CLAIM ESTIMATION - SO WHAT'S THE BIG DEAL?

INTRODUCTION

State receivers of insolvent insurance companies have grappled in recent years with the dilemma of how to close estates earlier while still providing equity and fairness to affected creditors. Unfortunately, the interests of all affected parties are often difficult to reconcile. Reinsurers and their side of the story have only recently come into this discussion because receivers are only now asserting a novel concept, that claim estimation as the basis for payment of reinsurance recoverable is the solution to the problem. But while claim estimation may have significant benefits for receivers, the other side to the coin is a potentially large, financial detriment for reinsurers, a problem that will, in turn, most probably be felt by primary companies and consumers as the consequences of claim estimation reverberate throughout the insurance marketplace.

Because reinsurance recoverables are often an insolvent's largest asset, reinsurers have much at stake in the claim estimation discussion. Likewise, they have much information and a unique perspective to add to and enrich the discussion. In this regard, this paper will explain the concerns of many U.S. and non-U.S. reinsurers regarding claim estimation and early estate closure, and offer a win-win solution to the problem for both

reinsurers and receivers.[1]

What Is the Problem with Claim Estimation?

Why do reinsurers resist claim estimation as a way to close an insolvent's estate early? After all, most reinsurers might understand and even be empathetic regarding receivers' problems

and reasons for proposing earlier estate closure. For example, receivers would like to close estates earlier because they believe

- keeping an estate open will incur further, unnecessary administrative expenses;
- supervising courts and state auditors don't understand why the estate of an insolvent insurance company must remain open for a decade or more; and
- policyholders have a right to be paid as soon as possible on their claims.

If reinsurers understand these reasons, why don't they go along with claim estimation? Basically, because claim estimation is a means of closing an estate early at reinsurers' expense, and there are better alternatives available. The claim estimation theory unfortunately does not take into account all of its serious, real life ramifications, including its reliance on unreliable estimates, its virtual rewriting of reinsurance agreements by

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requiring claim payment where there is no certain claim or claimant, and worst of all, claim estimation raises a genuine threat to reinsurer solvency. In turn, claim estimation could threaten insurer solvency and the industry as a whole.

Claim Estimation Unfairly Alters the Terms of Reinsurance Agreements

A fundamental premise of claim estimation 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's only response is to say that laws change and so may a reinsurance contract, i.e., that state law for insurance insolvencies may change to permit claim estimation and those changes alter the reinsurance contracts. However, the law is clear, in reinsurers' view, that neither a receiver nor a legislature can retroactively change a party's contractual liability. Receivers answer, asserting that this retroactive change is procedural not substantive, and that the law permits retroactive procedural changes in a contractual relationship, including the application of the "procedure" known as claim estimation.

Reinsurers reply that payment on the basis of estimation is far more than procedural because a reinsurer may well be forced to pay for more than it was contractually obligated to pay -- what, asks a reinsurer, can be *more* substantive?

Finally, receivers have expressed the belief that by not estimating the value of future claims, reinsurers will experience some sort of "windfall" due to the insolvency. Reinsurers respond by pointing out that there is no basis for such an assertion, that they have not sought a cut-off of their liabilities, only that they pay what they are contractually obligated to pay -- nothing more and nothing less. Because claim estimation unfairly alters reinsurance contracts, it is not a viable option to early estate closure for reinsurers.

Claim Estimation Is Based on Erroneous Assumptions about Actuarial Opinions in Insurance

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 currently being suggested. To wit, the difference between a commutation and claim estimation 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, 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 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 approach. As a result, reinsurers see claim estimation 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 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) -- 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 is the fact that actuaries produce ranges, not specific figures. Those ranges can vary widely over time. They may also change by wild proportions. As a result, they provide no reasonable basis for actual payment of claims.

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,[2] A.M. Best predicted that environmental and asbestos liabilities for the insurance industry would fall between $55 billion to $623 billion, with a

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

mid-range figure of $260 billion. Less than 2 years later, A.M. Best issued a new report[3] 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.[4]

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.[5] 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.

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

[4] Id.

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

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[6] 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 though the imposition of claim estimation (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

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

long-term benefit in claim estimation for anyone it affects.

Claim Estimation Could Threaten Insurance Industry Solvency

The solvency threat posed by claim estimation to the insurance industry and the insurance-purchasing public is definite and significant in light of the vast amounts that liquidators are allocating to speculative unknown claims.

- In one well-known insolvency, the Liquidator has estimated that the estate's liabilities will be in excess of $2 billion;

- Of this amount, the Liquidator estimates that approximately $701 million is based on outstanding *known* losses -- the *value* of which would be estimated, and approximately $1.34 billion is based on *unknown IBNR -- the existence of, liability for and value of which would be estimated*.

