

# Portfolio transfers in Europe



Reinsurance portfolio transfers in Europe have become easier under the EU Directive. **Dr Hubertus Labes\*** of Chilmington International outlines the pros and cons of using such transfers for consolidating or disposing of run-off portfolios

**B**y implementation of the EU Directive in 2007-2008 various European countries (including Austria, France, Germany, Gibraltar, Hungary, Ireland, Italy, Liechtenstein, Luxemburg, Malta, Netherlands, Spain – details vary slightly) made it possible to transfer reinsurance portfolios completely or partly from one reinsurer to another without prior approval of the reinsured.

This amendment in reinsurance regulatory law eased transfers of reinsurance portfolios, not least for run-off of reinsurance companies, by greatly simplifying the procedure to transfer run-off business into a single entity, enabling a separation of active and discontinued business.

In particular, EU companies wishing to be able to close a run-off can use the law to carry out a portfolio transfer from the original domicile into the UK. Once the business is within a UK entity, the scheme of arrangement procedure is available to close all liabilities following payment of all valid claims, enabling the capital supporting the discontinued business to be released, as has already been successfully exercised.\*\*

However, it should be emphasised that a solvent scheme procedure is not necessarily and in each and every

case the best way to finality. Rather, it has to be analysed precisely whether a portfolio in question is suited to such a procedure, or whether there are other tools which perhaps much better correspond to the specific needs and requirements of the respective company.

An alternative, for example, is the simple sale of a portfolio which provides for much faster finality. Such a sale, furthermore, can be realised within a certain jurisdiction and therefore without a cross-border transfer. This might be advantageous for an interested party because of costs, time, or for reputational reasons where this company needs also to consider ongoing business relationships.

The now easier process of local or cross-border portfolio transfers within the EU is already heavily used. By far the majority of such transfers are, however, not related to run-off portfolios but to corporate redevelopment and liquidity acquisition measures or fiscal optimisation and reduction of opportunity costs, enabling consolidation processes and the restructuring of international re/insurance groups, proving an alternative to complex merger, de-merger and spin-off procedures.

## Comparison with Part VII transfers

Transfers of this nature between reinsurers have been permissible in the UK under Part VII of the Financial Services and Markets Act (FSMA) for almost ten years now. However, the trade-off is that these transfers involve a four-part process requiring: FSA consultation and agreement; an independent expert's opinion on whether any policy groups are adversely affected; policyholder notification; and a court order. Inevitably, this can be a time-consuming and costly process.

The process provided by the EU Directive offers advantages over the Part VII mechanism, especially when the transferred portfolio has no reinsurance protection. The company's rights and liabilities from the reinsurance treaties are transferred to the accepting company together with the portfolio, without the involvement of a court, a notary public, etc.

The procedure under the EU Directive requires only approval by the local insurance regulator. A permit is granted if it can be proven by the authorities in the home country of the purchaser, pursuant to the supervisory regulations applicable, that the accepting company will use the equity capital in such a way as to fulfil solvency margin

requirements even after the takeover and under consideration of supporting assets.

At least according to German law (Article 121 f VAG) the local regulator (BaFin) does not have a wider scope of discretion, for instance, in safeguarding the cedant's interests. As a consequence, the insureds are only notified after the transfer has taken place.

A disadvantage of the EU Directive law compared with the Part VII transfer procedure certainly is that assets and contracts related to transferred reinsurance contracts do not fall under the approval of the supervisory authority. These must be transferred separately following the general principles of civil law (singular succession, principle of certainty, required approval from the contractual partner). This is particularly unfortunate regarding retrocession supporting the risks of transferred contracts, since it is certainly in the interest of both the transferor and the transferee to transfer such retrocession together with the reinsurance contracts.

### Volume of run-off business in Europe

Studies published between 2007 and 2010 (KPMG: Run-off survey; PWC: Unlocking value in run-off) indicate the estimated volume of non-life run-off business in Europe (including UK) at approximately €205 billion (PWC 2010, page 6) and for the German speaking property/casualty insurance and reinsurance market approximately €115 billion for discontinued business and €45 billion in pro-active run-off (KPMG 2010, page 7).

Despite the fact that these surveys represent only a limited market share (KPMG 2010: 51 per cent) and numbers are extrapolated, these kind of figures could imply fungibility of such portfolios, eg. for transfers into the UK in order to subsequently conduct solvent schemes.

However, this interpretation misleads. There indeed will be portfolios which are fungible; however, the largest part of these billions of Euro con-

templated are kept in big groups in Munich, Zurich, Hanover or Cologne and it is debatable whether these players are considering any external solutions whatsoever.

