

the



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Actuaries

PricewaterhouseCoopers LLP

The role of the actuary in the run-off sector today goes far beyond the traditional actuarial area of estimation of reserves. Actuaries are often involved in providing advice on all aspects of run-off strategy including commutations, sale, reinsurance, Part VII transfers, schemes of arrangement (see page 30) and, of course, on-going claims reserving work.

When planning a commutation (see page 11), the estimation of liabilities has long been an area where actuarial skills come to the fore, particularly where the modelling of complex and long-tailed claims is required. Actuaries are also often involved in the ensuing negotiations and assist the agreement process by applying their understanding of the key drivers and sensitivities underlying a particular claim valuation. Actuaries increasingly work side by side with the company and its advisers to achieve the optimal result.

The role of the 'scheme actuary' in an insolvent scheme is well established and actuaries have played an important part in several large insolvent scheme closures that have taken place in the market over the last ten years. Whilst there is no such formal role in a solvent scheme of arrangement, actuaries are likely to be involved from the very start of the scheme process, helping understand whether it is a feasible option and assessing the 'deal' to be offered to policyholders.

In relation to solvent schemes of arrangement, actuaries have also provided witness statements to Court on issues of classes and fairness and, at the creditors' meeting they can help both the creditors and the scheme company ensure that fair values are used for voting purposes. Post bar-date, the actuarial role in a scheme is similar to that in a stand-alone commutation ie. the actuaries are involved with the

Asbestos

KPMG LLP

Asbestos is a naturally occurring mineral that has been mined for commercial use. The thermal, chemical stability and resistance properties of asbestos fibres have resulted in asbestos being used in over 3,000 commercially manufactured products. These products include thermal insulation and fire-proofing materials, asbestos cement, friction materials, acoustic applications, electrical switchboards and insulators, vinyl floor coverings, gaskets, textiles, paints, coatings and sealants.

Exposure to asbestos fibres is linked to a number of lung diseases. These diseases range in severity from symptomless pleural plaques to the aggressive asbestos related cancer mesothelioma.

- Pleural plaques, typically develop 15-20 years after first exposure
- Diffuse pleural thickening
- Asbestosis, normally develops 15-40 years after first exposure
- Asbestos-related lung cancer, usually develops after 20 years from first exposure
- Mesothelioma, with onset typically 30 to 50 years after first exposure

Due to the long latency of asbestos-related diseases insurance companies are currently paying substantial claims from exposures dating back to the 1960s and 1970s. Asbestos claims are the signature claim type for most London market run-offs, and continue to dominate insured liabilities. In the mid-1980s the London insurance market responded to the growth in asbestos claims by inserting exclusion language in insurance policies for asbestos related claims (except for employers' liability policies, where such exclusions are prohibited).

United States

In 1973, asbestos manufacturers were found liable to workers injured as a result of exposure to their products (Borel v. Fibre-board, Fifth Circuit, US Court of Appeals, 1973). Prior to this landmark case, individuals that contracted asbestos-related diseases as a result of occupational exposure to asbestos, claimed compensation from their employers on a no-fault basis, and these in turn claimed against their insurers under workers' compensation coverages. The Borel case moved the claims into the US tort system and the producers in turn claimed redress from their insurers under product liability coverages.

The RAND Institute estimates that in excess of 700,000 people have filed asbestos claims in the US since the early 1980s. Originally the claims were filed against asbestos producers (e.g. Johns Manville), but claims were then filed against the manufacturers and distributors of asbestos containing products. More recently, following the bankruptcies of these companies, they have been filed against companies that owned or operated a facility where asbestos-related products were used. This has opened up premises insurance coverage for asbestos-related claims in the US.

Estimating the ultimate cost to the insurance market of US asbestos related claims is highly uncertain; however estimates around \$100 billion to \$120 billion exist. This compares to the most costly insured individual loss of around \$70 billion for Hurricane Katrina in 2005.

In an attempt to limit the vast sums claimed and being paid to claimants who had exposure to asbestos, claims handling practice in the US and also the UK now requires that asbestos claim-



Audits & inspection

Helix UK Ltd

claims valuation and agreement process. Actuaries are also increasingly being used in the 'scheme adjudicator' role when their expertise is relied upon in those rare cases where scheme claims cannot be resolved through negotiation.

Actuaries will often have a central role to play in Part VII transfers (see page 27) as the Independent Expert (see page 18) who has to ensure that no group of policyholders are disadvantaged as a result of the proposed transfer. Actuaries are also involved in the purchase and sale of run-off businesses where they assist with the balance sheet due diligence exercises and with the modelling of future cash-flows in order to help determine a fair price for a portfolio, for example this may be in terms of the return on capital to the buyer accepting risk onto its balance sheet.

Invoking a reinsurer's audits and inspection rights is a key tool in the run-off plans of a company or syndicate. While the rights of inspection do vary from contract to contract, and as claims continue to develop on major contracts, invoking these contractual rights allows reinsurers to obtain a better understanding of the underlying claims, and to check if the claims presented are within the terms and conditions of the underlying contracts and as originally intended and if the inuring reinsurances are dealt with correctly. It will also help reinsurers better appreciate what the drivers are to the future development of the contract.

Undertaking an inspection is time consuming and a specialised role therefore an increasingly reinsurers are opting to outsource this work to third party specialists in order to opti-

mise claims savings and to reduce the uncertainty of the development of their reinsurance portfolios.

It is of considerable benefit, when developing a commutation strategy, to conduct audits of the underlying contracts to evaluate the financial implications of an agreement within a range of criteria before commencing discussions. An independent audit can also give recommendations as to the best course of action as well as helping to build reinsurer/reinsured relationships.

The process includes reviewing the underwriting documents at the time of placing, the development of the contract to date, the premiums and claims presented under each contract to date and the financial position between the parties (including the role of the broker). It is market practice for the parties to sign a confidentiality agreement before the commencement of an inspection and for the reinsured to provide to the inspector a list of the contracts ceded (detailing the premiums and claims). From this list the inspector will make a selection of risks to be reviewed during the inspection.

Possible outcomes may result in claims savings, a better understanding of the business ceded, improved working relationships between the reinsure and the reinsured or commutation of the contracts. Arbitration/ litigation should be the last port of call.

Inspections may be commenced by reinsurers, recommended by solicitors or ordered by courts or arbitrators. Generally they are accepted within the normal route of business practice between reinsurer and reinsured in the US and more so in more recent years in London.

ants must also provide evidence of actual impairment.

United Kingdom

In the late 1960s the UK started to further restrict the use of asbestos in the workplace. In 1969 the Asbestos Regulations (1969) expanded the statutory duty of employers to ensure that all staff were protected from the dangers of working with asbestos and set the first quantitative limit for asbestos dust exposure. These regulations updated the largely ineffectual 1931 Asbestos Industry Regulations.

The Institute of Actuaries working party on UK asbestos in 2004 estimated a best estimate ultimate cost of UK asbestos related claims to the insurance market of around £7.3 billion. The estimation of mesothelioma insurance claims is uncertain in part due to the long latency of the disease, with the Health and Safety Executive expecting mesothelioma deaths to peak between 2011 and 2015.

Rest of world

Estimates of worldwide asbestos consumption by the US Geological Survey (Worldwide Asbestos Supply and Consumption trends from 1900 through 2003 – Robert L.Virta) indicate that world asbestos consumption peaked around 1980 at 4.7 million metric tons. Estimates for 2003 still indicate that over 2.0 million metric tons of asbestos are being consumed worldwide.

Although asbestos consumption in the US and UK has been minimal since the 1990s other countries have been using asbestos. Since the 1970s the Soviet Union/Russia has been the largest consumer of asbestos and it has not been until 2003 that it has been overtaken by China. In addition, India has been gradually increasing its asbestos consumption over the years. These countries may experience similar asbestos related diseases patterns as the US and UK but with a later development due to the later exposure.



B

Benchmarking

PricewaterhouseCoopers LLP

Benchmarking or comparative analysis is an important tool for decision making within any business sector and varies in application from strategic matters through to operational issues.

The performance of a business can be compared internally against other business lines, or against competitors, but it is important to ensure that these comparisons are on a like-for-like basis and that the information used to perform the analysis is of the right quality. Information for comparative purposes should possess a number of attributes; for example it should be:

- relevant and capture the key drivers of the business – the key performance indicators (KPIs)
- timely – in the insurance context the production of daily reports to capture major drivers such as significant claims reported or litigation
- succinct and accessible and avoid ‘analysis paralysis’ – a one page summary of key information taking a dashboard approach is best
- tiered and specific to the needs of the user

For insurance businesses for example, claims performance is critical and the measurement of performance of an organisation against its competitors can help it to understand where resource (both human and capital) can be most effectively employed and, as a result, enhance performance. The types of measures which could be used to analyse a claims department include struc-

Bermuda

KPMG LLP

In April 2008 it was reported that Bermuda’s reinsurance industry held assets of \$440 billion (or \$6.8 million per person for each of the island’s 64,000 inhabitants). In 2007 Bermudian reinsurers wrote gross premiums of approximately \$116 billion making Bermuda the fourth largest reinsurance market in the world.

It’s difficult to identify individual entities in run-off and therefore to gauge the overall size of the run-off market, however, it is estimated that as many as 400 of Bermuda’s captives are in run-off.

The Bermuda run-off market has a number of characteristics that distinguish it from its US and European counterparts.

- Corporate information – Lack of publicly available information on insurance companies.
- Service providers – Bermuda is less developed in terms of specialist run-off service providers. However, this landscape is changing given the interest being shown in Bermuda by established run-off firms.
- Liabilities – Bermuda reinsurers tend to be younger and

have less exposure to legacy issues (particularly APH risks).

(d) Collateral – Bermuda reinsurers, given the levels of US business, typically have high levels of encumbered cash.

(e) Regulation – The Bermuda Monetary Authority (BMA) has no specialist unit to oversee regulation of run-off entities, however like the UK, the BMA supports a robust and proactive strategy for managing run-offs and has formal criteria for allowing capital extraction from run-off companies.

(f) Schemes of Arrangement – Bermuda has generally followed the UK pattern of scheme development and the process from a legal and operational perspective is almost identical to that of the UK.

(g) Business Transfers – The Bermuda insurance statutes do not contain statutory novation provisions for non-life business. As a result, Bermuda reinsurers may have to rely on a scheme procedure in order to effect a portfolio transfer.

The Bermuda run-off market has developed in a number of distinct phases since its emergence as a domicile for captives in the 1960s.



ture and organisation, legal expenses, claims size, claims costs, valuation and leakage procedures, talent management, customer service and outsourcer management.

In the context of run-off business, where run-off outsource providers are often used, service provider performance should be assessed against the 'Service Level Agreements' (SLA) referenced in the outsourcing contract between the insurer and the provider. Appropriate KPIs are a further tool in completing that assessment, which needs to consider the overall performance and alignment with the wider objectives of the insurer. The recent PricewaterhouseCoopers survey Outsourcing Comes of Age, which surveyed 226 senior operating executives of private sector corporations that are 'customers' of outsourcing services, found that reducing costs was 'important' or 'very important' to 76 per cent of respondents. Minimising service provider costs whilst maximising performance creates an environment where understanding the relative costs and the pricing dynamics of alternative providers is powerful information.

Analysing or benchmarking performance is part of the overall toolkit used to manage businesses and whilst external benchmarks and internal benchmarks each have a role to play in helping insurance businesses maximise performance, identification of these measures is only the first step towards real changes in operational efficiency and effectiveness.

- The 1970s and 1980s – Saw a number of insolvent liquidations (such as Mentor and Cambridge Re).
- The 1990s – Saw a number of high profile insolvencies such as EMLICO and Bermuda Fire & Marine. The '90s also saw the distressed sale of a number of insurance companies in run-off and the use of the first solvent scheme for a non-life insurance company (Hopewell).
- The 2000s – Saw a considerable increase in the scale of run-offs such as LaSalle Re, and Centre Re and the greater use of solvent schemes to close reinsurers.
- Post 2005 – More recently, the most significant impact has been 2005 hurricane season which saw a number of property catastrophe reinsurers enter run-off.

In terms of future trends, the growth of the run-off market in Bermuda is likely to be driven by large loss events, changes in the political environment, rating agencies' influence, softening market conditions and M&A activity.

Broker Replacement

Reinsurance Solutions Ltd

Broker replacement is the act of removing tasks undertaken by the original placing broker or intermediary and transferring them to a selected, specialist service provider who will take full responsibility from the incumbent broker or intermediary for all functions going forward from the date of transfer.

