

the journal for discontinued insurance business

runoff & restructuring

number 38
autumn 2011

Danger lurks under Solvency II

- Dispute resolution: which way is best?
- Why audits are still in demand

Mediation - the alternative to litigation and arbitration



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European Parliament backs Solvency II delay

The Solvency II deadline looks certain to slip after the European Parliament backed the recommendation by the Council of the European Union that implementation be put back by one year. The Committee of Economic and Monetary Affairs of the European Parliament's draft report on Omnibus II includes the proposal that the full requirements of Solvency II should not be implemented until 1 January 2014.

How much practical difference this will make is debatable given the work many insurance entities including Lloyd's have already done. Concessions have also been made to the run-off sector, though these exemptions are tightly drawn.

Andrew Cox, insurance partner at LCP, comments: 'We are hearing from a number of our clients that they don't want Solvency II to be delayed. They have geared themselves up to meet the 2012 deadline. They believe that delays will only lead to more time being spent and higher costs without improving the outcome.'

Paul Clarke, global Solvency II leader at PWC, says: 'This is a positive development as it brings us closer to ending the distracting debate over whether there will be a delay.'

'Despite the delay in start date, the reality is insurers cannot afford to be complacent with their plans as they will still be required to file Solvency II information over the course of 2013 to prove their readiness,' he adds. 'This means insurers will need to have the appropriate systems and processes in place by the end of next year.'

'The more crucial piece for the industry now is how the areas of disagreement on some of the Level 2 implementing measures are resolved. We are unlikely to get any clarity on this until autumn and the rules won't be finalised until well into 2012.'

Specific transitional arrangements for run-offs are also included in the revised draft of Omnibus II. 'The run-off sector has been lobbying for Solvency II concessions, arguing that the costs of implementation are disproportionate for their



businesses,' says Mike Walker, head of KPMG's UK insurance solutions team. 'The concessions, which will lead to a significant proportion of the run-off sector being exempt for at least three years post implementation, will be broadly welcomed.'

The proposals apply to re/insurance undertakings which have ceased to write new re/insurance contracts, and to firms that are in some form of insolvency or restructuring procedure where an administrator has been appointed (the exemption period proposed here is five years).

However, this is not a blanket exemption; in particular, companies that are part of a group will not be able to avail themselves of this exemption unless the entirety of the group has also ceased writing new re/insurance contracts.

'Given the proposal is for full exemption from all three pillars, there are inevitably conditions attached,' comments Janine Hawes, a director in KPMG's Solvency II

technical group. 'Supervisors need to be comfortable that full termination will be effected within the period of the exemption, and they have the power to shorten that period if they are not satisfied with the progress being made. As part of monitoring this, firms will be required to provide the regulator with an annual report setting out what progress has been made in terminating its activity.'

Adds Walker: 'There will be some run-off companies that will still need to comply with Solvency II and it is also not clear what additional evidence supervisors will require to support the progress that is being made towards terminating activity.'

However, the new transitional arrangements will clearly be welcomed by the vast majority of the run-off sector. As a consequence of the new provisions we are also likely to see run-off entities revisiting schemes of arrangement and other finality options in an effort to benefit from the new run-off exemptions.'

Catalina acquires risk retention groups

Catalina Holdings (Bermuda)'s wholly owned subsidiary Catalina Echo Ltd is to acquire Residential Loss Control Holdings, LLC, which itself owns two risk retention groups, National Home Insurance Company (NHIC) and Residential Insurance Company (RIC), based respectively in Colorado and Hawaii. NHIC and RIC underwrote new home warranty businesses until they were placed into run-off in August 2010.

'RLCH and its management team is well known to Catalina as we are a re-insurer to NHIC and familiar with the business.

The acquisition is a good addition to our existing US business,' says Chris Fagan, chairman and chief executive of Catalina.

'We continue to be very acquisitive, and we are seeing an increased flow of run-off acquisition opportunities.'

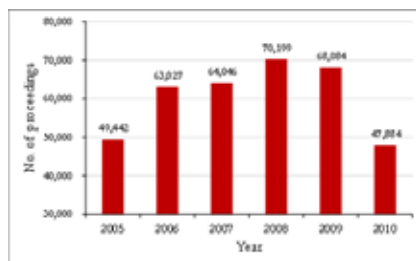
RLCH has total assets of \$168.4 million, gross technical reserves of \$113.7 million and net assets of \$19.4 million. The purchase price was at a discount to net asset value. Subject to regulatory approval from the Colorado and Hawaii Departments of Insurance, the acquisition is expected to close in the fourth quarter of 2011.

