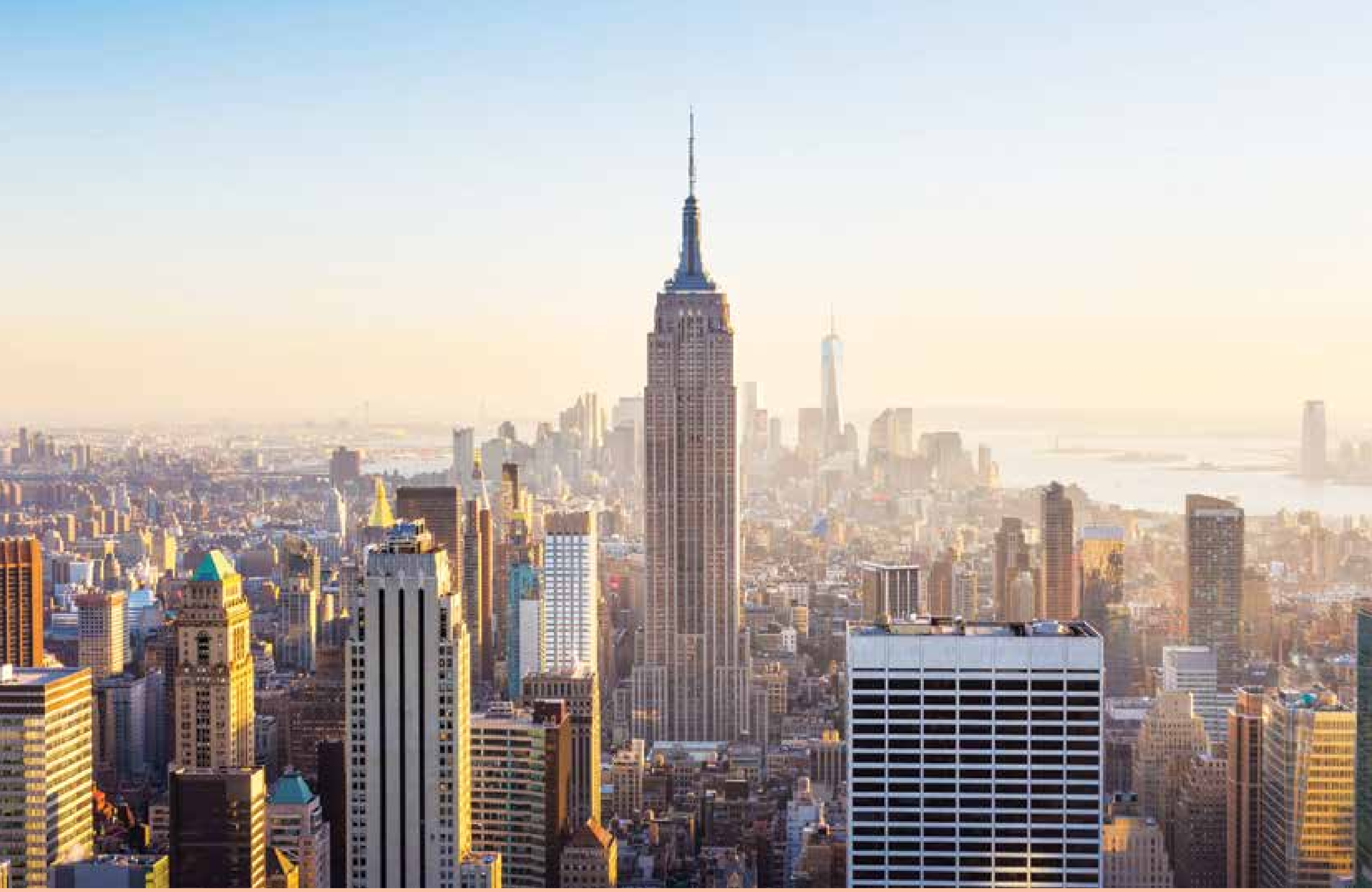

Supervised Run-Off, Liquidation and Payment of Claims
Lumbermens Mutual Casualty (2003)

Background and context

Table 9: Lumbermen's Key Financial Indicator, 2001-2003

Key Financial Indicators ($ million)	2001	2002	2003
Net premiums	1,880	697	240
Net profit / (loss)	71	(205)	(517)
Total assets	7,091	6,071	5,229
Total liabilities	5,825	5,374	5,027
Surplus (net assets)	1,266	696	202

Lumbermens Mutual Casualty Company (Lumbermens) was founded in 1912 to manage the risk exposures of the lumberyard industry under the then newly enacted workers' compensation laws in Illinois. By 2000, Lumbermens became one of the top 20 general or Property and Casualty (P&C) insurers and was also one of the largest workers' compensation insurers in the US. It also offered the widest range of personal and commercial P&C insurance in all 50 states in US and foreign markets including Canada, Mexico, Australia and Europe.