The service is normally utilised when a client has a problem with a poor performing broker or intermediary. This generally results in a failure to service an account which is evidenced by indicators, amongst others, such as ageing debtors, backlogs, personnel and/or location changes, poor response times, late claim presentations and a general lack of reporting.

However there are occasions when the client may wish to consolidate a portfolio with one selected provider for cost, efficiency, programme fit or consistency purposes.

Essentially it is an operational solution designed to increase cash flow and realise asset.

The broker replacement or consolidation service can cover the full gambit from entire client portfolios down to specific claim or reinsurer level.

In terms of timing, matters in the reinsurance recovery arena rarely improve with age, so the maxim should be sooner rather than later if the client is to maximise asset and mitigate future loss.

Selection of the right service provider is paramount in ensuring that the client receives the level of service and return that their investment demands. Some of the key attributes to look for in a specialist service provider are an appropriate infrastructure and system that facilitates the handling of a large number of risk and claims, proven migration routines, a worldwide network, an established track record, regulatory approval and oversight, transparent governance including conflict of interest policies and an informed and motivated workforce who possess the appropriate skillsets and experience.

The new service provider will normally enter into a tailored service level agreement with the client, thereafter creating a dedicated team who would align their activities with the client's strategy. The art is to construct an agreement between the client and the selected service provider that is fair to both parties and will lead to a major improvement on the current situation.

Business transfers

PricewaterhouseCoopers LLP

A business transfer involves moving the whole or part of a company's insurance and/or reinsurance business from one carrier to another. Part VII of the Financial Services and Markets Act 2000 (FSMA) came into force in the UK in 2006 and is the UK legislation which implements the EU business transfer provisions as required by the Third Non-Life Directive and the Reinsurance Directive. Over 100 business transfers have been effected to date under Part VII of FSMA (see page 27), including live and discontinued business, direct, reinsurance, life and non life business. Transfers have also occurred between companies in the same group and to external entities.

One key difference between the UK and other EEA territories is the ability to transfer reinsurance assets along with the underlying liabilities as established in case law precedent (to be confirmed by expected revisions to FSMA in 2008). In other EEA territories reinsurance is generally considered not to transfer without an explicit novation.

Features of a UK Part VII transfer include: a Court process, an FSA approved Independent Expert and written notice given to transferring and non-transferring policyholders (unless subject to a Court waiver). In other EEA countries an Independent Expert is not typically required, notification and advertising requirements differ and typically the regulator rather than the Court grants approval of the business transfer.

Before the introduction of the Reinsurance Directive in December 2005, pure reinsurance entities had not been subject to a homogenous regulatory framework across the EEA. The Reinsurance Directive extends to pure reinsurers the concept of a 'single passport' regime, allowing reinsurers to conduct business throughout the EEA without the establishment of subsidiaries in individual territories (see page 28).

Following the implementation of the Reinsurance Directive, the UK is proposing a streamlined Part VII process for certain transfers of reinsurance business. A 'Part VII-lite' may be applicable to straightforward and uncontested transfers (eg. transfers between companies within the same group) and will only require regulatory approval rather than a Court process. Certain notification provisions may also be relaxed.

There are a number of drivers for transfer activity including:

1) Capital and regulatory efficiency

By consolidating business in a single member state, companies can achieve a more efficient use of capital and reduce the regulatory burden. An example of this is the Swiss Re Group, which announced plans in March 2007 to transfer most of its European insurance and reinsurance business held in a

number of subsidiaries to new carriers domiciled in Luxembourg, and operate via a branch network in the EU. Swiss Re's new model is expected to be fully operational by the middle of 2009 and is expected to improve the alignment of its regulatory and economic capital requirements, achieving significant cost savings.

2) Tax efficiency

Companies may use transfers to take advantage of lower tax rates in territories such as Luxembourg and Ireland. In 2007 Partner Re announced that from January 2008, Partner Reinsurance Europe Limited (based in Ireland) will be its principal reinsurance carrier for business underwritten in France, Ireland and Switzerland.

3) Run-off efficiency

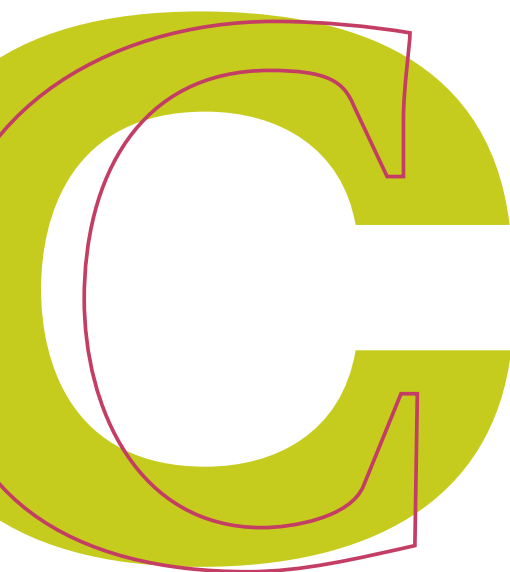
a) Consolidation – business transfers can be used to achieve operational efficiencies through the creation of a centre of excellence or to effect a sale of a group's discontinued business. An example of this is Compagnie Euro-Belge de Reassurances SA's transfer of its entire reinsurance portfolio of discontinued business to Hanseatica Rueckversicherungs-Aktiengesellschaft in January 2008.

b) Release of capital – by transferring similar business to one entity in a single territory the total capital required to support the combined business may be reduced.

c) Finality – by transferring business to another territory, companies can take advantage of local legislation to bring finality to their run-off. An example of this is transferring business to the UK and implementing a solvent scheme of arrangement.

The business transfer process can involve a number of stakeholders and there have been a number of objections raised to transfers as a result of genuine concerns or, in some cases, in order to gain commercial leverage in commutation discussions. In the UK, reinsurers are also affected by Part VIIs and their views will be taken into account during the Court process. Good communication with the local regulator is vital. In the UK, the FSA also conducts a formal consultation process with regulators in the EEA member states where policyholders are impacted. Careful stakeholder management is required in order to anticipate and manage potential adverse stakeholder reaction.

Business transfers are receiving greater prominence in the UK, and over the last two years there has been a significant increase in Part VII activity, both in terms of the number of transfers and size of liabilities transferred. As a result of the implementation of the Reinsurance Directive it is expected that business transfers in Europe are likely to become more common as a means of meeting corporate objectives.



Capital modelling

EMB Consultancy LLP

Capital models attempt to simulate all of the outcomes that may happen to a (re)insurance entity.

A capital model should look at all aspects of business. The FSA lists six risk groups that need to be examined – insurance, credit, liquidity, group, market and operational.

For a live business, insurance risk will include both underwriting risk and reserve risk, typically making insurance risk the dominant risk. For run-off entities, as underwriting risk is not usually there, other risk groups are likely to be relatively more important. For example, the credit risk, or bad debt associated with the reinsurance asset can be very important.

Whereas the reserving process estimates what is likely to happen on average, capital models look at a full range of outcomes and tend to be more concerned with outcomes at more extreme scenarios. In the UK, the focus has been on 1 in 200 or 99.5th percentile outcomes.

As a capital model pulls together all components of a company's risk, the interactions or correlations between the risks is critical. For example, if the gross reserves turn out to be at a 1 in 200 level, is it more likely that other insurers and reinsurers have also been affected and therefore is credit risk increased?

In most countries where capital models are now commonly used, including the UK, the initial catalyst was regulatory. Typically companies fell into two camps – those that embraced the models as good practice, realising that they should have been doing it anyway, and those who did the minimum necessary to keep the regulator happy. However, regulators and increasingly rating agencies are now looking to see how the capital model is used within an organisation as their key way of testing if a model is any good, so the second group will find it difficult to satisfy their regulator.

In a live company, there are many ways in which capital models are being used today, such as helping to purchase a reinsurance programme to optimise return on capital, or using the model to justify writing a new line of business. In the run-off world to date, capital models have typically only been created at the point of a major transaction such as a sale or transfer. However, going forward, capital models are likely to be used far more frequently for run-off portfolios to aid day-to-day decision making such as the optimal investment portfolio or commutation strategy.

Chapter 15

Chapter 15 of the US Bankruptcy Code replaced former Bankruptcy Code section 304 as of 17 October 2005. The change came as a result of the comprehensive US bankruptcy law reform under the Bankruptcy Abuse Prevention & Consumer Protection Act 2005.

Chapter 15 was introduced to incorporate the United Nations Model Law on cross border insolvency developed by the UN Commission on International Trade Law (UNCITRAL). The intention of the Model Law was to give greater certainty in the conduct and outcome of insolvency and restructuring proceedings touching more than one country.

Chapter 15 empowers the US court to grant relief in aid of the effective implementation of orders of non-US courts. It therefore supersedes section 304 as the mechanism through which proponents of UK solvent schemes of arrangement, and other non-US liquidation and reorganisation proceedings, can seek assistance from US courts. It offers debtors who are parties to non-US proceedings the ability to obtain protection from policyholders of their US-based assets.

A proceeding, such as a scheme of arrangement, pending in the

debtor's 'centre of main interest' (presumed, absent evidence to the contrary, to be the country in which the debtor has its registered office) is called a 'foreign main proceeding'. If the court recognises the scheme as a 'foreign main proceeding' then certain relief automatically comes into effect, including injunctive relief protecting assets from attack by local policyholders.

Since the introduction of Chapter 15 a number of schemes have come before the US bankruptcy courts and have obtained recognition and relief in aid of the non-US proceedings. However, whereas under section 304 a US bankruptcy court had in at least one case granted protection in respect of a UK Part VII transfer (while stating it did not set a precedent) no-one has to date sought to obtain relief for a Part VII transfer under Chapter 15. The point of uncertainty is that Chapter 15 applies to foreign proceedings relating to insolvency or adjustment of a debt, and it is not clear that Part VII of FSMA relates to insolvency or debt adjustment rather than simply sale of assets. However Chapter 15 does refer to a reorganisation which, the successful application under section 304 argued, a Part VII process is.



Collections

Global Reinsurance Consultants Ltd

It is accurate to say that all (re)insurance companies are faced with a credit control challenge when it comes to collecting claims on their outward reinsurances, particularly on discontinued cessions. However, the prompt collection of balances is essential in maximising the value of a reinsurance book. Poor performing asset has a negative effect on the company's balance sheet and as a result is often written off, even though with specialist assistance the debt can be collected and the asset realised. To make matters worse the worldwide reinsurance markets have become increasingly familiar with the statutes of limitation and the vast majority of companies will now raise 'time bar' as a defence against settling aged balances.

Whilst there are arguments for and against these statutes it is a fact of life that if balances are left to age without appropriate action the chances are they will become uncollectible. It is therefore imperative that cedants take a diligent approach to their credit control issues. Cedants do of course have the option of legal action (arbitration/litigation), however, this is an expensive process without any guarantee of a successful out-

come. It must also be highlighted that time bar will be prevalent in the reinsurers defence. The other option is to appoint a specialist reinsurance collection firm which offers collection services based on a pure contingency fee basis, ie. for a percentage of the amount successfully collected on behalf of the client.

The collection specialist has a challenging job, since it must accurately balance aggressive collection efforts on behalf of the client but also maintain a good relationship with the reinsurer. After all it is usually the good relationship and the established trust held between the collection firm and the reinsurer which results in a successful collection.

It must also be added that on many occasions reinsurers will reconsider their 'time bar' stance when discussing settlement with a trusted third party. Collection specialists can also offer the flexibility of assisting cedants with varying sized claims since they can use economies of scale by assisting a number of clients with small collections against one reinsurer.

Commutations

Elborne Mitchell

Commutations are the oldest and simplest way of achieving finality on old contracts or books of business. They are as old as treaty reinsurance itself but came into particular prominence in the 1980s and 1990s when the traditional UK subscription markets started feeling the strain from long tail APH exposures and the LMX spiral.

What is a commutation?

Put simply, the parties agree upon a price to close out a contract or book. The cedant gets cash in hand whilst the reinsurer buys out of its future obligations.

The easy part of pricing a commutation relates to the paid balances – amounts notified by the cedant as being due and payable but which the reinsurer has not paid – and the outstandings – reserves advised to the reinsurer by the cedant in respect of known losses. However, it is the Losses Incurred but Not Reported (IBNR) – estimates of the value of possible future liabilities that are not referable to any known loss – where the calculation becomes more complex, usually requiring professional actuarial assistance.

What are the pitfalls?

The greater risk under a commutation is borne by the cedant as it is disposing of its reinsurance asset. If it undervalues its exposure, it only has itself (and possibly its advisers) to blame.