Insurers turn to alternative dispute resolution

Last year saw a 30 per cent fall in the number of commercial cases launched in the High Court, down to 47,884 in 2010 from 68,084 in 2009, according to law firm Reynolds Porter Chamberlain (RPC). But this fall almost certainly masks a high number of major commercial disputes, which are frequently funded or defended by an insurer, being fought outside the courts.

Paul Castellani, partner at RPC, explains that companies and their insurers are increasingly dealing with other forms of dispute resolution such as arbitration or are holding back from court action in the hope of settling in mediation:

'The fall in new court claims may look like good news for businesses and insurers hoping to avoid time-consuming litigation, but the data should not make insurers complacent: a lot of hard fought commercial disputes against insured entities are taking place that will



never end up in court.

'The effects of the international financial meltdown and recession are still being felt in disputes against insured professionals in particular,' adds Castellani. 'Cases are increasingly settled at the pre-action stage, whether by way of negotiation or more formal mediation, particularly as early settlement discounts are available to insured defendants who are often the paying party in the dispute. 'Unfortunately, a fall in the number of litigated cases does not indicate a reduction in the total number of legal disputes in the market.'

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CTIS extends static claims service

Charles Taylor Insurance Services (CTIS) has won its first contract for handling static claims in the company market, following the launch of its static claims service for the Lloyd's market in April this year. German insurer Württembergische Versicherung has appointed CTIS to provide claims services for its UK branch, addressing static claims from the 2000-2007 policy years.

Under the service CTIS will review open claims files for Württembergische, validate the reserve where appropriate and identify which claims can be closed. A static claim is defined as one where a claim has been notified

to insurers but no further update has been received over a 12 month period. CTIS will also make recommendations to resolve outstanding issues. The project will be managed by Amanda Morris, static claims contact manager, CTIS.

'This is an important win for CTIS as it takes us into the company market for static claims for the first time,' says Michael Campbell, director – services, CTIS. 'This has the potential to open the door to the wider corporate market for our services and we are already in discussions with other companies to explore business opportunities in this area.'

EAPD to merge with Wildman

Law firms Edwards Angell Palmer & Dodge and Wildman, Harrold, Allen & Dixon are to merge from 1 October 2011. The new firm will have 14 offices and 650 lawyers and will be known as Edwards Wildman Palmer.

'This is a transformative moment for both firms,' says Walter GD Reed, managing partner of EAPD. 'In this competitive market, clients expect their preferred law firms to deliver a full range of legal services in a variety of geographies. This combination enhances our already-strong capabilities and establishes a solid foundation for continued growth.'

Robert L Shuftan, managing partner of Wildman Harrold, adds: 'While considering a merger, we found that we have a great deal in common. We are impressed with EAPD's approach to client service, as well as its collaborative culture.' Reed will serve as the managing partner of Edwards Wildman Palmer. Shuftan will serve as deputy managing partner and chair of the firm's strategic planning committee. Judith Hurley will serve as chief operating officer. The website for the new firm will be edwardswildman.com.

Acumen completes GAIL acquisition

The Acumen Group has completed its acquisition of Bermuda based Great Alliance Insurance Ltd (GAIL), a captive insurer in run-off. Established as a Class 2 Bermuda captive in 1985, GAIL wrote property/casualty business and went into run-off in 2002. 'I am pleased that our acquisition of GAIL has now completed successfully. Acumen has provided the former 27 shareholders of GAIL with an exit solution which allows them to realise the value of their remaining investment in the company several years early,' says Nick Briggs from Acumen. 'We have a strong pipeline of captive insurance opportunities in run-off and we look forward to continuing to provide exit solutions to the captive industry.' Founded in January 2006, Acumen offers a range of run-off management services as well as seeking to acquire captives in run-off.

Market moves & appointments



The International Association of Defense Counsel (IADC) has elected **Bill Perry** as president for the 2011-2012 term. He is the first non-American lawyer in history to be elected to this position. The IADC is an invitation-only professional association for corporate and insurance defence lawyers around the world. Perry is senior partner of UK law firm Carter Perry Bailey. His practice centres on insurance and reinsurance coverage issues, litigation and arbitration as well as advice on policy wordings. Perry joined the IADC board of directors in July 2007 and became president-elect in July last year.