From 2000 to 2003, a number of P&C insurers in the US became financially troubled and were placed under liquidation proceedings, triggering the obligation of insurance guarantee funds to pay protected claims. Lumbermens, however, was an exception. It was placed into supervised run-off[83] in 2003, and was liquidated in 2013. The resolution of Lumbermens (including its insurance subsidiaries and affiliates) was one of the largest P&C run-offs in the US. It lasted almost a decade under the close supervision of the Illinois Department of Insurance (Regulator) and culminated in the successful orderly wind-down of Lumbermens.

In 1996 and 1997, Lumbermens was hit hard from asbestos claims relating to its workmen compensation policies. This resulted in limited capital, inadequate operating profitability and pressures from downgrades by rating agencies. However, Lumbermens was able to address its immediate capital needs through the issuance of subordinated debt. It also pursued the strategy of rapid growth through acquisitions and product expansion, and maintained a strong rating. From 1997 to 2000, there was further growth in underwriting and premiums as Lumbermens added 20 insurance subsidiaries and various non-insurance entities through more acquisitions and new company formations. This created a large and complex corporate structure that posed significant challenges to the Regulator during implementation of Lumbermens' wind-down.

In 2001 and 2002, the capital position of Lumbermens significantly deteriorated. Its surplus (excess of asset over liabilities) narrowed due to reserve strengthening, realised capital loss and weak operating results. As a mutual insurer (owned by policy owners), Lumbermens also found it hard to raise capital while efforts to find a sponsor for demutualisation proved unsuccessful. By December 2002, Lumbermens' risk-based capital dropped to an 'authorised control level',[84] and three rating agencies downgraded its rating to 'B'. By 2003, Lumbermens had run out of options and entered into run-off.

Resolution of Lumbermens – Timeline of Key Events

2003
Lumbermens entered into run-off (cease writing new or renewal business).

Feb 2003
Risk based capital at "mandatory control level".

Regulator issued corrective orders requiring Lumbermens to address its capital.

Lumbermens's capital restoration plan was not accepted.

Jul 2003
Regulator issued corrective order for Lumbermens to cease writing new or renewal business.

Oct 2003
Lumbermens engaged professional run-off management firm to continue its run-off.

Dec 2003
Lumbermens strengthened its reserve.

Regulatory support (e.g. accounting allowances).

Realised need for formal run-off plan and Regulator's support.

Mar 2004
Lumbermens submitted comprehensive run-off plan with committed guiding principles.

Aug 2004
Professional run-off arrangement was terminated and some of the firm's staff joined Lumbermens.

Jul 2012
Receivership of Lumbermens.

10 years of run-off produced positive results with greatly reduced liabilities and a simplified corporate structure. Eased Lumbermens's transition into closure through receivership.

May 2013
Liquidation of Lumbermens triggered the guarantee fund across 50 states to assume responsibility for the claims liabilities up to the coverage limit.

[83] A state where the insurer could not issue new policies and could only collect premiums and pay claims under existing policies
[84] A state where the regulator may place the company under regulatory control

Resolution actions

Corrective actions and run-off

In early 2003, the Regulator imposed several corrective orders on Lumbermens, including the requirement to submit a capital restoration plan. However, the Regulator rejected a proposal by Lumbermens, and subsequently issued an order for it to cease writing any new or renewal business effective 1 July 2003.

The decision by Lumbermens to adopt run-off as a resolution strategy was premised on four key considerations. First, the external environment was not conducive for either a private market solution or receivership. The latter would adversely disrupt the market, since Lumbermens was the sixth largest insurer for workmen compensation in the US with over 200,000 open multi-state claims. During that time, almost 30 workmen compensation insurers failed, including large providers such as Reliance, Legion, Superior National and Fremont. Consequently, guarantee funds in the US faced significant pressures from strained resources. Secondly, the run-off solution would protect the interest of policy owners from premature cancellation of policies, as well as avoid delays and costs from placing Lumbermens under receivership. Third was Lumbermen's arrangements with reputable reinsurers to support the run-off. Lastly, run-off was seen as an orderly approach to "shrink" Lumbermens as a means of orderly transition into liquidation.

