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A FAIRFAX COMPANY

What Is 'Best-in-Class' Due Diligence?

HOW IT CAN MAKE OR BREAK THE SUCCESS OF YOUR RUN-OFF ENGAGEMENT

An effective run-off strategy can yield very positive operational and financial benefits for the insurance companies, while also honoring and protecting the insured.

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ISSUES TO CONSIDER

The latest global PwC annual run-off survey estimates that the total value of the UK, EU, and US run-off markets is over $700 Billion[1]. Run-off has come into its own. Together with the evolution of available options to manage legacy insurance exits, there is also more organization, greater discipline, and improved processes around how parties construct and execute run-off deals. Creating the right run-off solution is more vital than ever to ensure the best results for both buyers and sellers.

Certainly everyone wants to strike the best deal for themselves – economics, risk, reputation, flexibility and other factors all matter. But there is also a vested and shared interest in any given transaction, which invites more up-front collaboration. An effective run-off strategy can yield very positive operational and financial benefits for the insurance companies, while also honoring and protecting the insured. Often the difference in being "RiskSmart" to the benefit of all comes down to one of the more important steps in the evaluation of run-off: ***the due diligence process.***

An insurer or reinsurer looking to put a portfolio or even an entire company and its policies into run-off can learn a tremendous amount about by how the prospective buyer conducts its due diligence, which can then inform the seller's confidence in any proposed deal. Contracting parties all know and want the same things on the surface: reasonable terms, responsive parties, and smooth and rapid transactions – e.g., insurance companies typically come to run-off with a purpose and accelerated timing to "get the deal done," often with the help of brokers.[2] At the same time, insurance companies often underestimate the volatility they face.

For example, in one instance, a particular insurance provider believed it had a "small asbestos problem" when actaully, thanks to a single exposure in one market where there was a change in that jurisdiction's allocation law, the real

1 *Global Insurance Run-off Survey, 2018, PwC. https://www.pwc.com/gx/en/insurance/assets/pdf/global-insurance-run-off-survey-2018.pdf*

2 *See our Point of View on The Value & Importance of Brokers In Run-Off.*

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liability was close to $100M. It was proper due diligence that uncovered the hidden liability. And yet this was not the end of the run-off transaction. Rather, it called for a more creative approach in the form of a reinsurance transaction and cascading thresholds of liability shared between the insurer and RiverStone to implement the most **RiskSmart Run-Off®** transaction for both parties.

Proper due diligence can uncover and help address issues that arise around these questions. Due diligence done well means not only understanding what problem you are trying to solve but identifying all the factors that will enable both parties to be creative in how they solve it, together. So, what are the key steps for best-in-class due diligence? At RiverStone, we have found that history is not typically predictive of the future, so sellers and buyers should treat each book and case with fresh eyes and energy to ensure they uncover essential data and information that helps to educate both parties.

Proper research and analysis are critical for thorough risk-based and actuarial assessments, focused on the specific claims and based on proper industry and market understanding. Put more simply, you must know what to look for and where. While good due diligence may seem overly involved to the untrained eye, it is the critical step to help both buyers and sellers see and solve problems. Together they must be intellectually curious, informed on the law, methodical and systematic in their approach, and uniform and consistent applying that approach. In fact, proper due diligence has inherent value in and of itself – there are numerous examples of how due diligence has delivered value to sellers in its own right, uncovering hidden risks and liabilities that point towards an adverse impact on the seller. Sellers should be automatically and earnestly skeptical of any buyer who does not do a thorough job in its due diligence, including reviewing actual claims (even closed claims) and insurance policies.

RIVERSTONE'S APPROACH

Below is an outline of the approach that RiverStone takes to due diligence, so that potential sellers and brokers know what to expect:

STEP 1 – Getting to "Why?"

We want to understand what the seller's goals are in terms of mitigating risk, maintaining its reputation, releasing capital and focusing on its core business.

STEP 2 – Information Exchange

We want to access and examine any actuarial analysis the seller has already done and review claim bordereaus and policy listings.

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STEP 3 – Actuarial Review

We conduct our own actuarial review, looking at the seller's reserves and calculations to give an indicative price. This is often a "go" / "no go" point for both parties.

STEP 4 – In-Person Discovery

We conduct interviews with key managers and associates and review actual open and closed claims, often remotely if technology allows. For certain liabilities, like asbestos, we tend to look at all claims, while for others, like construction defect or premises exposures stemming from general liability policies, we may only examine a percentage of claims.

STEP 5 – Transparent Dialogue to Close

At RiverStone, it is core to our philosophy and ethos to be transparent and open in our findings. Our goal is for our indicative price to be our final offer. That price changes only if we later find that there is a material change to the analysis as a result of the file review process – i.e., if materially new information arises.From start to finish, the due diligence might take anywhere from 4 to 8 weeks. While some may lament the "extra time", any seller who has consummated a deal with RiverStone can attest that taking a step back with the proper due diligence will in fact enable both parties to accelerate how they safely and securely execute any run-off agreement.

We are proud to note that some of our most enduring relationships have resulted from such a process, where sellers leave the table only to return when they realize that RiverStone has fairly and properly priced the deal based on the circumstances and risks. Not all deals are made for all parties, including RiverStone, but we believe strongly that a fundamentally sound and thorough approach to due diligence ensures security, anticipates regulatory issues, provides room for greater innovation and ultimately serves the best interests of all stakeholders.

ABOUT RIVERSTONE

RiverStone is a group of insurance, reinsurance, and service companies specializing in the management of legacy and run-off insurance businesses and portfolios. With nearly 500 professionals with deep industry expertise in claims, customer service, litigation, and financial restructuring, we offer creative and varied deal structures to deliver sustainable outcomes you can count on. We lean forward to develop and deliver innovative exit solutions to help shore up capital and meet board-level mandates to help focus an insurer's business. We know that reliability, security, and finality all come from an ability to not only assess the risk up front but to execute the deal at the scale and speed required by the business.