The Chartered Insurance Institute (CII) has appointed **Peter Taylor** as the new lay chairman of its disciplinary committee. The role of chairman must be held by someone independent and who is not a member or a student of the CII. Taylor is a consultant in the insurance and reinsurance group at Hogan Lovells where he held the position of partner from 1993-2010. The disciplinary committee exists to hear complaints lodged by complainants against members, former members, students and examination candidates of the CII. The role of the disciplinary committee chairman is primarily to chair meetings of the committee and hearings of the disciplinary panel. Tenure is for a maximum of nine years, comprised of three three-year terms.

Best gives A- rating to Citadel Re

AM Best has assigned a financial strength rating of A- (excellent) and an insurer credit rating of 'a-' to Citadel Reinsurance Co Ltd. The outlook assigned to both ratings is stable.

The ratings reflect Citadel Re's strong balance sheet, excellent liquidity and its diversified operating strategy, and recognise the company's experienced management team, niche and specialised markets.

Compre has appointed **Tom Whittingdale** as head of its audit and consultancy team. A longstanding member of the team at Compre, Whittingdale takes over from Jonathan Hughes, who continues to support the service business part time in a business development capacity. 'We are delighted that Tom is taking over the day to day leadership of the team,' says Rhyddian Williams, managing director at Compre. 'He is an experienced and valued member of the Compre team. We are equally pleased that Jonathan will stay with the business, providing continuity for the team and clients in the insurance audit and inspection market, albeit in a reduced capacity.'

Sarah Talbott has joined Grant Thornton to lead its insurance internal audit services. Previously head of internal audit for Insurance Australia Group UK, Talbott has over 20 years' experience in the insurance sector including ten years as head of internal audit. During this time she has worked with a variety of businesses including brokers, insurers and Lloyd's managing agents. 'We are delighted that Sarah has joined us to help us to develop further our offering in the insurance sector,' says Sandy Kumar, partner and head of financial services internal audit, risk & technology services for the UK.

'At a time when insurance businesses are facing increasing regulatory change and scrutiny, the pressure on resources within underwriters and brokers is becoming very intense.'



events

- 23 September**
Midwest Asbestos Litigation Conference
St Louis, MO, USA
Contact: www.harrismartin.com
- 3-4 October**
14th Annual National Asbestos Litigation Conference
Amelia Island, FL, USA
Contact: www.litigationconferences.com
- 11 October**
ARC Academy - Capital Management Event
One America Square, London
Contact: www.arclegacy.eu
- 17-20 October**
New Jersey Rendez-Vous
Hilton East Brunswick, New Jersey
Contact: www.rqih.com; www.airroc.org
- 18-20 October 2011**
Stress Testing & Operational Risk Within Insurance Firms
London
Contact: www.informaglobalevents.com
- 27 October**
Current Issues in Run-Off & Commutations
London
Contact: www.falconbury.co.uk
- 2 November**
ARC Members Annual Dinner
City Grange, London
Contact: www.arclegacy.eu
- 3 November**
IAIR Meeting
Washington DC
Contact: www.iair.org
- 21 November**
AirSP Quiz Night
London
Contact: www.airsp.org
- 25-26 November**
Malta International Risk & Insurance Conference
Hilton, Malta
Contact: www.reactions.net
- 30 November**
Commutations & Actuarial Estimations of Long Tail Liabilities
100 Fetter Lane, London
Contact: www.arclegacy.eu
- 5 December**
AirSP Christmas Reception
London
Contact: www.airsp.org
- 7-8 December**
InTAP 20th Anniversary Technical Meeting
Gen Re, Cologne
Contact: www.intap.org.uk
- 19 January**
ARC New Year Quiz
Grange City, London
Contact: www.arclegacy.eu
- 28 February**
ARC Congress 2012
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- Exit solutions
- LOC solutions
- Reinsurance management



Ready for inspection

Audit and inspection specialists have always enjoyed a steady demand for their services; **Barbara Hadley** talked to several practitioners to see how market developments are affecting business

Art Coleman, President of Citadel Risk Services US Inc, is unequivocal in his view of the value and importance of audit and inspection work: 'An inspection is still an efficient method of validating a reinsurer's participation on a cedant's book of business. An audit is also a priority when large commutations are being considered.' He also believes it

con- tin- ues to be cost effective: 'When comparing costs, audit and inspection costs have held relatively steady over the years as compared to arbitration costs. The reason for this, in our opinion, is the number of small firms or sole practitioners in the market which is the result of contractions of staff

throughout the market.'