- Based on this guesswork, the Liquidator seeks to accelerate $1.24 billion in reinsurance recoveries for unknown IBNR.

Receivers -- and certainly regulators -- cannot turn a blind eye to the real solvency risks posed by claim estimation to reinsurers and the industry. Doing so for short-term gain of early estate closure would be to win the battle but lose the war. And the claim estimation method is even less savory in light of the fact that there are other, viable options available that pose no such solvency risk.

Thus, the only certainty about claim estimation is that every reinsurer will pay the *wrong* amount and every claimant (and policyholder) will receive the *wrong* amount. But the real costs of claim estimation are not all that reinsurers find difficult with the matter.

Reinsurers resist claim estimation also because they have a different perspective on the problem it is supposed to solve, i.e., early estate closure, that some receivers have to date failed to recognize.

Receivers and Reinsurers Need to Share Perspectives on Early Closure of Estates

Receivers need to take into account the differing, reinsurer perspectives on early estate closure because reinsurers (and their recoverables) are the key to success of most any estate closure. Claim estimation fails to do this. Taking into account reinsurers' views on early estate

closure will lead to parties finding a solution that benefits all. Failure to do so will result in continued litigation and substantial waste of estate assets.

Administrative Expenses of an Estate Do Not Need to Be a Problem

To begin with, as noted above, receivers explain the need for claim estimation and early estate closure, in part, because keeping an estate open for long periods of time will incur further, unnecessary administrative expenses. However, many reinsurers believe that some estates have not been economically or efficiently administered, and that there are other ways to run-off an insurer's claims that incur far less expense. And this viewpoint is difficult to simply dismiss because it comes from reinsurance companies that are run by successful business executives who have more than a little experience in administering

enterprises with cost-efficiencies while fulfilling legal, contractual, and other obligations.

Reinsurers also note that had the insurer not been insolvent, administrative costs would have been incurred over the life of the claims in any event. And incurring such cost for a number of years, albeit in a more efficient and economical manner, is implicit in the insurance business, in solvency or insolvency -- it is simply the nature of insurance claim development. Therefore, reinsurers do not necessarily understand why receivers believe it is essential to close an estate for the sole purpose of preventing future administrative costs. In reinsurers' view, the focus should be on streamlining administration -- not ending it prematurely.

Reinsurers Can Help Receivers Educate Their Audiences about Insurance Insolvencies

Turning to another receiver view regarding estate closure, there is little doubt that many supervising courts and state auditors don't understand why the estate of an insolvent insurance company must remain open for a decade or longer. Reinsurers do not dispute the existence of this problem for receivers and their need to address it. In fact, receivers would probably agree with reinsurers that this problem is indicative of a need to educate those courts and auditors about the facts and circumstances surrounding long-tail casualty insurance and reinsurance business.[7]

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[7] There are a number of objective, authoritative documents and studies in existence that demonstrate this quite clearly. For example, the RAA's

To the extent that reinsurers can assist receivers in this educational process, they are more than willing do so. Moreover, it only makes sense to include reinsurers in this education process as they can provide the best and most relevant materials, statistics and other resources. In reinsurers' view, the answer is not to buy into the views of the uninformed but rather to enlighten them.

Consider a Different view on the Early Claim Payment Issue for a Better Solution

With respect to the third rationale often heard from receivers -- that policyholders are entitled to earlier distribution -- again, reinsurers are not in disagreement with the general idea. Rather, reinsurers see receivers' framing of this issue as too broad; in reinsurers' view, the issue requires a more sophisticated analysis in order to properly and equitably address it.

To wit, when receivers discuss paying claims, they are talking about more than just policyholders, it's not quite that simple: claimants who might be paid earlier and who it is assumed might benefit from claim estimation include (1) persons with claims that a guaranty fund pays on behalf of the insolvent (i.e., policyholders), (2) persons with claims not covered by a guaranty fund that the insolvent's estate pays directly (i.e., policyholders and others), and (3) the guaranty fund itself. Facing the reality of these claimant details, in reinsurers'

Historical Loss Development Study, 1995 Edition, shows that for general liability (including asbestos and other environmental liability), it takes 9 years for 90% of a primary insurer's liability to develop, P.22, yet it takes 29 years for 90% of the reinsurer's liability to develop on that same business *excluding* asbestos and other environmental liabilities. p.11.

view, is the only way to arrive at a way to properly and timely pay their claims. As it turns out, timeliness of claim payment is a different matter for each category of claimant.

For example, as receivers are well aware, the vast majority of policyholder claims *are* in fact satisfied by guaranty funds in a very timely manner -- quick payment of policyholder claims is the very purpose of guaranty funds.[8] As a result, the focus of timely payment cannot be on

the needs of policyholders generally, but it must point to the two other remaining concerns, i.e., claims paid directly by the insolvent's estate, and the guaranty fund itself.