From the start, in March 2004, Lumbermens adopted a comprehensive run-off plan with sound guiding principles. It committed to the Regulator that all valid claims under the policy contract would be paid in a timely manner without reduction, or be settled at an amount mutually agreed with the policy owner or claimant. A key aim was to maximise the value of assets, among others, through recovery of premiums and reinsurance receivables. Management would also provide the Regulator with full information required for effective supervision and oversight, including monthly results of actual performance against projections. In addition, Lumbermens would adopt high standards of transparency and accountability to policy owners and creditors through disclosures in publicly available filings (quarterly and annual financial statements) and regular meetings with various regulators and guarantee funds to provide status updates. However, implementing the run-off strategy was not straightforward. Lumbermens engaged a professional run-off management firm but terminated the agreement in less than a year, having realised that run-off activities were best performed by Lumbermens' own staff and management.

During the run-off, Lumbermens undertook three key measures to implement an orderly wind-down. Firstly, surplus enhancing transactions created balance sheet surplus via settlement of Lumbermens' obligations at payments considerably below book value (e.g. commutation of Lumbermens' participation in reinsurance pools, policy disengagement with large commercial insureds, and commutation of inward reinsurance). Second, liquidity enhancing transactions that supported claims payment (e.g. timely collection of reinsurance recoveries on paid claims, collection of outstanding premiums, ceasing of policy owner dividends, mergers of subsidiaries to release liquidity, and restructuring of the investment portfolio to maximise yield and meet its cash flow needs). Third was staff retention arrangements, to avoid the flight of institutional memory that proved to be essential for the wind-down. The measures taken by Lumbermens ended up producing positive results, as direct claims were reduced by almost 90% (from $11 billion to $1.3 billion) through settlement. Inward reinsurance claims were also lowered by almost 90% (from $1.3 billion to $100 million) through settlement at discounts that exceeded those granted to direct insureds. Besides that, the number of claims files were brought down by 95% (from 213,000 to 11,000 cases), and non-US operations were wound-up through closure or disposal of operations of subsidiaries in Canada, Europe and Australia.

A key success factor of Lumbermens' resolution was close regulatory support and oversight throughout the run-off process. The Illinois Department of Insurance ended up issuing over 500 corrective order to Lumbermens and prescribed allowances for accounting practices that had a positive effect on its statutory surplus of $1 billion (e.g. through discounting rate for loss reserves). Under this "supervised" run-off, the Regulator permitted Lumbermens to use an "economic" basis accounting practice for financial statements, compared to statutory accounting principles.

> ***Liquidation was the next step in the process ... our staff has worked diligently during this transition with interest to Lumbermens' creditors and customers***
>
> Illinois Department of Insurance

The successful run-off resulted in a group with greatly reduced liabilities and a simplified corporate structure that served to ease Lumbermens' transition into receivership (July 2012) and liquidation (May 2013). The latter triggered provisions of insurance guarantee funds across 50 states in the US to assume responsibility for claim liabilities of policy owners up to coverage limits.

Key takeaways

The strategy of run-off for resolution of troubled insurance companies can yield significant advantages. These include minimising disruption to the market and crucially, to protect the interest of policy owners through claims settlement and continuity of coverage (compared to direct liquidation which results in termination of policies). The run-off period also opened up a window for policy owners to find replacement cover. In addition, run-off by management eases the strain on insurance guarantee schemes in terms of administrative costs, as well as payout obligations.

The case of Lumbermens demonstrated three key factors for successfully implementing a run-off strategy. First was leveraging the expertise and knowledge of existing employees for the settlement of claims, marshalling of assets, or other activities purposed to "shrink" Lumbermens. Second was the "supervised run- off", which entailed combining a formal run-off plan with close supervisory oversight by the Regulator. This led to the positive outcome of an orderly wind-down, and the eventual transition of Lumbermens into liquidation with a simplified structure and reduced liabilities. Last but not least, early and decisive action by the Management of Lumbermens to enter into a run-off arrangement and to work closely with the Regulator, proved to be highly beneficial to policy owners and claimants. This decision was challenging on many fronts, particularly when the capital position of a troubled insurer was rapidly deteriorating in market conditions that were not conducive for capital raising.