However, if the reinsurer needs to recover from its own retrocessionaires, it must also take care. The Singapore decision in *Overseas Union v Home* (2000) still casts a shadow, even if it has not been followed in the UK. There, the Court held that a commutation did not qualify as a 'loss settlement' under a treaty follow fortunes clause, meaning that it was unrecoverable from retrocessionaires.

The recoverability of IBNR – which represents un-crystallised obligations – remains problematical and has featured in numerous arbitration disputes. To the extent that a commutation payment relates to IBNR, it is not attributable to known obligations. The reinsurer arguably cannot prove loss against its retrocessionaire.

The latter problem can however be obviated by careful structuring of the agreement and having the cedant continue to account until the commutation figure is reached.

The future of the commutation

The last decade has seen the development of many sophisticated finality structures and it is no secret that the commutation of liabilities does not feature in the business model of some major players in the run-off market. For all that however, the commutation remains an important part of any finality tool-kit.



Debt purchase

Global Reinsurance Consultants Ltd

Whilst reading the 'collection' section of this supplement you will have acknowledged the need to effectively manage outward reinsurance collections in order to maximise value within a reinsurance portfolio. However, in certain circumstances a cedant may decide that whilst they wish to clean up their poor performing asset, appointing a specialist collection firm is not the right approach for them. Instead they may prefer complete finality enabling them to concentrate resource on alternative strategies.

In this instance some specialist firms offer a 'debt purchase' solution. This is all too commonly associated with the final clearout of a closing liquidation, however, this is not always the case and many debt purchase transactions are taking place with organisations, active and in run-off both in the company and Lloyd's markets.

Debt sales are very flexible vehicles available to cedants since they have the freedom to decide how much or how little debt they wish to sell, whether it is their entire outward book, a proportion of the book or just one particular problematic debt. The decision as to what debts should be incorporated into a transaction is at the discretion of the cedant. These debts may be in respect of recalcitrant reinsurers, small debtors or claims against insolvent estates. The sale process is relatively simple and does not require any regulatory approval. In addition the purchaser will be aware that a clean cut-off is the essence of a successful debt transfer and they should therefore ensure that any obligations for the seller are kept to a minimum. This may include an agreement whereby the purchaser has access to the sellers' records for a predetermined period so as to enable them to obtain supporting information without consuming the sellers' resource. Such an agreement would include access limitations and also strict confidentiality agreements. Specifically for insolvent debts the purchaser will consider debts whether or not they have been filed/agreed within a scheme or liquidation. The pricing mechanism can be quite complicated but essentially consists of a calculation based upon the size and nature of the claims, expected dividend payments and distribution dates together with appropriate net present values. Depending upon the sale and the sellers' requirements uplift mechanisms may also be incorporated in the purchase price.

Debt purchase as an option can be a surprisingly cost effective solution to cedants' overdue and problematic collections.

Data management

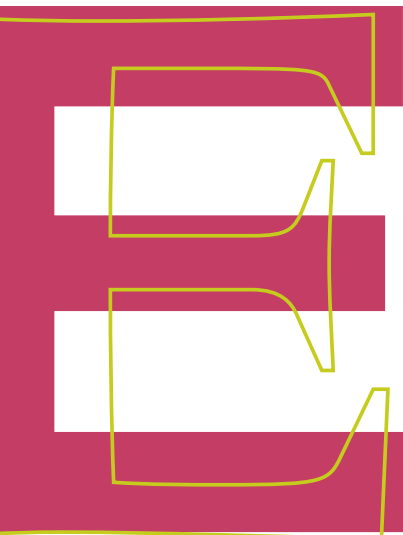
City Computers Ltd

IT systems cost money and the older they get the more expensive they become.

On top of that, when it comes to run-off and discontinued business they don't always provide what's needed since they weren't designed for tools and techniques such as portfolio transfers or commutations or for recording IBNR. And when it comes to risks written pre-computers, a high proportion of relevant detail has often been left out. All those odd portfolios which have either been acquired, or gladly donated by managements keen to see the back of them, come with their own computer systems which nobody understands. All of this means that it can be very difficult to keep tabs on the whole operation.

But there are things that can be done. It's not difficult to extract data from most systems and set it up in a parallel form of technology that more people understand, such as SQL or Crystal Reports. This is the data warehouse approach, which allows to you extract information from your systems, usually for reporting purposes, far more easily. As computer hardware is ridiculously cheap, this can be inexpensive, and it should give you the benefit of being able to manage your entire operation on a level playing field. You could also go the whole way and invest in a system designed for the particular needs of the run-off market.

And you really don't need to worry about whether your computer hardware works, or how you can access it. Someone else can manage it for you; you don't have to provide space for it, worry about whether it gets backed up every night, or even the consequences of a long-term loss of your office space. IT outsourcing is not just handing over your claims management to someone else – there are plenty of savings to be made by getting other types of professional involved in your operation.



Enterprise Risk Management (ERM)

EMB Consultancy LLP

Enterprise Risk Management (ERM) is a management process that enables an organisation to identify the risks it faces and the steps necessary to manage them without stifling entrepreneurial endeavour. It encompasses all types of risk and the way they interrelate with each other. It balances risk and reward based on the company's risk appetite and may place special emphasis on those risks that threaten the survival of the organisation.

Implementation of ERM within (re)insurance companies normally requires the use of sophisticated financial models to simulate the impact of different possible scenarios.

The FSA's ICAS regime has pushed all (re)insurers, including run-offs, toward ERM processes. In practice, it has applied a light touch in this respect to companies that are no longer writing live business. The regulator has tended only to ask to see financial models in specific circumstances such as transfers, sales and purchases or capital extractions.

The FSA is increasingly alive to this issue, however, and many run-off companies are starting to use the ICAS process to better understand the risks they face and to be ready for any future exit strategies or reorganisation. Indeed the FSA has suggested that in time it may increasingly wish to see models for run-off companies. The implementation of Solvency II will also drive greater use of ERM.

Some of the more sophisticated run-off operations use ERM techniques anyway, not for regulatory reasons but as a strategic tool to understand their portfolios better and so increase profitability and the probability of solvency. ERM is a proven method of obtaining objective analysis of alternative strategies, predicting the cost of the different options and the potential variability of outcome.

Equitas

Equitas – the vehicle which in 1996 reinsured the liabilities of Lloyd's of London syndicates spanning from 1688 through to 1992 – is the largest run-off on record and arguably one of the most successful.

Equitas was first mooted in January 1992 as a solution to the myriad of problems that nearly bankrupted Lloyd's, most notably the proliferation of long-tail asbestos, pollution and health hazard (APH) liabilities. It then took over four years to get Equitas off the ground. The challenges were steep. First, Lloyd's had to estimate accurately the future cost of volatile APH claims. If the estimate was too low, Equitas would go bust; if it was too high, it would be impossible to raise the necessary funds. Lloyd's then had to squeeze billions of dollars out of a motley group of concerned parties, which included the increasingly belligerent 'Names', who at the time supplied all of Lloyd's capital and many of whom attempted to avoid paying up despite agreeing to assume 'unlimited liability' when they joined Lloyd's.

At the same time, policyholders facing APH claims – including some of the largest US industrial corporations – believed that Equitas was nothing but a scheme (in the American sense of the word) perpetrated by Lloyd's to avoid paying valid claims.

Despite all of this, Equitas officially came into being on 4 September 1996, saddled with nearly \$30 billion in claims liabilities (at 2008 exchange rates) under the leadership of Michael Crall whose plan was to pay valid claims as quickly as possible and then toughly negotiate mass settlements of the APH liabilities. In some cases, Equitas allegedly used the prospect of its own demise as motivation for a policyholder to settle for a fraction of what it had originally sought.

Crall's strategy worked well (including the then-radical notion that Equitas would not reimburse an asbestos company unless it could prove that claimants were actually injured), even though asbestos claims skyrocketed in the late 1990s.

Crall retired in 2003 and was not around to see Berkshire Hathaway hammer out a deal in autumn 2006 whereby it would effectively guarantee Equitas' remaining \$8.7 billion in liabilities. It was a deal where apparently everyone was a winner: Lloyd's is still alive today, Warren Buffett got billions of additional dollars to invest from Equitas' portfolio; the Names will effectively get off the hook when all parts of the deal are finalised and received a \$100 million refund to boot; policyholders now benefit from Berkshire's AAA-rated security; and, last but certainly not least, a small group of Equitas senior executives pocketed one-time bonuses totalling \$20 million.



European run-off

PricewaterhouseCoopers LLP

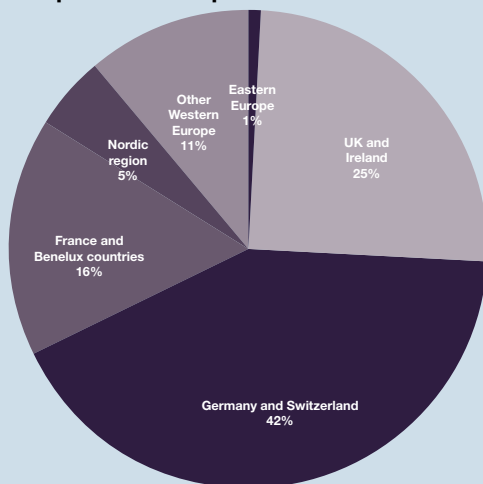
European run-off has received a great deal of attention in recent years and a comprehensive summary can be found in PricewaterhouseCoopers' Survey of Discontinued Insurance Business in Europe (the 'Survey'), the second edition of which was launched in February 2008.

The development of European run-off

The first edition of the Survey, published in 2007, looked at the size and spread of run-off liabilities across Europe. It estimated total liabilities across the market of €204bn and also explored some of the challenges facing European insurers and reinsurers in respect of their discontinued liabilities. The 2008 edition of the Survey considers recent developments in the run-off market and summarises the results of an online questionnaire that was completed by a cross-section of insurers and reinsurers with both live and discontinued business across Europe.

In terms of the size and spread of European run-off liabilities, the market is estimated to have shrunk slightly in 2008 to €202 billion, with Germany and Switzerland accounting for 42 per cent of this number. This revised overall liability number reflects an increase in run-off throughout Continental Europe offset by a relatively significant decrease in the size of the UK market.

Figure 1: Spread of European run-off liabilities



Source: PricewaterhouseCoopers

The term 'European run-off market' is now used regularly, but refers to a diverse market, unlike the homogenous one in the UK. The Survey draws attention to the potential value that is locked-up in respect of run-off insurance business throughout Europe. The UK market is characterised by numerous standalone run-off companies where, over the past decade, owners have focused on accelerating closure in order to access capital. For many European insurance and reinsurance organisations, where run-off business exists alongside live business, less direct focus may have been given to addressing the challenges posed by managing run-off business.

Key factors shaping the European run-off market

1. The Reinsurance Directive

The implementation of the Reinsurance Directive by many EEA states in 2007 (see page 28) has been a significant factor in the development of restructuring through insurance business transfers, both in the discontinued and live markets. In March 2007, the Swiss Re Group announced plans to transfer all of its existing reinsurance and insurance liabilities and assets held in a number of subsidiaries to new carriers domiciled in Luxembourg. The importance of this Directive in respect of run-off is twofold. Firstly, run-off portfolios can be transferred to another jurisdiction to allow tax, capital, regulatory and economy of scale efficiencies to be realised, or to make exiting the portfolio easier. Secondly, non-life portfolios of business can be separated from life portfolios of business which are harder to exit.

2. Solvency II

Another significant driver in the European run-off industry at the moment is Solvency II (see page 30) and the results of the Survey suggest European insurers are already preparing themselves for the implementation of this Directive. The Survey responses indicated that the impact of Solvency II on many European insurers is likely to include:

- an increased focus on operational efficiencies and the extraction of capital
- a need to have a greater appreciation of the exit routes available to deal with discontinued business
- an increase in transfer activity

Key issues highlighted by the Survey

Some of the other key findings from the most recent Survey are summarised below:

- over 70 per cent of respondents thought that their existing run-off portfolios would take over 10 years to expire naturally
 - the most common concerns for insurance organisations in Europe when considering run-off were cited as: tied up capital, the risk of adverse loss developments and the level of operational costs involved in dealing with run-off
 - almost 60 per cent of respondents considered that their run-off reserves had increased in the last five years over 80 per cent of respondents believe that the Reinsurance Directive will result in an increase in transfer activity across Europe in the next five years;
 - over 60 per cent of respondents thought Solvency II would drive an increased focus on run-off business and the exploration of various exit solutions; and
 - only 20 per cent of respondents were aware of the widespread use of solvent schemes of arrangement as an exit mechanism for non UK domiciled run-off businesses (or portfolios of business) which have 'sufficient connection' to the UK – there have been over 30 such exits using this method.
- Factors such as the economy and the regulatory environment are pushing run-off up the agenda for European insurers and reinsurers and organisations are increasingly recognising the benefits that the active management of run-off business can bring them.



