopts a claim estimation statute, but it prohibits the acceleration of reinsurance recoveries on the basis of those estimates;
- Illinois, Missouri and Utah adopt claim estimation statutes; [2]

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- RAA is twice successful in changing Missouri law to prohibit the acceleration of reinsurance recoveries on the basis of claim estimates;
- RAA and Illinois receiver are successful in obtaining reversal of Mission's Final Dividend Plan permitting claim estimation/acceleration;
- In response to Mission defeat, California Insurance Department attempts to pass claim estimation/acceleration legislation three years in a row;
- RAA is successful in defeating California legislation three years in a row;
- Holland-America Court in Missouri upholds use of claim estimation/acceleration (prior to change in Missouri law referenced above);
- Integrity receivership court permits claim estimation/acceleration - reinsurers, including RAA will appeal - but appeal is not yet ripe. (New Jersey law is essentially the same as California law on the subject on which the reinsurers prevailed at the appellate level);
- Interstate Insurance Receivership Compact Commission (including Illinois, Nebraska and Michigan) adopted balanced approach in the Uniform Receivership Law (URL) which prohibits the accelerations of reinsurance recoveries on the basis of claim estimates.

III. SO WHAT'S THE PROBLEM?

State receivers of insolvent insurers have grappled in recent years with the dilemma of how to close estates earlier while still providing equity and fairness to affected creditors. But while claim estimation/acceleration may benefit some creditors, it disadvantages other claimants and works a potentially large financial detriment on reinsurers, a problem that will, in turn, likely be felt by primary insurers and consumers as the consequences of claim estimation/acceleration

[2] Illinois and Missouri Statutes were passed prior to employment of current RAA staff and before RAA members recognized the full ramifications of the practice.

reverberate throughout the insurance marketplace. Unfortunately, the interests of all affected parties are often difficult to reconcile.

a. Claim Estimation/Acceleration Unfairly Alters the Terms of Reinsurance Agreements

A fundamental premise of claim estimation/acceleration is to place a dollar value on claims that *may* be reported in the future and have reinsurers pay that dollar sum today. The problem for reinsurers is that their contracts with the insolvent insurance company, and the price the insolvent paid for that contract, are based on reinsurers paying only claims that are fully developed and definitely reported, i.e., there is no coverage under reinsurance contract terms for "future" claims, and the price of the reinsurance would very likely have been much higher had the terms addressed them.

Receivers have taken the view that statutes change and those changes may legitimately affect reinsurers' contract rights.

Reinsurers believe that the law is clear that neither a receiver nor a legislature can retroactively change a party's contractual liability. Although receivers have argued that claim estimation/acceleration effects a procedural - not a substantive - change, reinsurers disagree. Claim estimation/acceleration can result in a reinsurer paying more that it was contractually obligated to pay -- what, asks the reinsurer, can be *more* substantive?

b. Windfall for Whom?

Receivers have claimed that failure to estimate/accelerate reinsurance recoveries will result in a "windfall" to reinsurers. But this argument is premised on the theory that there will be a cut-off of liabilities. Reinsurers have not advocated a cut-off. They are ready and willing to pay what they are contractually obligated to pay -- nothing more and nothing less.

Indeed the "windfall" may inure to the estate through claim estimation/acceleration and will certainly inure to the benefit of *some* creditors at the *detriment* of others, as discussed below.

c. Why Do Reinsurers Resist Reliance on Actuarial Opinions?

What is wrong with actuarial estimates as the basis for claim payment under a reinsurance agreement? After all, reinsurers often commute their liabilities with receivers based on actuarial estimates, and they set their reserves in on-going business based on actuarial estimates. In fact, it seems the reinsurance business uses actuarial estimates on a regular basis.

