Article Title: ARCHIVE | Criteria | Insurance | General: New Insurance Run-Off Payment Assessments Evaluate Capacity To Pay After An Entity Closes Data: (EDITOR'S NOTE: — This criteria has been retired and is no longer current.) The nature of the insurance industry makes it difficult to simply close an operation. An insurer may cease to write new risks but could spend years, sometimes decades, settling the liabilities that arise from the policies written before it closed its doors. Where the whole of the portfolio is closed to new business, the insurance entity is said to be "in run-off" and must then settle all future liabilities from the resources it has available. In this situation, the entity which has ceased trading has limited ability to fund any shortfalls in its provisioning from future profits and may be unable to raise additional capital to fund deficits. Liabilities arising from some classes of non-life insurance are also difficult to value, increasing the uncertainty. Standard & Poor's Ratings Services has introduced run-off payment assessments to give policyholders and other interested parties confidence under these conditions. The assessments will indicate our expectation of the likely level of claims paying capacity and, where we expect full payment, the degree of certainty associated with that expectation. Some insurers in run-off are keen to use the uncertainty surrounding their ability to continue meeting claims over the extended period of the run-off to negotiate favorable commutation of liabilities. Others are looking to reassure interested parties, such as policyholders or insurance supervisors, that the company has the capacity to meet its contractual obligations. Run-off payment assessments provide valuable information for all interested parties. Assessment Scale A Standard & Poor's run-off payment assessment is a current opinion of the capacity of an insurance company, in run-off, to pay under its policies and contracts in accordance with their terms (see table). It indicates the anticipated payment, and in the case of the highest assessment categories, where 100% payment is anticipated, the likelihood of that. The assessment reflects our current evaluation of an insurer's capacity to meet its obligations over the life of the run-off. The run-off payment assessment is not linked to, or limited by, an insurer financial strength rating or any other rating. Standard & Poor's Run-Off Payment Assessment Scale RUN-OFF PAYMENT ASSESSMENT DESCRIPTION OF PAYMENT PAYMENT CAPACITY RANGE RP-1 Very high likelihood of full payment of claims 100% of claims RP-2 High likelihood of full payment of claims 100% of claims RP-3 Full payment of claims is anticipated 100% of claims RP-4 A substantial payment of claims is anticipated 80% to 100% of claims RP-5 A meaningful payment of claims is anticipated 50% to 80% of claims RP-6 A modest payment of claims is anticipated 30% to 50% of claims RP-7 A poor payment of claims is anticipated 0% to 30% of claims Run-off payment assessments are based on information furnished by the organization assessed, or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit in connection with any assessment and may rely on unaudited financial information. Assessments may be changed, suspended, or withdrawn as a result of changes in or unavailability of such information or based on other circumstances. A run-off payment assessment is not a recommendation to maintain or discontinue any policy or contract. Methodology The assessment reflects our evaluation, today, of the insurer's capacity to meet its obligations over the life of the run-off. To evaluate this capacity fully, we cooperate with the insurer in run-off. The assessment will be subject to ongoing surveillance and will be subject to a formal review at least once a year. Assessments may be changed at any time if our opinion of the capacity of the insurer to meet its claims changes. The assessment may also be withdrawn at the insurer's request, or we may choose to suspend it at our discretion. Many of these assessments are likely to be confidential and will be used by the entity and a specific counterparty. The nature of the evaluation demands that it be focused on the range of possible future cash flows. Therefore the assessment will be based on a quantitative assessment using a simplified stochastic cash flow model. We will overlay this with a qualitative evaluation of management, their strategy and their run-off planning, possible support from shareholders, and the regulatory environment in which the entity operates. Stochastic cash flow model The quantitative element of the assessment will evaluate whether the capital and reserves will be sufficient, at the appropriate level of confidence, to meet the liabilities as they become due and if not how far they will fall short. We will use the model to project a range of future balance sheets, at each year-end, by developing the opening balance sheet using distributions for key variables. The number of times the company fails to pay any of its valid claims per 10,000 simulations will indicate the probability of insolvency over each future year and thus over the future life of company. These results will enable us to assess the frequency of failure at predetermined confidence levels. The heart of the model will be a projection of the cash flows from the settlement of claims based on historic gross paid claims patterns. To generate net claim payments, these will be modified to reflect expected changes in the future gross payment patterns and the impact and timing of reinsurance recoveries. Both of these adjustments will reflect historic patterns and changes in environment and behavior that result from being in run-off. We will also review the expense budgets for the period of the run-off, in particular how realistic are the insurer's assumptions regarding ongoing overheads, staff incentives, managing lease commitments, and the costs associated with downsizing the operations during the run-off period. Our evaluation of these budgets will feed into the cash flow model. The other major element of the model incorporates the financial assets of the business. These will also be modeled stochastically, using standard modeling techniques. However, allowances may be made where management actions could affect strategy; in particular the order in which assets are realized to meet liabilities. Management and strategy Management, its strategy, and its operational and risk controls are important elements to the qualitative part of the assessment. In addition to our usual evaluation of management, we will consider the quality and continuity of management, and its ability to retain sufficient expertise to maintain the quality of claims handling and financial management. We will review the company's strategy for retaining and motivating key staff and its approach to negotiating claims settlements and commutations. It is particularly important that insurers in run-off have the ability to successfully manage their ongoing relationships with reinsurers. Where our qualitative assessment is less than positive, the run-off payment assessment will be reduced to reflect the increased risk that the anticipated payment level will not be achieved. Regulation We consider it crucial to assess the legal and regulatory environment and the threats and opportunities this presents for the successful run-off of the liabilities. Group support Our established group methodology, under which we categorize a company as "core", "strategically important" or "nonstrategic" to its parent, has limited application in a run-off situation. However, where the parent or another part of the group continues to run a significant reputation risk, it may be possible to factor in some element of group support for the run-off company from its parent company. It is unlikely that a company will achieve the highest run-off payment assessment category without support from a parent company that is itself strong and capable of offering meaningful support.