Finality

Finality is sometimes described as the holy grail of run-off. This is perhaps a little misleading as it is by no means unattainable, but it can prove elusive and involve a long and tortuous journey.

Finality may be said to be reached when all the liabilities of the entity in run-off are extinguished. There are strictly speaking only two ways by which this may be achieved: by run-off to the natural expiration of all risks, or by commutation which may subsequently culminate in a solvent scheme of arrangement, which is itself effectively a form of mass commutation. (An insolvent run-off in the UK will normally be closed by means of an insolvent scheme of arrangement.) While run-off to expiry is still favoured by some, the attraction of accelerated run-off is primarily the earlier release of the capital tied up in the run-off, plus the curtailing of administration costs which can otherwise mount up and drain the available funds.

As for the alternative exit strategies, reinsurance cover may transfer the risk but it does not remove the liabilities. Sale or transfer of the run-off entity does provide finality for the vendor, however the liabilities are transferred elsewhere within the market rather than extinguished. Similarly, the purchase of reinsurance to close (RITC) by a syndicate at Lloyd's does achieve finality for that syndicate, though in effect the liabilities are transferred elsewhere within the Lloyd's market.

Often a combination of techniques may be used on the road to finality. For example, a sale or transfer of the run-off, bringing an early release of capital for the vendor, may be followed by a programme of aggressive commutation by the new owner. Where a scheme is in prospect it is generally necessary to commute with major creditors before proceeding to a scheme. Not all books are suitable for a scheme (see page 16) and reinsurance cover may be sought where a portfolio cannot be closed.

Whether an accelerated run-off strategy is pursued will depend on the attitudes of the major stakeholders, notably the shareholders, the capital providers and also the regulator. While the regulator's remit is to protect the policyholder's interests, a crystallisation of liabilities and early closure may be preferable to a long drawn out run-off in which funds may be exhausted and a solvent run-off may become insolvent. However, direct policyholders can prove resistant to policy buybacks and solvent schemes and thus frustrate the achievement of finality, while objections in principle are encountered less often in reinsurance run-offs.

Financing run-off acquisitions

Barclays Bank plc

An increasing number of companies are now looking to purchase run-offs and most need a suitable finance provider/partner to help fund the transaction. Every run-off transaction is slightly different with some opportunities more suitable to higher levels of debt finance than others. In order to determine the appropriate level of debt the chosen finance provider will need to undertake almost exactly the same level of analysis as the run-off purchaser.

In terms of the due diligence, the finance provider will focus on the classes of risk and the period of time over which the business was written. The more volatile exposures, such as environmental and APH, will be less suitable to high levels of debt than catastrophe risk, for example. Irrespective of the classes of risk underwritten, an element of debt financing could still be a viable option.

The adequacy of reserves and the historic volatility is an essential component of the due diligence report. In addition to the assessment of the 'Best Estimate', the finance provider would expect the actuaries to take reserves to the 95th percentile to demonstrate the balance sheet in a stressed scenario. Clearly, those portfolios with higher certainty of reserves and a record of low volatility will be more suitable for higher levels of debt finance.

The finance provider will also require a thorough analysis of the assets on the balance sheet. The size and quality of the reinsurance receivable will need to be assessed in addition to the asset classes and concentration of the investment portfolio. High quality assets will provide scope for greater leverage.

Quality due diligence is essential but, perhaps, even more important is the management team as the acquisition will only be profitable if the run-off strategy is successfully implemented. Therefore the finance partner will assess, in depth, their experience, capability and track record.

Lastly, the jurisdiction in which the run-off will take place will be considered. The approach of the FSA and BMA is well known, but if the run-off is domiciled elsewhere the finance provider will need to be confident that the purchaser fully understands the approach of the applicable regulator.

The structure of the facility is obviously important and the repayment profile needs to accommodate the uncertain timing/value of capital releases. Full repayment is likely to be required between three to five years with at least an element of interest serviced periodically during the term. The purchaser's cash flow model and business plan will be used to determine the appropriate profile for the particular acquisition.



Germany

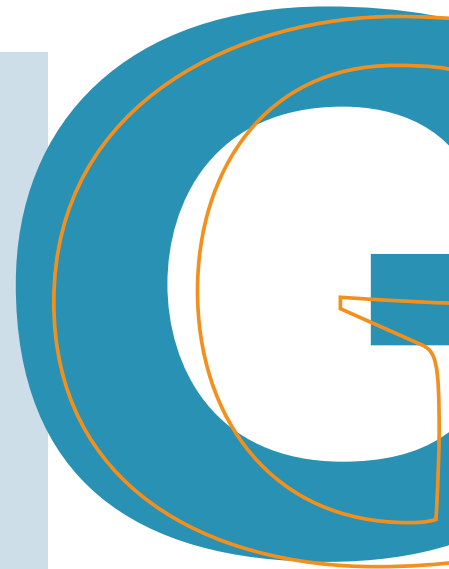
KPMG LLP

Run-off in Germany is still a private phenomenon associated with failure. Run-off activity is largely conducted in-house, behind closed doors. Run-off tools and techniques lag approximately 10 years behind the more advanced run-off markets of the UK and US where run-off outsourcing is commonplace.

However, within the European markets, Germany is already being viewed as more proactive when it comes to run-off and is tipped as the market most likely to embrace change in terms of utilising run-off tools and outsourcing. Given that the run-off segment of the non-life German speaking markets of Germany, Austria and Switzerland is estimated to have combined technical reserves of approximately €66.5 billion, (compared to €56 billion in the UK (Source KPMG in Germany, 2007)) – or around 20 per cent of the total non-life German market – it is not surprising that it is attracting attention.

One of the key factors driving developments in run-off in Europe is Solvency II, which will increase the visibility of 'unprofitable' business. Many organisations have begun to reorganise their business through exit strategies such as disposals, securitisations, outsourcing and accelerated in-house run-off for underperforming or unprofitable lines of discontinued business, ahead of the implementation of Solvency II, due in 2012.

Another driving factor is the implementation of the EU Reinsurance directive in June 2007. This facilitates legally binding reinsurance portfolio transfers previously only available under EU Directives for books of direct insurance. This enables intra-group reorganisations to be completed within the EU, an essential tool for an insurer to concentrate discontinued business into one entity or 'sell' such books to a third party. We have already seen the first use of the transfer of a discontinued reinsurance portfolio from Germany to the UK.



Human resources

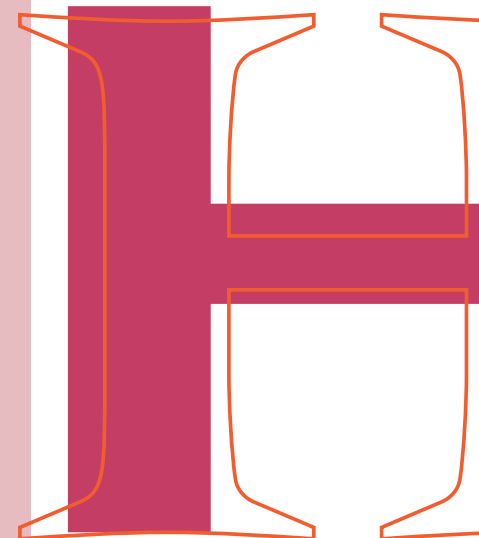
HR is especially significant for the run-off sector, primarily because of the image problem the sector has had in the past. In the traditional run-off scenario, where a whole company stopped writing new business, it was normal to haemorrhage staff quickly. Underwriters were likely to be first out of the door, on the not unreasonable premise that there was no more underwriting to be done, followed swiftly by others who were unwilling to stick around in what was perceived as a dead end with no prospects.

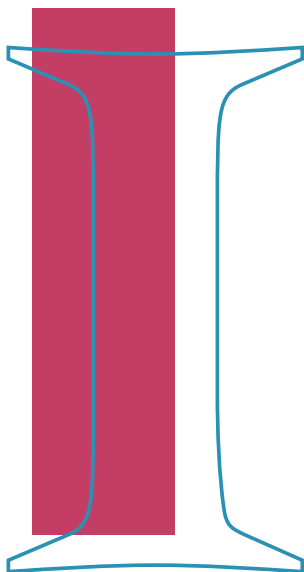
For the employer, this posed a dilemma. Cost pressures might encourage a reduction in the headcount, but the downside was the disappearance of staff with the knowledge that you needed to handle the run-off. So it was always a difficult balancing act, seeking to retain the most valuable staff while not keeping on too many people sitting around idle.

To some extent times have changed, at least in the London market, as run-off lost the stigma it once had and people realised the skills acquired handling run-off would be marketable elsewhere. For this reason, peo-

ple were happy to work for Equitas knowing it would have a finite lifespan. But the paradox remains that it can be hard to motivate people when the better you do your job, the sooner it comes to an end.

One solution tried with varying degrees of success is for the entity in run-off to set up as a third party service provider, acquiring or managing other portfolios that the in-house staff can then move on to. Another solution can be to outsource the whole operation. The service provider's appeal to the employee is that with a variety of portfolios under management and more being sought, there is an ongoing career path provided – though with the dearth of recent outsource contracts this proposition begins to look less certain. Fortunately, the culture of frequent job moves in the London market and the raised profile of run-off as a whole has meant that the relevant skills are highly transferable and likely to be in demand elsewhere. And indeed the expected shift towards more discontinued business within live groups instead of whole entities in run-off changes the equation for employees yet again.





Insolvency

KPMG LLP

An insurer, like any other company, is deemed insolvent if its liabilities (including prospective liabilities) are greater than its assets, or it is unable to pay its debts as they fall due. Generally an insurer will become insolvent on the basis of the balance sheet test rather than the cash flow test. An insolvency procedure may be initiated by the company, its directors, creditors or the regulator. Typically an administrator or provisional liquidator will be appointed and the officeholder will act to secure the assets of the company and to put in place, or maintain, a run-off process (which may or may not involve outsourcing). The officeholder will then typically agree claims in the normal course but will only make distributions to creditors when he has collected in sufficient assets and is comfortable with the valuation of assets and liabilities.

The extent of set-off will often impact this valuation and will need to be factored into these calculations. Interim distributions may be made by the officeholder and certain priorities to payments of claims may apply. Any secured creditors will receive distributions from the realisation of the secured assets, preferential creditors (such as employees) will then be paid first from the unsecured assets, followed by insurance creditors and lastly reinsurance and other creditors. Distributions can be made by an administrator, but often a scheme of arrangement will be promoted and distributions will be made through that mechanism. In respect of protected claims, policyholders may also have recourse to the UK insurance guarantee scheme, the financial services compensation scheme, which can pay up to 90 per cent (or 100 per cent for compulsory insurance) of the agreed liability.

Independent expert

Milliman Inc

Insurance business transfers are subject to Part VII of the Financial Services and Markets Act 2000 and must be approved by the Court under Section 111. To assist the Court any application made must be accompanied by a report on the scheme by an Independent Expert. The expert's appointment is approved by the Financial Services Authority (FSA).

The process of appointment is that the intended applicant nominates an expert to the FSA. The FSA determines the suitability of the expert which is dependent on the scheme and the firms involved and whether the expert has the necessary skills. The FSA may, itself, nominate the Independent Expert.

The Independent Expert is typically an actuary although no formal requirements are needed. They need to show independence both at a personal and firm level, and other work done by the firm may be an issue. They need to have relevant knowledge of the types of business being transferred.

The form of the report also has to be approved by the FSA. In particular, the FSA may wish to highlight and address certain issues.

The report needs to address the rights and expectations of policyholders, whether the scheme is equitable between groups of policyholders, and any safeguards needed to protect those interests and ensure that the scheme operates as presented. The report needs to consider the policyholders transferring, the policyholders not transferring and the policyholders of the receiving entity. In particular, the report will address the likely effects if the scheme is or is not implemented, the security of policyholders and the level of service provided. The report is not expected to comment on new potential policyholders, nor required to ensure that the capital position of the receiving entity after the transfer is at least as strong as the transferor. However, he/she does need to ensure that the capital position after transfer is adequate for the security of the policyholders.

The report needs also to highlight the commercial nature of the transaction. Some legal input is also often required in the more complex schemes. The report may consider alternatives.

The Judge really does rely on the Independent Expert, as is evident in the number of times he is referred to in judgments. Indeed the Independent Expert has a duty to the Court and may be scrutinised. The FSA also has the right to participate in the proceedings (although as the FSA now provides the Court with its own report on what it considers are the significant issues of the transfer, such participation is less likely).