While reinsurers *do* use actuarial estimates in their business, they *never* use them in the way being suggested by claim estimation/acceleration proponents. To wit, the difference between a commutation and claim estimation/acceleration is that the former is voluntary and the latter is forced. Reinsurers agree to commutations because the process is a two-way dialogue of give and take, where reinsurer and receiver alike have a say in the ultimate actuarial methods used and dollar value placed on reinsurer liability. It is this very give and take that often leads to both parties ferreting out the details and the infirmities in their respective positions that enables them to arrive at an acceptable number. Ultimately, if a party determines that it is not comfortable with the reliability of the estimates, it has the choice to walk away. Claim estimation/acceleration, on the other hand, is a draconian, one-sided approach that requires a reinsurer to pay a sum that is not a correct valuation of reinsurer liability -- whatever the number and whatever the method used, the reinsurer *must* pay the sum whether it is unilaterally determined by the receiver (Mission) or the result of an arbitration panel's decision (Utah statute). In fact, a reinsurer must pay under claim estimation/acceleration procedures even though no one knows better than a particular reinsurer how claims develop under certain of its reinsurance agreements; this information may never be adequately considered or simply rejected

in a claim estimation/acceleration approach. As a result, reinsurers see claim estimation/acceleration as heretofore proposed as a diametrical opposite to commutation, completely incomparable.

But what about reinsurers' use of actuarial estimates for establishing reserves? Is this scenario the same or similar to claim estimation/acceleration as a basis for paying claims? The short answer is absolutely not.

Actuaries are the first to point out that they change reserves from year to year, based on a variety of political, social, legal and other factors. Such estimates do not form the basis of actual payment (as in claim estimation/acceleration) -- unless the parties agree through a commutation that they can abide by an agreed-to sum.

A factor often overlooked in discussing the desirability of claim estimation/acceleration is the fact that actuaries produce ranges, not specific figures. Those ranges can vary widely over time. They may also change by wild proportions. It is because of these and other factors that actuaries typically provide wide-ranging caveats to their estimates. As a result, they provide no reasonable basis for actual payment of claims.

This can be best illustrated by the various estimates over the years concerning environmental and asbestos liabilities.

For example, in 1990 testimony before a House Subcommittee, a well-known accounting firm, Tillinghast, formulated illustrative scenarios under which U.S. insurers incur varying amounts of Superfund liability costs. After netting out reinsurance and direct excess writings abroad from the sum of the costs, insurers' liabilities for Superfund ranged from $37 billion to $426 billion (undiscounted). After discounting, the range was $23 billion to $170 billion.

In a March 1994 report,[3] A.M. Best predicted that environmental and asbestos liabilities for the insurance industry would fall between $55 billion to $623 billion, with a mid-range figure of $260 billion. Less than 2 years later, A.M. Best issued a new report[4] in which it "significantly lowered" its earlier projections resulting in a 78% reduction to $57 billion of the mid-range estimate and a 85% reduction of the worst-case scenario to $92 billion. This "sharp reduction" according to A.M. Best reflected "both improved information and more favorable industry trends."[5]

Under the rationale of claim estimation, Tillinghast's 1990 actuarial estimate of Superfund liabilities could have been the "reasonable basis" to determine reinsurers' future liabilities, and receivers would have made them pay in 1990 a sum somewhere in the huge actuarial range.[6] But what about the A.M. Best estimates of the same Superfund liabilities in 1994 and 1996? The sum reinsurers would owe under *these* estimates would have gone up significantly, then dropped tremendously. So which estimate is "more correct?" The estimate of 1990, 1994, 1996, or some estimate in the future? The answer is that *none* of these estimates was correct; but of course none was meant to be; after all, they were only estimates in on-going business operations and not the basis of any actual payment.

The problem with reliance on actuarial projections can inure to the detriment of an insolvent estate and its creditors, as it can to reinsurers. Industry and analysts had predicted a tapering off of asbestos liabilities only to find that creative plaintiffs' lawyers have now

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[3] Environmental/Asbestos Liability Exposures: A P&C Industry Black Hole.

[4] P&C Industry Begins to Face Environmental and Asbestos Liabilities.

[5] Id.

[6] Although such figures were estimates of potential industry liability, the wide variance remains when extrapolated and applied on an individual company basis.

expanded the potential liability, once again, beyond any previous estimates by bringing claims on behalf of individuals exposed to asbestos but not yet sick (unimpaired claimants), targeting third and fourth tier defendants and inventing seemingly endless theories of liability for non-product coverage. As a result, A.M. Best, Tillinghast and Milliman & Robertson have significantly increased their projections for asbestos liability. For example:

- In 1982 Johns-Manville (bankruptcy trust) projected total filings against it of 17,000 with total individuals exposed to its asbestos products in the neighborhood of 18-20 million;
- In 2001 Manville revised its projections, noting that as of May 2001, 530,000 claims had been filed with a projection of an additional 1.4 to 2.2 million filings. It increased its estimate of the number of individuals exposed to its products to 80-100 million;
- In October 2000, A.M. Best increased to $65 billion its estimation of how much asbestos personal injury claims will cost US insurers, which represents a 62 percent increase over its 1996 projection; and
- Milliman & Robertson increased its estimate of the mid-range cost of asbestos personal injury claims facing US insurers to $70 billion -- a 56 percent increase over their pervious $45 billion estimate.