These two remaining concerns then raise the issue that is the focus of claim estimation -- entitlement to payment of a claim. Where a claimant has a legitimate and definite claim that the insolvent's estate will pay directly, reinsurers do not dispute that payment should be made without requiring the claimant to wait decades until all claims in the estate are reported and resolved. But where a claimant has yet to identify a particular claim, under both insurance policies and reinsurance agreements, payment is not forthcoming now -- a claimant has no right to payment today -- but only at some future date

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[8] The NAIC's model law for states to use to establish a guaranty fund explains that "the purpose of this act is to provide a mechanism for the payment of covered claims under certain insurance policies, *to avoid excessive delay in payment* and to . . . minimize financial loss to claimants or policyholders because of insolvency of an insurer[.]" Post-Assessment Property and Liability Insurance Guaranty Association Model Act, NAIC Model Regulation Service, July 1996 at 540-1, Section 2 (emphasis added).

when the claim is reported and fully resolved. Receivers, on the other hand, appear to argue that such claimants are entitled to payment now, before the claimant has any right to claim payment, and before a "claim" even exists.

Indeed, had the insolvent insurer remained solvent, future claimants would not be paid until a known claim was reported, fully developed and resolved. Reinsurers believe that future claimants are entitled to no better treatment as a result of their insurer's insolvency. It simply is not fair to reinsurers to completely ignore their view on this matter in fashioning a way to pay future claims today.

Are the above review of the problem and differing views on present and future claims reconcilable? In reinsurers' view, the claim estimation procedure is one-sided and does not address their concerns. Claim estimation makes no place for reconciliation. As explained below, however, there are alternatives that exist that may satisfy the desires and needs of both receivers and reinsurers.

The Solution to Early Estate Closure and Alternative to Claim Estimation

Because reinsurers have a fundamental opposition to the claim estimation resolutions being proposed by some receivers, they have undertaken during the past year a comprehensive review of the early estate closure issue in an attempt to find some middle ground.

In doing so, reinsurers have started with the premise that an analytical approach is

needed, specifically one that:

- identifies the interested parties;
- identifies the specific interests and needs of each of those parties; and
- designs alternatives to meet the legitimate needs and interests of those involved.

Because the analysis takes into account the interest and needs of *all* parties, it necessarily precluded consideration of claim estimation as a viable alternative. This is because, as noted earlier, claim estimation is one-sided, excluding the interests of many parties it affects.

Interested Parties

There are a number of groups interested in the administration and outcome of a receivership, including

- policyholders
- receivers
- primary companies/guaranty funds
- reinsurers

The goals of these parties varies and may seem to conflict. However, there *are* alternatives available that can harmonize these divergent interests.

Goals

Policyholders understandably want to receive payment on their allowed claims as soon as possible. Because state guaranty funds cover the vast majority of these claims, timing is more of an issue for policyholders with claims not covered by a guaranty fund, and those with claims in excess of covered claim limits.

Secondly, policyholders have an interest in receiving the highest dividend payment possible on their allowed claim. Again, the issue affects only those with claims not covered by a guaranty fund, and those with claims in excess of covered claim limits.

Thirdly, receivers have an interest in reducing administrative costs in a receivership in order to maximize payments to claimants. Additionally, receivers favor early closure to avoid

external pressure, whether that pressure is exerted by politicians, supervising courts, auditors or other receivers/regulators.

Receivers are also interested in equitably treating all claimants. For this reason, they tend to disfavor cut-off approaches because they disenfranchise those with claims involving a longer development period.

Primary companies and guaranty funds have an interest in recouping their assessments sooner and reducing administrative costs to maximize their recoveries on

assessments. And, reinsurers want to pay their obligations in accordance with contractual terms or, in their discretion, voluntarily commute.

A New Alternative Approach

Various parties have proposed alternative approaches to this problem. One approach suggested by reinsurers would provide as follows:

- 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, and 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 is 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 she had a *known* claim, liability had been established and the value of the claim had 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

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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, as proposed thus far, is plainly not a viable option for early estate closure -- it is an unfair and one-sided, short-term fix for a long-term problem. The grave faults of claim estimation coupled with acceleration of reinsurance recoveries come

into further relief when one considers that there are other, viable options for early estate closure without the negative side-effects. The alternative suggested by this paper is such a win-win method for early estate closure that benefits *all* parties involved in an insurance company insolvency. It is hoped that receivers and legislators alike will embrace this positive alternative, fashioning a remedy that
is designed to address the interests of all affected parties, and that recognizes its long-term effects on the insurance marketplace.