Judgments

Barlow Lyde & Gilbert LLP

The battleground for solvent schemes keeps moving. Arguments already having raged over the appropriate constitution of classes, we wait to see whether there is the appetite for further challenges. Whilst for those who are the subject of a legal challenge it is time consuming and disruptive, once handed down judgments provide greater certainty over procedures for both those proposing, and those voting on, future schemes.

The two most important decisions to date have been:

- Re The British Aviation Insurance Company Ltd [2006] BCC 14 (BAIC); and,
- Willis Faber (Underwriting) Management Ltd [2006] EWHC 1335 Ch (WFUM).

British Aviation

The solvent scheme of arrangement proposed by BAIC was successfully challenged at the sanction hearing on the basis that the classes were not correctly constituted. In this case the judge found that the scheme meeting had not been properly held and the scheme could not therefore be sanctioned. Classes are to be comprised of 'persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest', and the requisite amount of votes in favour of the scheme must be secured from each class. This effectively gives each class a right of veto. Although it is possible for a scheme to go ahead in respect of only one class of creditors it is unlikely that a company would wish to proceed on this basis as the benefit of early crystallisation of liabilities and release of funds would not be achieved.

Prior to BAIC, commonly all policyholders would be put into one class. The argument brought in BAIC

related to the differing interests of creditors whose claims have been incurred but not yet reported 'IBNR'. An example of IBNR claims, particularly relevant in BAIC, would be asbestos claims where the damage has occurred to a former employee during the course of employment, but physical symptoms of the resulting disease have not yet arisen or been diagnosed.

It was argued that claimants with IBNR claims should constitute their own class as their economic interest was different to claimants with agreed but unpaid claims or outstanding claims (claims already notified to the insurer but where the quantum has yet to be decided).

WFUM

The WFUM Scheme of Arrangement was seen as the case that would determine whether the issues raised in BAIC could be satisfactorily dealt with in a scheme. Through that WFUM scheme 16 member companies of the WFUM Pool sought to crystallise their liabilities. It was proposed that each scheme company should have one class of creditors on the basis that all creditors held the same rights, ie the right to indemnity. This constitution of classes was challenged at the convening hearing where it was held that each company should hold two meetings to vote on the scheme, one for IBNR creditors, and one for all other creditors. It was also argued that reinsurers or foreign creditors should constitute separate classes but the judge found against this argument. Importantly, the WFUM judgment clarified that the BAIC decision did not make it mandatory that IBNR creditors should constitute a separate class and that each scheme should be considered on its own facts. In most cases, however, IBNR will be in a separate class.

Kwelm

Provisional liquidators were appointed to Kingscroft Insurance Company Ltd, El Paso Insurance Company Ltd, Lime Street Insurance Company Ltd (all registered in England and Wales) and the Mutual Reinsurance Company Ltd (registered in Bermuda) in March 1992 closely followed by the Walbrook Insurance Company (registered in England and Wales) later the same year. To become known as the Kwelm group of companies, it became one of the best known, albeit protracted, schemes of arrangement in the run-off market. The \$50 billion insurance failure was posted as a scheme to creditors the following year and following overwhelming support received Court approval at end 1993. Following a number of payments from 1994 onwards, the last creditor payments to be made in 2006 pushed the percentages up to an impressive 100 per cent for Walbrook and El Paso, 86 per cent for Lime Street, 83 per cent for Kingscroft and 74 per cent for Mutual. The scheme administrators expect to make two further small distributions – one in 2009 and one in early 2012.

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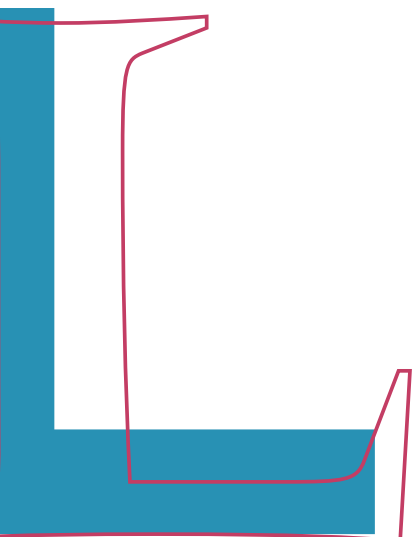
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Life run-off

Although the value of the worldwide life run-off market has, to date, not been quantified, since the UK market alone is estimated at over £130 billion in liabilities this gives some indication of the immense size of the market as a whole.

The UK life run-off market was last surveyed by KPMG/ARC in 2006 in a report (published 2007) which concluded that 58 life companies were in run-off at that time, accounting for approximately 11 per cent of the policyholder liabilities of all UK life insurers, and with total policyholder liabilities of £132 billion. The report also observed that approximately £16.2 billion of capital was tied up in UK life run-off businesses at that time and that the life run-off market spent over £730 million in administration costs.

The acquisition of life run-off portfolios remains a buoyant sector with purchasers gambling on being able to reduce the administration costs or increase the investment proceeds or in some cases both.

The current market leader in closed life books in the UK is the Pearl Group which recently purchased the former leader Resolution in May 2008 and now has £87.5 billion of funds under management.

Lloyd's Open Years

Although Lloyd's had dealt with all its pre-1993 liabilities through the creation of Equitas (see page 14), the number of its unnaturally open years and syndicates in run-off for post-1992 underwriting years continued to grow.

In 2002 Lloyd's decided to tackle the problem through agreeing a reinsurance to close (RITC) deal for 13 run-off syndicates which released a total of 3,600 trapped Names. RITC effectively operates as a 100 per cent quota share reinsurance of a year of account of a Lloyd's syndicate. An RITC closes a year of account by transferring the responsibility for discharging all the liabilities that attach to that year of account (and any year of account closed into that year) plus the right to any income due to the closing year of account into an open year of account of either the same or a different syndicate in return for a premium.

RITC is the approved finality tool for Lloyd's but until recently had been both in relatively short supply and expensive. However, a new flexible approach by Lloyd's, plus a softening underwriting market and more available capital, has meant that the supply of RITC and RITC players have increased steadily and as a result the last three years have seen a dramatic reduction in open years, open syndicates and liabilities (see Table 1).

Lloyd's operates a stringent approvals system for admitting companies to offer RITC to syndicates. There are currently 11 entities able to offer RITC: Imagine, Liberty, Marlborough, Capita CMGL, Alea, Faraday, Markel, Shelbourne, RITC SM, Chaucer and Centrewrite, which is the Lloyd's 100 per cent Central Fund-supported vehicle.

Although one life syndicate was the subject of a Part VII transfer and other syndicates have effected similar agreements, Lloyd's has made it clear that RITC is its finality tool of choice and also that schemes of arrangement are not being considered.

The number of syndicates going into run-off has also tailed off in recent years – just one new one last year with one open year – due partly to the benign underwriting environment but also to the strict supervision maintained by the Open Years Team at Lloyd's under Steve McCann.

Table 1: Lloyd's Open years

	2005	2006	2007
Number of Open Syndicate Years	102	90	54
Number of Open Syndicates	48	40	23
Gross Liabilities	£7.0bn	£4.7bn	£2.7bn
Net Liabilities	£4.4bn	£3.0bn	£1.6bn



M&A

Whittington Group

In essence, buying another insurance company or a portfolio of business (either one that is in run-off or is still live), is no different from buying any other company. Take a good look at the balance sheet, the past and projected cash flow and the business plan, and reach a valuation. Beyond the 'simple' economics of the deal however, any acquisitive CEO or financial director eyeing a potential purchase will need to ask themselves two simple questions: why are we buying? And why is the vendor selling?

Is the buyer looking for synergies with

their existing business for example, or is the purchase purely intended to drive bottom line growth and boost investment income? Pursuit of growth is often the acquirer's objective but there must be a realistic assessment of the deal's potential to increase value for shareholders.

Why is the vendor selling? Are there regulatory pressures being applied? Do they perceive the business to be failing? Are they restructuring the business or are they raising cash or, indeed – just cashing in? These questions are a critical part of the due diligence process and need to be addressed from the outset.

All acquisitions are different; but the process might look something like this;

- Making initial contact with the vendor
- Risk assessment – ongoing throughout the process
- Initial financial appraisal
- Deal finance – equity and/or debt leverage?
- Preparing an initial

offer

- Carrying out due diligence
- Valuation
- Negotiation of the overall form of the contract and on the contract process – the 'heads of terms'
- Detailed contract negotiation and agreement
- Gaining regulatory approval
- Reaching completion
- Separation and integration

It's a relationship business

Much depends on the initial contact with the vendor and establishing good relationships at this point in terms of honesty and transparency will pay dividends in the long term. If they are not already in-house, getting the right advisers on board is critical. An experienced corporate lawyer is clearly essential to the process but, buyers should also seriously consider using the services of a professional finance adviser.

So what problems can arise? In theory, any single issue can hold up a deal. Financing can prove to be a major crunch point, even more so in today's difficult lending environment if the transaction is to be financed in any way by debt (see page 16).

Other problems include obtaining regulatory approval which can be a significant hurdle and again early communication with the regulator will help ensure future problems are kept to a minimum. The process of integration is also something that should not be left until the ink is dry on the contract documentation. Key issues like addressing staff concerns and getting the communication right need to be thought about from very early on in the acquisition process.

Know when to walk away

Above all, when it comes to an acquisition the ability to walk away at even a late stage is crucial. Beware of the condition known as 'deal fever' – it's difficult to do this when you've invested significant resources both financially and emotionally, but the long term costs of a deal that is not right for your business will be far greater.

Managing claims

Claims management assumes an even greater importance for entities in run-off than it does for live (re)insurance groups. The reason is simple. Once you go into run-off the premium income dries up, and the only money coming in will be from returns on investments and from collecting on the reinsurance asset. Controlling costs becomes paramount and a prime area for consideration must be the area of claims management.

It might be said that the need to contain costs and monitor claims carefully is common to all insurers. But in a live operation there are counterbalancing pressures in the form of maintaining the ongoing business relationship which may encourage a climate in which claims are not actively managed – the temptation being to nod through claims that should perhaps have been examined more carefully, it being more important to retain the business at renewal. The number of parties involved in the claims process in the subscription market is also a hindrance.

Conversely, the temptation when in run-off may be to delay and dispute legitimate claims unnecessarily and it should be remembered that reputational risk is of importance for run-off managers too. The FSA will want to know about any changes to the claims process, which should be included in the firm's run-off strategy, and will be watching for any evidence of unwillingness to meet claims settlement obligations or of unfair practice.

So, on transition to run-off the claims department should move from being a medium priority support role to being the central function. Proactive claims management should look to control settlement costs, minimise claims leakage and improve reserving accuracy. A claims handling guide should be put in place and updated on a regular basis.

Attention should be paid to managing cashflow and to minimising outwards reinsurance disputes. Reinsurers' attitudes to primary insurers' claims have hardened in recent years. Such increased scrutiny from reinsurers should be addressed via closer links between the claims and reinsurance departments, so that inwards claims handlers have a greater understanding of the outwards reinsurance programme. Finally, the quality of data capture and management information should be reviewed and upgraded if necessary.



Non-life run-off

Generally speaking, any discussion about run-off insurance that does not specify otherwise can be assumed to be talking about non-life business. Likewise the various associations and rendez-vous in the run-off sector are largely concerned with non-life.

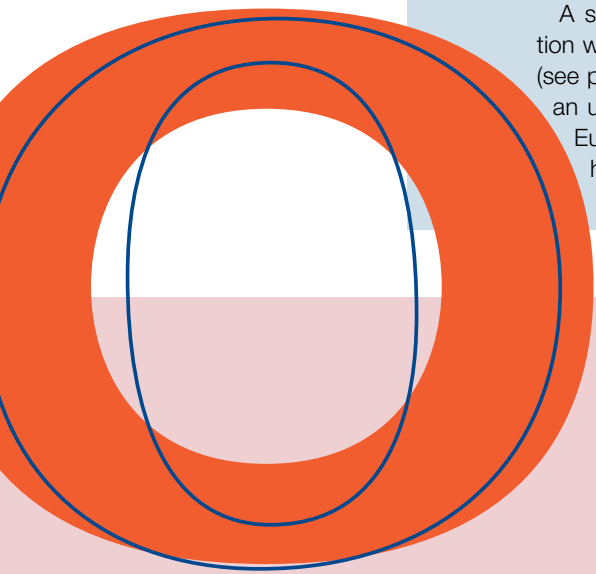
Non-life run-off has attracted so much attention because, first, it can contain long tail liabilities that can take many years to run-off, and second, it is often amenable to the application of accelerated run-off techniques. As a rule, personal lines and compulsory cover such as employers' liability are not deemed suitable for accelerated run-off, but most other commercial lines can be so treated in the right circumstances.