Receivers with estates that have asbestos exposure would have significantly harmed their estates by estimating that exposure several years ago.

Delegating estimation to "qualified actuaries" using "sound actuarial practice" conveys a false sense of security. Given the paucity of data and an unstable legal environment, even sophisticated actuaries are likely to produce widely diverging estimates of individual loss distributions. [7]

[7] Neil A. Doherty, Ph.D. Professor of Insurance and Risk Management, The Wharton School, University of Pennsylvania.

Receivers have maintained that even though actuarial estimates may not be exact, they are still credible enough for purposes of claim estimation/acceleration. But "not 100 percent exactitude" seems to suggest that valuations can come reasonably close to the true underlying value of claims - the degree of exactitude may be closer to 0 percent than 100 percent.[8]

These vast changes in estimates of the same liabilities over time are illustrative of reinsurers' concerns and their point that actuarial science has its limits -- such estimates are intended to assist insurers and reinsurers in predicting future liabilities to reserve more appropriately for the realization of future claims -- but they were never intended nor is it appropriate, to use such "educated guesses[9] to demand actual payment based on wide ranges that will be adjusted the following year based on better information and new developments. If it turns out a receiver's actuarial estimate of a reinsurer's liabilities was wrong (which, as demonstrated in the above examples, is inevitable), the reinsurer will never recoup its later, proven overpayment. Likewise, policyholders will lose out when their percentage of dividend distribution for known claims (not covered by a guaranty fund) is diluted by the over-inflated and over-estimated losses of policyholders with unknown claims. Similarly, guaranty funds stand to lose when their often-substantial claim upon estate assets is diluted by the estimates of future asbestos, environmental, tobacco, and other claims that may never materialize.

In sum, forcing reinsurers to accept inaccurate actuarial estimates as the basis for payment can only be described as a massively flawed and short-term solution that will foul up an already bad situation for all involved, reinsurers and policyholders alike. There is no long-term benefit in claim estimation/acceleration for anyone it affects.

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[8] Id.

[9]Even A.M. Best called its 1994 actuarial estimates an "educated guess" on how environmental liability may affect the industry over the next 30 years."

d. Claim Estimation/Acceleration Disadvantages Claimants

Claim estimation/acceleration, by its very nature, is a benefit to some claimants while it is a detriment to others.

The rationale that receivers have used for claim estimation/acceleration is their desire to close estates earlier to (1) avoid the administrative expense of a longer run-off, and (2) obtain reinsurance recoveries sooner than later, particularly if the reinsurer is in questionable financial condition.

Ultimately, the use of claim estimation/acceleration requires the distribution of estate assets using one of at least two methods: a ground-up estimation or a top-down estimation. Either one results in substantial inequities to policyholders and other claimants as the following illustrates:

Ground-Up Estimation - Policyholder must show actuarial projections that it has suffered unknown losses – but only large corporate insureds can meet this standard, not individual policyholders. Thus, claims of individual policyholders are cut-off.

Third party claimants are not even aware that they have suffered a compensable loss. Thus, their claims are cut-off.

Top-Down Estimation - Assuming the receiver uses this type of estimation process, every policy is determined to have a value and every policyholder has some type of recognizable future loss.

But if there are 5,000 policyholders

- and 250 have claims;

- and claims are $25,000 each;
- in the aggregate there is $6,250,000 of unpaid loss.
- If each policyholder is given a share, then each receives $1,250;
- 4,750 get $1,250 too much; and
- 250 get $23,750 too little.

Claim estimation/acceleration by *any* method guarantees that every policyholder and claimant will receive the *wrong* amount (or *no* amount) and every reinsurer will pay the *wrong* amount.

e*. *A Better Approach to Estate Closure

Through the course of the late 1990s, reinsurers analyzed the estate closure issue, the interest of the affected parties, the goals that those parties sought to achieve and the equities for all concerned. In conjunction with state receivers during the deliberation of the Interstate Compact Uniform Receivership Law, the RAA helped to develop a different approach to estate closure, which is reflected in Chapter 8 of the URL, a copy of which is attached to this paper.