### Impact of Solvency II

The need for run-off solutions and therefore also for portfolio transfers

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## 'The process provided by the EU Directive offers advantages over the Part VII mechanism'

will most probably increase under Solvency II. So far, under the existing legal regulations, portfolios including run-off portfolios must be supported by equity based on the present volume of premiums and claims expenditure. In default of income from premiums, claims expenditure therefore is key for run-off portfolios. Should sufficient reserves be available, only marginal additional equity capital commitment is required for such portfolios.

This will change under the new regulation as run-off portfolios will then require significant higher funding with equity capital without this additional capital being mirrored by respective benefits.

Consequently, companies in Europe are indeed considering future opportunities for their old reinsurance books of business in run-off. An additional reason for doing so is where staff with corresponding historic knowledge of these books are close to retirement, or retired already, and companies wish to avoid building up a new workforce for past business who would not be needed for future development.

### Impact of change of control clause

It is disputable whether the approval process of the EU Directive, putting the decision solely in the hands of the supervisory authorities, can be waived based on an approval caveat agreed upon by the contractual partners, for

instance through a special right of termination ('change of control' clause). This substantial interference with the freedom of contract is already dubious since such clauses are arranged for situations where the cedant of a reinsurance contract expressly wants to ensure the identity of the contractual partner.

However, respective legal regulations in the various European jurisdictions represent a provision of public law that regulates reinsurance portfolio transfer conclusively. The regulator does not have to consider a contractual right of approval.

It is nevertheless advisable to include such a private agreement in writing, as civil right clauses after all cause indemnity claims. That private agreement should also place reporting requirements on the reinsurer, since otherwise the direct insurer might not find out in time about a planned portfolio transfer.

### Impact on mixed insurers

In most European jurisdictions the law on insurance regulation restricts the scope of application for reinsurance portfolio transfers to professional reinsurers only (eg. Articles 119 et seq. VAG in Germany). So-called 'mixed insurers', ie. direct insurers who (also) write or wrote active reinsurance business, are excluded from this and are instead subject to the applicable legal regulations and the supervisory authority of direct insurers. That is true even if the transfer portfolio represents a pure reinsurance business transaction but the ceding legal entity is a direct insurer.

This may be important depending on the respective national law if legal regulations for direct insurers only grant permission for portfolio transfers if the

permanent fulfilment of contracts and the interests of the insured parties are safeguarded. Direct insurance law in most European jurisdictions protects third party interests to a larger extent than reinsurance law. The reason is, of course, that the cedant of a direct insurer generally is a 'weak' private party which needs to be protected in view of its contractual partner being a 'powerful' large and professionally acting company. This obviously is not the case between insurers and reinsurers, both being professional organisations.

Exceptions to this rule exist in some jurisdictions, such as for example in Article 120 I 4 VAG in Germany, considering a holding company within a direct insurance group a professional reinsurer when this holding only contains reinsurance business.

#### Impact on Value Added Tax

The obligation of VAT payments in the contents of portfolio transfers was recently decided by the European Court of Justice in a case in which Swiss Re Germany sold life reinsur-

ance contracts to Swiss Re in Zurich. The German tax authorities took the view that the transfer was a supply of goods and therefore subject to VAT. The European Court of Justice decided that the transfer was not a supply of goods but of services, but this nevertheless was not exempt from VAT.

This decision, however, relates specifically to the case in question, taking no account of cases which might have a completely different background. Therefore, a portfolio transfer which does not apply to a sale of an active reinsurance (life) portfolio in return for payment covering an inherent mismatch between receivables and liabilities as in the present case might result in a completely different decision. It is furthermore questionable if that decision refers to books of business in run-off.

#### Outlook

Managing run-off portfolios is an active and competitive market with large full-service companies operating alongside specialist providers. Fur-

thermore, run-off business undoubtedly continues to be a growth area. The growth in European run-off business, coupled with the ease with which portfolios can be transferred, will ensure run-off services continue to be in demand.

The toolkit for transfers of reinsurance business can only become more extensive – a development bound to bring with it some interesting opportunities. But it is essential to be acquainted with the legal and regulatory background, which in Europe may differ from country to country. ●

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*\*\* (Deutsche [Rück] first German firm to move run-off to UK subsidiary, Insurance Day 9 November 2007, page 1; Labes/Smith, How cross-border portfolio transfers can revitalise outsourcing, Re-Sources 2008, page 29).*

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