The size of the non-life insurance run-off market in the UK was estimated at £32.7 billion in total liabilities at the end of 2006, according to the most recent KPMG/ARC survey published in 2007. This figure, which represents 18 per cent of the UK non-life insurance market as a whole, was down by 14 per cent on the previous year's £38.2 billion. However the total capital tied up in solvent UK non-life companies in run-off rose by 2 per cent to £4.9 billion.

The fall in total liabilities was attributed to the proactive management of existing run-off portfolios, leading to final closure in some cases, an absence of any major portfolios entering into run-off, and the weakness of the US dollar against the pound. In addition the survey, which includes Lloyd's business but excludes UK business of companies from other EU countries, reflects the reduction in total liabilities of the Lloyd's syndicates open years to £5.2 billion at end-2006.

A difficulty in estimating the size of the market is the unknown amount of discontinued business hidden within live groups, and this is even more prevalent in mainland Europe.

A survey published in February 2008 by PricewaterhouseCoopers, again in conjunction with ARC, estimated total non-life run-off liabilities across Europe at Euro 202 billion (see page 15), with the caveat that, for the reason noted above, this figure is likely to be an underestimate. The survey also noted that an increase in run-off within Continental Europe was offset by a decrease in UK liabilities (which comprise 25 per cent of the headline figure).



Outsourcing

The traditional debate between those wishing to handle their run-off in-house versus outsourcing to a third party continues unabated in certain areas of the market. The proponents of outsourcing push the advantages of allowing companies with continuing live business to concentrate on their core competencies as well as making substantial savings along the way.

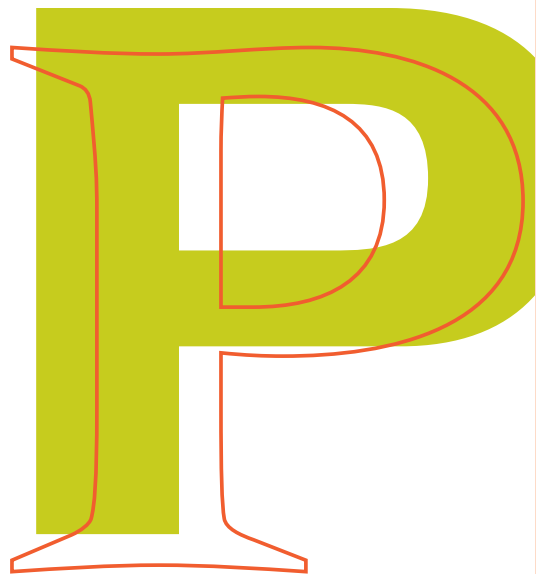
The range of services and skills which can be outsourced is wide. Typically, the outsourcing of claims management – and its incumbent IT aspects – is now very widespread with companies happy to see the back of legacy claims data on old systems. Collection and debt recovery is another relatively straightforward service to offload to a specialist – particularly if it involves

trying to recover monies from far flung places or if the amounts involved are small but frequent. Audits and inspections of (re) insurers books is also increasingly outsourced to specialists with detailed knowledge and understanding of particular countries and companies and the way they view being audited.

Of course the ultimate outsourcing move is to sell the run-off business to another company and get rid of the problem altogether and many outsource companies are increasingly in the market to buy up portfolios alongside the specialist buyer vehicles in some cases to run them off more cheaply than they believe the seller could have done, transfer them into a more advantageous location or put them into a scheme of arrangement.

But on the in-house side of the argument there remains the firmly held view that there is nothing wrong with steadily handling the problem from within and in the case of live companies either incorporating into the general running of the company or hive it off into a separate unit.

For businesses in total run-off keeping everything in-house also preserves the chance of making a go of taking on other companies' run-off and turning into a full blown service provider (see page 33).



Part VII transfers

KPMG LLP

A Part VII transfer is a legal mechanism for the transfer of insurance and/or reinsurance business from one insurer to another under Part VII of the Financial Services and Markets Act 2000 (FSMA). The process is compulsory for the transfer of all or part of an insurance business carried on by a UK authorised firm anywhere in the European Economic Area. The transfer is effected by means of an order of the Court, which usefully has the ability to include ancillary provisions to give effect to the transfer (such as an order to transfer the reinsurance asset protecting the portfolio being transferred).

The details of a Part VII transfer are set out in a report prepared for the Court by an Independent Expert, who must

provide an opinion on the impact of the transfer on affected policyholders. As the procedure is not subject to policyholder approval, the Court's decision will, to a large extent, be based upon the findings of the Independent Expert. The Court will also be cognisant of the role of the FSA, which must approve the appointment of the Independent Expert and the form of his report. The FSA will also offer its own views on the transfer by way of its own report for the Court.

The Part VII transfer process requires appropriate policyholder and reinsurer notification, and their support for the transfer is a key consideration for the transferring parties.

Policyholders and/or reinsurers who may wish to object to the transfer scheme can appear at the Court hearing and raise their concerns.

Pools

KPMG LLP

During the 1960s, 70s and 80s, many insurance companies in the London market formed joint ventures to write insurance risks together. These joint ventures, called Underwriting Pools, allowed companies to combine the administration of their underwriting business with one underwriting agent. The agent handled the underwriting, reinsurance purchase, claims handling and accounting functions on behalf of the pool members.

Pools were an attractive method of underwriting in the London insurance market for the following key reasons:

- It was seen as an easy entry route to the London insurance market;
- Companies gained access to experienced underwriters, skilled staff and established systems;
- By pooling capacity, pools were often able to write larger lines than the companies could underwrite individually. Companies therefore gained access to risks which would otherwise not have been available to them;
- All costs were shared between the pool companies, resulting in economies of scale compared with each company establishing its own systems and underwriting programmes.

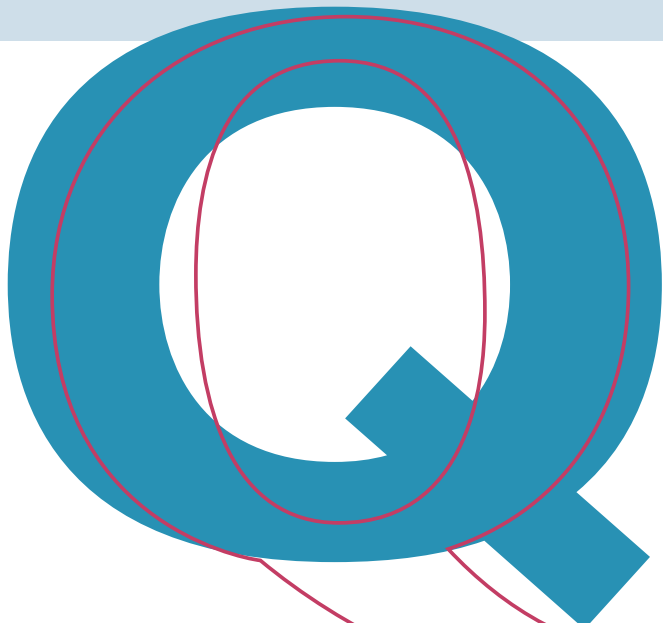
The benefits of underwriting pools can be undermined, however, whenever a pool business goes into run-off. In addition to the general problems of run-off, such as claims deterioration, increased costs and problems with reinsurance collections, pool participants and their managers have often struggled to get to grips with:

- Agreement over a unified run-off strategy;
- Poor records and maintenance of legacy systems;
- The potential loss of knowledgeable staff and management expertise;
- Responsibility for and maintenance of administration and records;
- Management of complex reinsurance programmes and the collection and allocation of pool reinsurance;
- Unwinding complex inter-participant relationships, including pool fronting arrangements;
- Consequences of insolvency of one or more participants;
- Co-ordinated pool closure issue.

The run-off of underwriting pools, therefore, has unique challenges and may require greater levels of resource. The most recent example of a finality mechanism for an underwriting pool is the WFUM pool (see page 20).

Quantitative Impact Studies (QIS)

QIS are the series of detailed technical studies investigating the structure and calibration of the Solvency Capital Requirement calculations under Solvency II regulations (see page 30). The fourth QIS was launched in April 2008 by the European Commission's Insurance Supervisory group (CEIOPS) and addresses issues such as the use of internal models, diversification benefits under group capital support and, most importantly, the minimum capital requirement calculations. QIS 4 includes a number of questionnaires for European insurers regarding their readiness for Solvency II and gives them an opportunity to test their own capital models against those being proposed.





Ratings

The possibility of whether entities in run-off should, or could, be given credit ratings has been debated in the market for some time. The questions arising concern how effectively a discontinued operation can be rated, to whose benefit it would be and who might pay for such ratings. A comment frequently made on this topic is that many run-offs would prefer to be perceived as weaker than they are, in order to enhance their negotiating position in commutations, and so would be unlikely to pay for ratings that confirmed their financial strength.

After a long gestation period, Standard & Poor's has now come out with its Run-off Payments Assessments which will place run-offs into one of seven categories, ranked by likelihood of claims being paid and by what percentage. S&P says it has adapted the debt recovery rating terminology it uses in the capital markets and coupled it with new criteria specifically designed to assess the characteristics of entities in run-off.

It is yet to be seen where the demand for these ratings will come from or how useful they will prove, but S&P foresees three main areas of applicability, namely: protecting ongoing insurers from reputational risk when closing down books of business or subsidiaries; easing the onward sale of businesses by giving both sides of the transaction security; and improving the understanding and confidence of policyholders.

One point S&P has emphasised is that no entity in run-off will be rated unless it has given its permission to be rated.

Reinsurance Directive

The EU Reinsurance Directive was approved by the European Parliament in June 2005 with the clear intention of establishing a legal framework for the regulation and supervision of reinsurers headquartered in the EU. Until that time there had been no EU regulation of reinsurance; although all member countries had been bound by EU directives covering direct and mixed insurers, pure reinsurers had not been included. In some EU countries reinsurance had been regulated in the same way as direct insurance whereas in others it had not been regulated at all, for example in Greece and Belgium.

The EU Reinsurance Directive applies only to companies writing pure reinsurance, along with captives, since direct insurers writing some reinsurance are already bound by existing insurance directives, and it is an interim measure until Solvency II (see page 30) is implemented in 2012. The deadline for the implementation of the Directive was December 2007 but so far the only countries which have complied are Ireland, the UK, Spain, Sweden and Germany.

The key elements of the Directive are that it requires all reinsurers to be authorised and licensed by the member state where it is headquartered; that a 'passport' regime prevails whereby all authorised reinsurers can carry on business in any EU country, and that the responsibility for the financial supervision of each reinsurer rests with its home state. The Directive also lays down rules covering solvency margins and mini-

mum guarantee funds to apply throughout the EU. The solvency margin is similar to that required by direct insurers and the minimum guarantee fund must equal one third of the solvency margin but not less than €3 million.

The Directive has two main implications for the run-off sector. First of all the passport regime makes it unnecessary and inefficient to have multiple reinsurance entities each needing separate financial requirements and so it should trigger more companies to move their headquarters to more attractive jurisdictions in terms of tax or regulatory attitude etc. For example, the way in which Swiss Re has made the strategic decision to base itself in Luxembourg and Partner Re to move to Ireland. Such moves could in themselves trigger a certain level of 'restructuring' on the part of the company and subsequent shedding of inefficient, costly and/or discontinued portfolios.

The second implication for the run-off sector is that the Directive has created a level playing field among EU member states and, far more importantly, allows for the easy transfer of portfolios of run-off business between EU jurisdictions. Until Article 18 portfolio transfers are permitted 'under conditions laid down by national law' with the onus on the 'accepting' regulator to check that the transferee possesses the necessary solvency margin. This of course means considerably more flexibility (although potential inconsistency between EU states) and advantages particularly for the UK.



Rendez-Vous

Say Rendez-Vous to most insurance people and they will most likely think of the Monte Carlo Reinsurance Rendez-Vous, the annual big bash which celebrated its 50th birthday in 2006. But the run-off sector also boast several such events of its own.

A rendez-vous is neither primarily a conference nor an exhibition; while it may contain elements of those, it is chiefly a meeting place where participants can set up private meetings. Whereas Monte Carlo was originally set up for meetings between insurers and reinsurers, the origins of run-off rendez-vous were based on commutations and a forum for discussions with counterparties – though like Monte Carlo they are also very much about networking in general.