The following is a brief overview of the approach:

- Once the liquidator makes a determination that the essential liquidation functions of the estate have been completed, except for the continued processing of claims and reinsurance recoveries, the liquidator *may* apply to the liquidation court for an order authorizing the liquidator to close the estate.
- If granted, the liquidator obtains a qualified actuarial projection of the estate's ultimate assets and ultimate liabilities and, based upon those projections, determines the dividend that creditors would be entitled to if all claim liabilities

were run-off to natural conclusion. The liquidator, with court approval, declares a percentage dividend to be paid to all claimants. In the event that the liquidator's projections are inaccurate, and insufficient assets are available to pay the same percentage dividend to later-year claimants, a statutory provision would provide the liquidator with immunity from any liability for the shortfall as long as the liquidator acted in a reasonable manner.

- Once the declared dividend is paid to all claimants with known and allowed claims, the liquidator has the flexibility to: run-off the remaining claims; transfer the run-off to a liquidating trust; arrange for the assumption of the run-off by a licensed insurer or reinsurer; or contract with a state guaranty fund to perform the claim handling function. In all instances, reinsurers would remain obligated to pay claims as they are reported and liquidated. Depending on the alternative chosen by the liquidator, the estate can be closed decades earlier, those with reported claims will still be timely paid, and those with future reported claims will still be paid as their claims develop.
- Statutory provisions ensure that claimants are protected by the oversight function of the Department of Insurance similar or identical to the way in which such oversight is performed for the claims handling practices of a solvent insurer.

The advantages of this approach are many:

- Policyholders, guaranty funds and other creditors with known and allowed claims are paid their dividend earlier, without waiting for the completion of the run-off of outstanding and unknown claims.

- The obstacle which often prevents liquidators from declaring and paying interim dividends -- potential liability -- is removed.
- The administrative expenses of the receivership and the duplication of costs between the liquidator and guaranty fund functions are eliminated. Claims are run-off with the typical overhead costs associated with a normal insurance operation.
- Policyholders and third-parties who may become aware of known claims in the future are protected in that they may file the details of their claim as they become aware of it, and it will be adjudicated in the normal course of business. They are not prejudiced by an early cut-off of liabilities, and they receive payment of their dividend when they would have received payment of their claim had their insurance company remained solvent, that is, the claimant is paid when the claimant has a *known* claim, liability has been established and the value of the claim has been determined.
- The assets of the insolvent insurer are protected in that claimants are not paid on the basis of estimates. Basing payment on estimation can result in the approval of amounts in excess of what the insolvent insurer's ultimate liability would have been had the claims been allowed to develop.
- Likewise, the contractual rights of reinsurers are protected as they continue to pay reinsurance recoveries on the basis of *known* claims in accordance with their contractual obligations, with the ability to assess whether there is, in fact, liability under the insurance policy or reinsurance contract.

This approach meets the goals of the affected parties and preserves the rights and obligations of those involved in the process.

Reinsurers cannot and should not be expected to pay funds based on speculative guesswork. Claim estimation and acceleration of reinsurance recoveries will adversely affect the insurance marketplace by making reinsurance less available and less affordable as a result of the significant credit risk that reinsurers would have to bear through the drastic modification of their contractual obligation, and the elimination of their contractual rights. And consumers will ultimately bear the burden of a fiscally unsound and irresponsible process that would allow a liquidator to write in the amount due the estate on the reinsurer's blank check.

In sum, claim estimation/acceleration, as proposed thus far, is plainly not a viable option for estate closure -- it is an unfair and one-sided short-term fix for a long-term problem.

There are only three truths that we know for certain about claim estimation/acceleration, and they are

- Some reinsurers will bear burdens that ought to have borne by others;
- Some reinsurers will pay estimated IBNR that would never have developed into claims at all; and
- Some reinsurers will escape the liabilities they would have otherwise incurred.[10]

In a time when potential terrorism losses threatens reinsurers' very survival and asbestos losses are rising significantly with no end in sight, reinsurers will and must continue to engage in the battle against ideas and approaches that further erode their contracts. In Springstein's words:

No Retreat – No Surrender.

[10] Phillip R. O'Connor, Ph.D., Principal/Coopers & Lybrand Consulting, Former Director of the Illinois Insurance Department.