

# PUTTING THE PAST BEHIND YOU—A SELLER’S GUIDE TO NOVATIONS

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Once deemed a market of last resort, legacy insurers have seen a rise in transactions centered on the transfer of aged liabilities. These “legacy” transactions are now an integral part of a captive insurer’s capital management strategy.

## Why are captive insurers suddenly very focused on proactively managing their legacy reserves?

A confluence of macroeconomic factors including economic inflation, social inflation, and volatility in the equity markets is creating uncertainty around embedded return assumptions and pressuring reserve adequacies of captive insurers. As a result, captive managers are seeking retroactive or legacy reinsurance solutions that will manage volatility and protect the balance sheet from adverse development or reserve deterioration.

## What options do captive insurers and risk managers have at their disposal?

Captive managers have essentially 3 options when it comes to a captive’s legacy reserves:

Options	Advantages	Disadvantages
<b>Allow reserves to run off naturally</b>	Collect all claim balances from reinsurance	Retain underwriting and timing risk, capital remains trapped. Further servicing of reserves required.
<b>Commutation with cedent</b>	Full legal and economic transfer of reserve liability, no further servicing required	Cost is typically higher than booked reserves, cedent often reluctant to commute other than oldest years.
<b>Novation</b>	Same as commutation, but with benefit of better pricing due to active competition among legacy buyers, free up trapped capital and ability to transfer all prior years	Requires sign-off from cedent, 8-10 weeks to close transaction contracts.

## Why captive insurers should be considering a novation?

In addition to bringing price certainty to the captive’s reserves, cleaning up the balance sheet, and allowing captives to refocus on core business—competition among legacy writers ensures the most advantageous terms for the captive. Acquirers of legacy liabilities are often backed by sophisticated and sizable hedge funds whose investment expertise translates into better pricing terms for the captive. The current high-yield environment is especially appealing to these investors. Other factors, such as the ability to diversify their books and leverage their off-shore status, leave them well-positioned to offer more aggressive discounting of reserves.

## Execution and Timing

While a non-binding indication or bid could be offered within 2 to 3 weeks, a typical novation transaction needs 10-12 weeks of lead time for execution. This includes data gathering, modeling, marketing the placement, receipt of a non-binding indication and finalizing the placement. Generally, the following data is needed to structure a novation solution:

- Recent actuarial report
- Recent loss run
- Program parameters (e.g., years to be novated, lines of business, policy limits)
- Current collateral requirement

Captive insurers and risk managers don’t need to wait until their captives have experienced reserve deterioration or adverse development before considering a novation. By proactively managing reserves, captive insurers can execute a novation as a hedge against adverse development or reserve deterioration. They can allocate capital to take advantage of current market conditions in lieu of continued exposure to the uncertainties and burdens associated with expired policy years.

**NOVATION CASE STUDY**

**Client Challenge**

A member-owned group captive looked to transfer prior accident years in order to: re-focus on its core business and strategy, limit reserve risk associated with economic and social inflation and release trapped capital. The group captive attempted to commute directing with the insurer but they were unable to agree on terms.

**Guy Carpenter’s Solution**

After analyzing the losses and potential IBNR within the captive’s portfolio, we were able to identify the captive’s exposure to economic and social inflation. This included a static view and several modeled outcomes using Guy Carpenter’s proprietary reinsurance optimization tool, MetaRisk®, with increased inflation at multiple confidence intervals. After evaluating its exposure to increase volatility and capital deterioration, Guy Carpenter was able to structure and sell a novation of the captive’s prior-year liabilities.

**Client Value Delivered**

Released reserves of USD 31 million and freed up USD 3 million capital. The reinsurer assumed all future liabilities associated with these years as well as all associated collateral obligations.

**Pre-novation Cash Flow**



Fronting carrier (insurer) issues policies to captive members.



Captive members pay fronting fee to insurer.



Captive indemnifies the insurer for the retention layer via a reinsurance agreement.



Captive posts collateral to protect insurer against credit risk.

**Post-novation Cash Flow**



Captive pays novation premium to legacy reinsurer.



Reinsurer assumes captive’s rights, obligations and liabilities under existing reinsurance agreement between captive and fronting carrier (insurer).



Fronting carrier permits captive to novate the reinsurance contracts.



Fronting carrier releases captive collateral while legacy reinsurer simultaneously replaces same collateral with insurer.



Novation agreement is signed by all 3 parties—establishing a direct relationship between insurer and legacy reinsurer.

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**About Guy Carpenter**

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