In 1997 Cavell held its first Commutations Rendez-Vous in its home town of Norwich. The first one drew 100 people and it has since gone from strength to strength, becoming a major fixture in the calendar for anyone in the UK run-off sector, and for many from abroad as well. Its success is probably due to equal parts of good organisation and an attractive venue, distinctly different but not too far from London. Perhaps its only drawback is that the event has become so popular, the venue is now bursting at the seams.

Buoyed by the success of Norwich, Cavell has tried repeating the formula in other venues. A one-off event in Singapore proved disappointing. The Bermuda Rendez-Vous held in 2003 and 2004 fared better, but the breakthrough in the Americas came via a link-up with AIRROC and the New Jersey Rendez-Vous has attracted growing numbers from both sides of the Atlantic since its inception in 2005. The same year saw the first Cologne Rendez-Vous, held in conjunction with Global Reinsurance Group.

Though not officially described as a rendez-vous, the ARC Congress Commutation Day is another key event in the calendar along broadly similar lines, though it differs in being preceded by a whole day conference. And Monte Carlo too is now as popular with those in the run-off as in the live market.

Reserving

EMB Consultancy LLP

The dictionary definition of reserving is 'Keeping back for future use or for a special purpose'.

When applied to insurance, reserving relates to estimating the value of claims which will be settled in the future. It is a critical function within any (re)insurance company. It helps determine the profitability of business written and contributes to the feedback loop in the pricing of new business. In a run-off context, it has a crucial role to play in commutations, acquisition or sale of portfolios, capital modelling, accounting profitability and general management information.

Reserving typically consists of placing a value on four elements:

Case reserves assigned to specific claims,

A provision for future development on known claims,

A provision for claims that re-open after they have been closed,

A provision for claims that have occurred but have not yet been reported to the insurer.

The claims department will often assume responsibility for item 1, the specific claim reserves.

The combination of items 2, 3 and 4 is typically referred to as IBNR (incurred but not reported). There are numerous techniques used (predominately by actuaries) to evaluate IBNR. These techniques typically vary by class of business, claim type and maturity

of the losses.

Reserves may be before (gross) or after (net) the application of reinsurance. Where reserves are presented net of reinsurance there may be a provision in respect of possible reinsurer default or dispute risk.

Reserves may be inclusive or exclusive of future premium receivable. In a run-off context future premiums could be reinstatement premiums or swing rated premiums.

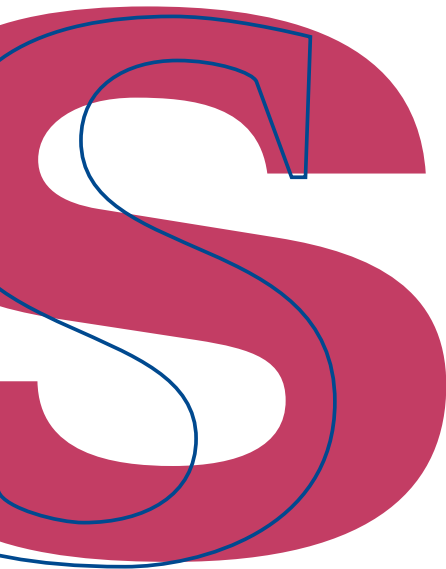
Reserves may also include claim handling expenses, which typically break down into two elements:

Allocated claim handling expenses (ALAE); these are expenses which can be directly attributed to the claims, such as legal fees.

Unallocated claim handling expenses (ULAE); these are costs that can't be allocated to any specific claim, such as audit fees.

Reserves can be shown before or after the time value of money has been taken into account, undiscounted or discounted respectively.

Historically, reserves have often been quoted as a point estimate, usually a best estimate; defined as the mean of the distribution of possible outcomes. More recently the full distribution of reserves has been explored and presented based on stochastic methods. This is a key input into capital models (see page 10) and wider ERM processes (see page 14).



Solvent schemes of arrangement

PricewaterhouseCoopers LLP

The concept of using a scheme of arrangement ('scheme') for solvent insurance companies in run-off was introduced over a decade ago and the use of this tool as a means of effecting a planned exit from this type of business has increased as schemes have evolved.

What is a solvent scheme?

A solvent scheme is a compromise or arrangement under English law (now governed by Part 26 of the Companies Act 2006, which replaced s425 of the Companies Act 1985 on 6 April 2008) between a company and its creditors or any class of them, which becomes legally binding on all creditors or any class of creditors if the necessary majority of creditors or class of creditors vote in favour and the English High Court then approves the scheme.

A solvent scheme is usually proposed as part of an overall strategy to finalise the run-off to achieve certainty, finality and the possible release of capital. Given the nature of occurrence – based insurance policies, it can be difficult to finalise run-off business of a company that has written long-tail business. Once effective, a solvent scheme provides for a wholesale estimation of all present and future claims by a set date and, in essence, effects a commutation with all policyholders. Policyholders are usually required to submit claims by a certain date and the company is required to agree claims or submit them to an independent adjudication process.

Solvency II

PricewaterhouseCoopers LLP

The Solvency II Directive, scheduled to be introduced in 2012, has the primary objective of strengthening policyholder protection by aligning capital requirements more closely with the risk profile of the company.

Although the requirements of Solvency II will not apply to entire reinsurers in run-off as at 10 December 2007, its application will impact the treatment of portfolios in run-off before this date and reinsurers that enter run-off beyond 10 December 2007.

The recent Quantitative Impact Study (QIS 3) (see page 27), the third in a series of studies to collect feedback on the framework Directive from insurers across Europe, indicated that the capital impact of Solvency II will be broadly neutral. However, QIS 3 participants were primarily larger insurers, with diverse exposures. It is fair to suppose, therefore, that capital requirements for smaller insurers might rise.

The increased focus on risk and capital management and more extensive disclosure requirements will intensify scrutiny on the effectiveness of each company's risk management systems and processes. At the same time, the capital markets, with their desire for increased return on capital will demand increased efficiency or returns

of capital to shareholders where capital cannot generate adequate income.

Solvency II will encourage companies to consider their capital allocation and management through reviews of the profitability and viability of individual portfolios. The focus on capital efficiency may lead to capital intensive lines of business being placed into run-off as well as increased focus on exiting from run-off portfolios.

Solvency II will also encourage wholesale reviews of group structures to ensure that groups are arranged in a capital efficient manner. Capital requirements and the concept of 'Group Supervision' under Solvency II will encourage restructurings to lower groups' overall group capital requirements as well as the solo requirements of their constituent entities. This will be an additional change agent to the goals of achieving regulatory and tax advantages through restructurings.

While the Directive is designed to be 'proportionate', companies with the most diversified businesses and most effective systems and controls may reap the greatest competitive benefits. In its current form, the impact of the Directive could result in smaller insurers struggling to remain competitive against larger, more capital effi-

cient groups and force smaller businesses to enter run-off or consolidate to remain competitive.

Solvency II will be a force for change in the European insurance market. The results from the recently released PricewaterhouseCoopers LLP 2008 Survey of Discontinued Insurance Business in Europe indicate that insurers are already showing an increased interest in capital management in anticipation of Solvency II. There has also been an increase in restructuring activity both in the UK and in Continental Europe.

It is likely that an increased focus on run-off will increase the resources allocated to the run-off industry and the professionalism of its approach to finalising liabilities. Centres of run-off expertise have already started to develop and it is likely that this trend will continue. It is also likely that buy out activity will increase as portfolios of capital intensive business are placed into run-off.

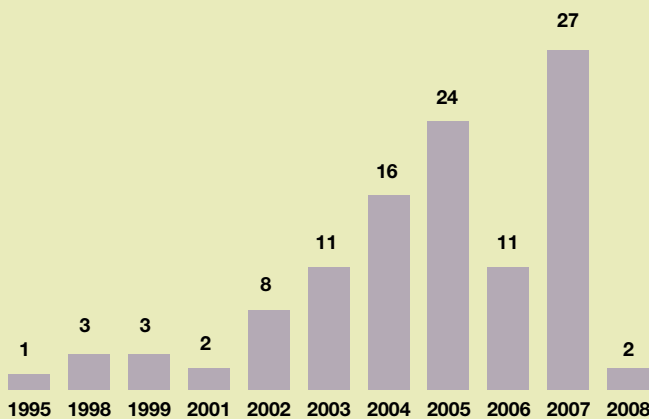
It is clear that Solvency II will change the rules for European insurers by bringing risk awareness and capital efficiency to the forefront of how businesses are managed and judged by regulators, investors and customers.



Application of solvent schemes

Although a solvent scheme may not be appropriate in all situations, a total of 108 such schemes have become effective to date, and recent solvent schemes have dealt with hundreds of millions of dollars of liabilities, complex pooling arrangements and long tail liabilities emanating from North America.

Figure 1. Number of effective solvent schemes (April 2008)



Source: PricewaterhouseCoopers

A solvent scheme can be applied to almost all run-off business. A key factor in considering whether a solvent scheme is an appropriate option for any portfolio is whether liabilities can be estimated with reasonable certainty. In promoting a solvent scheme, a company must demonstrate it is offering a fair deal to policyholders and a number of recent schemes have provided policyholders with an element of risk premium over and above the estimated claim.

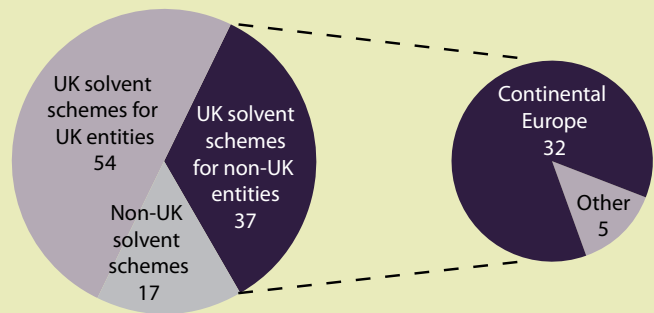
In circumstances where a reasonably certain estimate of future liabilities cannot be made (for example, where the business is relatively recent but there will be a long period of run-off before the majority of claims arise), the risk premium required by policyholders may be too high for the company to consider a solvent scheme as an appropriate option. To date however, most policyholders have considered the risk premiums offered under schemes to be a fair reward.

A global perspective

Although a solvent scheme is given legal effect under English law, they are not only available for use by UK companies. A solvent scheme can be sanctioned in the UK for a non-UK company where there is deemed to be 'sufficient connection' with England. Although there are no prescribed rules or regulations for the test of sufficient connection, the Court is likely to consider whether policies have been underwritten through a UK business presence such as a UK branch, if business written has been produced by London market brokers and the location of

creditors, reinsurers and other company assets. In addition, similar scheme legislation exists in many Commonwealth countries, for example Bermuda, Singapore and Australia.

Figure 2. Number of solvent schemes in effect by jurisdiction (April 2008)



Source: PricewaterhouseCoopers

For European companies where sufficient connection with the UK cannot be established, the route to finality using a solvent scheme can still be achieved, following a transfer to the UK using the Third Non-Life Directive for insurance companies, or the Reinsurance Directive (where implemented) for reinsurance companies.

Where next for solvent schemes?

The scope of application for solvent schemes has evolved over the last few years from relatively simple, low liability portfolios to large, complex businesses including pools (see page 27). With the increasing focus on capital efficiency and the impact of preparations for Solvency II in Europe, solvent schemes using sufficient connection to the UK are likely to be a growth area and an important option for those seeking a more efficient use of the capital currently allocated to run-off business.

A further trend is likely to be an increase in the use of a combination of restructuring tools, for example, a transfer to the UK followed by a solvent scheme. In addition, recognition of the potential of solvent schemes to remove the complexity associated with underwriting pools whilst ensuring finality is likely to increase given the numerous legacy issues that pools generate for all parties concerned.

The inherent flexibility and ability to deal with almost any commercial situation means that solvent schemes are likely to remain one of the most effective tools for bringing finality to discontinued insurance business in the future.



Training

Until relatively recently little attention had been given to formal training in the run-off sector. Since many run-offs – whether in-house or outsourced – carry forward with existing or original staff it was often assumed that further training or education was unnecessary and little attention was paid to career opportunities. However, it became clear that the skills needed in run-off were often very different from the ones needed in a live company since the new situation meant looking at issues such as claims from a completely new perspective.

In the UK the Association of Run Off Companies (ARC) decided to address this growing problem by establishing its Academy in 2005 to provide cost effective and relevant training courses. ARC now has a CII CPD Accreditation licence and runs regular courses on subjects such as: actuarial skills, schemes of arrangement, legacy management, creditor participation in insurer insolvency committees, run-off skills and master classes in commutations.

At the same time a number of companies in the UK offer run-off related training courses and in the US, the ARC counterpart AIRROC (the Association of Insurance and Reinsurance Run-Off Companies) has established an education committee.

UK run-off service providers

Born out of necessity courtesy of the immense amount of run-off emanating from the London market from the late 1980s onwards, the UK's run-off service provider roll call now embraces all manner of practitioners from the large 'we can handle everything' conglomerate with branches worldwide to the small niche one-man band specialist who knows everything there is to know about collecting debts in Nicaragua.

Many firms, of course, have evolved from the original teams of people carrying out an in-house run-off who, having completed their task, or in most cases needing to spread their costs, opted to capitalise on their growing skill base and take on third party business.

The *Run Off & Restructuring* annual directory of service providers (see page 38) demonstrates just how dominating the UK is in terms of the service provider skills it has on offer and the range of innovative finality tools and techniques it has developed. Another indicator of the role and importance of the UK in the run-off services arena is the growth of the Association of Run Off Companies (ARC), now in its 10th year and representing the issues and concerns of companies in run-off and their service providers and the Association of insurance and reinsurance Service Providers (AirSP).

The cloud on the horizon is, of course, the fact that these days very little run-off service work is coming out of the UK; a relatively benign underwriting environment, greater supervision by the FSA and tighter operating, solvency and capital regulations have all done their bit towards turning the run-off torrent into a trickle. Which means that the burgeoning number of service providers face some tough choices; expansion into overseas markets or consolidation or, in a number of cases, both.

So far expansion overseas for service providers is proving a hard nut to crack. The European market (see page 15) would appear to offer boundless opportunities – but not quite yet and only for those prepared to invest both time and money in persuading risk carriers to a) acknowledge the portfolios of discontinued business on their books and b) hand the business to a third party based, as far as a number of companies are concerned, in the very market from where their run-off problems emanated. The US market spells out a similar picture but with the added complication of differing rules and regulations from state to state.

As a result consolidation has already been rife in the market – the most recent large move being the merger of Capita and CMGL. But still the small specialists appear to be surviving – evolving in many cases into the providers of specialist services to the service providers...

Valuing a run-off

Milliman Inc

The valuation of a run-off business is a complex process, taking into account the expected value of claims, uncertainty, discounting and the costs of running the business among a number of other considerations.

The expected value of claims (or reserves) may be thought of as the undiscounted amount of the future claim payments. It is usual to assess the reserves by considering a number of distinct segments such as APH, LMX Spiral claims, other exceptional claims, casualty residual and property residual claims. In addition, the uncertainty associated with estimating the reserves needs to be assessed using appropriate reserve variability techniques. APH reserve variability is complex as many claims may be at policy limits, and the uncertainty may therefore arise from assessing the source and cost of new claims. For LMX claims the uncertainty may be in the claims settlement process including the outcome of legal decisions.

The value of the reserves then needs to be adjusted for the time value of money. The cash-flow pattern is first estimated and then the expected payments are valued by discounting them at an appropriate discount rate. This does not represent the market value of the reserves as a margin for the risk transfer needs to be added. Transfers on a willing buyer willing seller basis will allow for a margin, for example by using discounted reserves calculated at (say) the 80th percentile. A load then needs to be added for expenses.

When valuing a business appropriate allowance needs to be made for other risk areas, which may include the capital charge for risks like new unexpected claims, adverse legal decisions, system failure and so on. Another key component is the quality of any potential reinsurance recoveries and known reinsurance disputes.

A more sophisticated valuation approach is to assess projected profit & loss accounts, allowing for claims, investment income, expenses, commutations, tax and so on. The net profit emerging may then be valued at an appropriate risk discount rate. The variability in the assumptions producing the cash-flows may be incorporated either stochastically or by stress testing. Allowance can also be made directly for the cost-of-capital, that is the need to maintain capital at an appropriate level to satisfy both regulatory and commercial criteria.



Winding-up Directive

Barlow Lyde & Gilbert LLP

In April 2003, the government introduced into UK Law an EU directive which could have a big impact on how the London insurance market operates.

The Insurers (Reorganisation and Winding-Up) Directive (the Winding-up Directive) was brought into force in the UK by the Insurers (Reorganisation and Winding-Up) Regulations on 20 April 2003.

The most important feature of the Directive is that it provides for insurance claims to have priority in a winding-up over the claims of other unsecured creditors, whereas previously they ranked equally with other unsecured creditors. This will have significant impact where a company has issued both insurance and reinsurance.

The intention of the Winding-up Directive and the subsequent regulations is to ensure that EU subsidiaries of an insurance undertaking based in the member state are not each subject to a different set of rules, and to different procedures, to the rules to which the head company is subject.

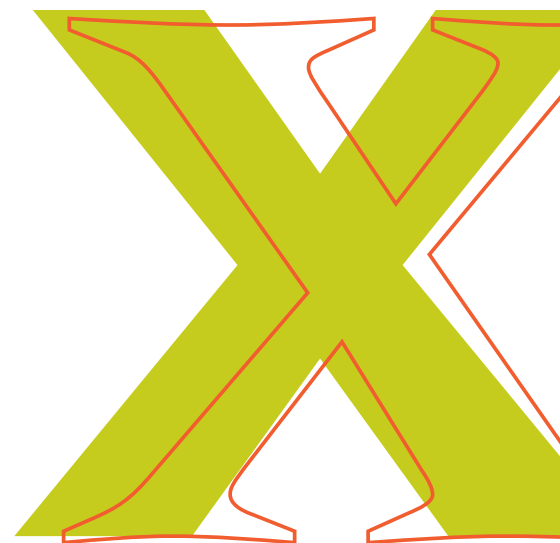
The Winding-up Directive also means insurance companies and all branches should enter into a single insolvency procedure in its 'home' country, the home country being the member state in which the undertaking is authorised to carry out its business by an appropriate regulatory body.

Once an insurance undertaking enters into an insolvency procedure in their home country then the member states' rules relating to that procedure apply throughout the EU without the need for any application to the local courts for recognition.

Finally, the Winding-up Directive also attempts to ensure that all interested parties throughout the EU, including policyholders, are made aware of any reorganisation measures or winding-up proceedings started in an insurance undertaking's home country. To this end the regulations contain provisions requiring a liquidator or administrator to give notice of the relevant procedure to creditors across the EU in all official languages of the EU.

The Winding-up Directive applies to both formal winding-up procedures (Article 2 (c)) and reorganisation measures (Article 2 (d)). However, the regulation explicitly excludes schemes of arrangement.

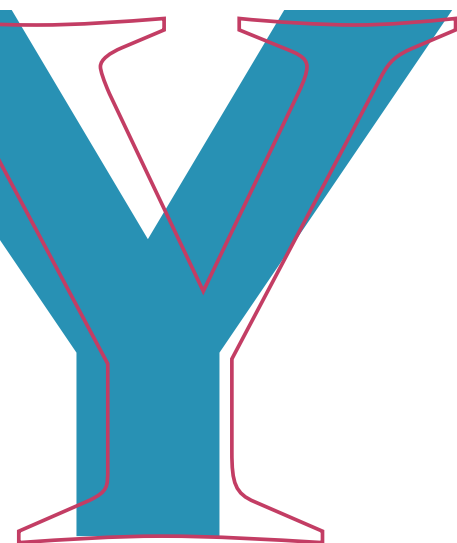




X-tinct companies A-Z

Bannister International Research Organisation

Anglo American Insurance Company Ltd	UK	Lumbermens Mutual Casualty	USA
Brandywine Reinsurance Company (UK) Ltd	UK	Minster Insurance Company	UK
British Aviation Insurance Company Ltd	UK	Municipal General Insurance Ltd	UK
Cavell Insurance Company Ltd (NW Re)	UK	Municipal Mutual Insurance Ltd	UK
Centre Insurance Company	USA	Mutual Reinsurance Company Ltd	UK
Centre Re Group	Bermuda	NRG London Reinsurance Company Ltd	UK
Chester Street Insurance Holdings Ltd	UK	NRG Victory Reinsurance Ltd	UK
Commercial Risk Reinsurance Company Ltd	Bermuda	OIC Run-Off Ltd	UK
Copenhagen Reinsurance Company (UK) Ltd	UK	Overseas Partners Ltd	Bermuda
CX Reinsurance Company Ltd	UK	Phoenix Assurance Plc	UK
Dominion Insurance Company Ltd	UK	PMA Capital Insurance Company	USA
Drake Insurance Plc	UK	QBE Reinsurance (UK) Ltd	UK
Eagle Star Insurance Company Ltd	UK	Reliance Insurance Company	USA
El Paso Insurance Company Ltd	UK	Reliance National Insurance Company (Europe) Ltd	UK
English & American Insurance Company Ltd	UK	River Thames Insurance Company Ltd	UK
Equitas Ltd	UK	Riverstone Insurance (UK) Ltd	UK
Excess Insurance Company Ltd	UK	Sovereign Marine & General Insurance Company Ltd	UK
First State Insurance Company	USA	Sphere Drake Insurance Ltd	UK
Gerling Global General & Reinsurance	UK	St. Paul Reinsurance Company Ltd	UK
Gerling Global Reinsurance Company of America	USA	Stronghold Insurance Company Ltd	UK
Gerling Global Reinsurance US Branch	USA	Taisho Marine & Fire Insurance Company	Japan
(Gerling) Global Re	Germany	Tanker Insurance Company Ltd	UK
GIO	Australia	Tenecom Ltd	UK
Highlands Insurance Company (UK) Ltd	UK	Trenwick America Reinsurance Corporation	USA
Highlands Insurance Group	USA	Trenwick International Ltd	UK
HIH Insurance	Australia	Tryg Baltica International	UK
Hillcot Re Ltd	UK	Turegum Insurance Company	Switzerland
Home Insurance Company	USA	UIC Insurance Company Ltd	UK
Kemper Insurance Companies	USA	Underwriter Insurance Company Ltd	UK
Kingscroft Insurance Company Ltd	UK	Unionamerica Insurance Company Ltd	UK
LaSalle Re	Bermuda	Unione Italiana (UK) Reinsurance Company Ltd	UK
Lloyd's syndicates in run-off (post Equitas)	UK	Walbrook Insurance Company Ltd	UK
London & Overseas Insurance Company Plc	UK	World Auxiliary Insurance Corporation Ltd	UK



Yearbook & Directory

The Yearbook and Directory of Run-off Service Providers, published each December by *Run Off & Restructuring*, is a handy reference guide to the world of run-off. Each edition contains articles reviewing the major developments in the year, as well listing a variety of service providers both alphabetically and by category. An online version of the directory can be found on our website www.runoffandrestructuring.com.

Run-off service provision is at last a globally recognised industry. And with the wide number and range of service providers now on offer potential clients need specific information when it comes to choosing the right one(s) for the job. The yearbook facilitates this choice with full summaries of the entrants' services, areas of expertise and locations. The directory listing is accompanied by articles, interviews and reports which examine and analyse the emerging issues and trends from the previous few months, while also taking a look at likely developments for the year ahead.

With year on year growth of the number of entrants and coverage, the international distribution of the yearbook and attendance at the major rendez-vous, meetings, conferences and seminars throughout the year, the Run-off & Restructuring Yearbook and Directory strengthens each participant's exposure. The regularly updated online version of the yearbook also ensures their year-round presence and allows for personnel changes, reorganisations, new office locations and other significant developments.



Zeitgeist

The spirit of the times in the run-off sector has been subtly shifting. No so long ago, run-off in the London market had a stigma to it, as it still does in some parts of the world, being primarily associated with failure if not insolvency, and seen as a backwater of little interest. Things started to change with the influence of Equitas which showed what could be done where there was a will to accelerate the run-off, and with the educational and lobbying work of the Association of Run-off Companies (ARC). At one point there was even a move to create a company market version of Equitas to mop up all the discontinued business in the market.

With the wider realisation of the merits of proactive run-off came an increased willingness to outsource its management to specialist service providers. Run-off came to be seen as an identifiable market with its own regular gatherings at the Cavell Norwich Rendez-Vous and the ARC Congress in London. And it attracted the interest of outsiders, with capital coming into the market to buy up the discontinued books that live groups were keen to offload. Some established service providers became keener on acquisition than on outsource contracts.

Now we are entering a new phase in which the older, intractable run-offs are being closed or are at least in sight of finality. A new wave of run-off, the product of M&A activity and the desire to redeploy capital trapped in discontinued business, is now anticipated – but the big contracts have been slow to materialise.

As other markets around the world, notably the US and mainland Europe, have also seen a shift in attitudes to run-off, so the question arises as to what extent their development will mirror the pattern seen in London, or will cultural and regulatory factors ensure that they continue down a different path? Service providers in particular are impatient to know the answer.