'There are numerous reasons for the demand of this service including, a basic tool in controlling one's business, AICPA audit standards and guidelines, regulatory oversight, quest for independent verification of data, and investigation of unresolved queries to name a few,' points out Andrew Klivan, president of National Re Consultants.

And according to Ashley Prager at Risk Resolutions Ltd, increased regulation is also having a major impact on the demand for audit and inspection work: 'Due to the Sarbanes Oxley Act 1992 and accompanied with the new regulatory landscape of Solvency II due to be implemented on the 1st January 2013, clients are looking to identify redundancies in reserves and to ensure the adequacy of their reserves. We have noticed

an increase in claims activity accomplished through significant merger and acquisitions activity over the past years.

'The economic climate accompanied with further regulations has created a platform where increased regulation and economic practicalities require clients to have access to additional business decision making instruments. In this regard we see audits and inspections at the forefront of some of the major management decisions in the run-off market.'

Tom Whittingdale, head of Audit & Consultancy at Compre Services (UK) Limited agrees wholeheartedly: 'Audits and inspections remain an effective tool in resolving legal disputes and establishing a third party view of business transactions. Increasingly clients are recognising their benefits with commutations and management of ongoing business relationships.' And he also points out that 'as audits and inspections have

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‘Unauthorised or excluded lines of business are still the prevalent types of coverage issue that we find’

Art Coleman, Citadel Risk

become more widespread local markets are more aware of their advantages. Each client has a different priority and focus. This is reflected in their specific scope.’

The ultimate value of an audit, says Prager, can be measured by a reduction in the claims that they are being requested to pay or locating redundant reserves resulting in a more favorable commutation. But, Prager stresses, it is not only the reporting aspect that clients are seeking. ‘We see an increase in the need for our services in entering into discussions with parties where relationships may have or are about to break down with key individuals and we are asked to intervene before expensive litigation takes place. Again this is one of the hidden cost savings advantages that clients benefit from,’ he says.

Meanwhile service providers are applying an increasingly forensic approach to their audit and inspection reports as Keith Pooley of Global Reinsurance Consultants explains: ‘I’ve always regarded audit and inspection as a project which needs to be looked at from the very beginning. Some companies specialise in providing a claims audit – a tick and bash exercise – which makes sure that claims have been put through or recovered correctly but as far as I’m concerned that has limited value,’ he says.

‘What I’ve specialised in is providing a proper forensic audit by which I mean looking at the original books and records from the time of placement and the need to review that information, and not only that but to see if that information is actually held by the company. Many of the books in run-off, or even live books in run-

off, are maintained or managed by third party service providers – and the more aged books, before 2000 in particular, are often incomplete, lost or offsite. And if a client asks to see the records and they are not available then that is not a good start particularly with a commutation.’

Of course, a high proportion of inspections result in the discovery of



‘We see audits and inspections at the forefront of some of the major management decisions in the run-off market’

Ashley Prager, Risk Resolutions

coverage issues to the advantage of the client. ‘I would say with around 75 per cent of inspections you will find some issues – with the placing information, the type of business ceded in the case of proportional business, business not managed properly etc which you only discover at a forensic level,’ maintains Pooley. ‘Coverage is complex but not that complex. For example when you are talking about a company that has been on a marine quota share for 20 or so years and paying claims on a bordereaux basis and then you see that there has been 40 per cent of non-marine business going through on it. Often it is just as simple as that,’ he adds.

According to Coleman ‘unauthorised or excluded lines of business are still the prevalent types of coverage issue that we find,’ while for Whittingdale ‘the misallocation of cessions is frequently found which usually arises from systems and/or

control issues. Underwriting outside of agreed parameters in general is another common theme.’

‘Essentially we come across so called “time bar” claims under the statute of limitations Act. Each case has its own factual matrix which gives rise to numerous coverage issues, for example warranty,’ adds Prager

The problem comes, of course, when clients subsequently decide not to act on the coverage issues. ‘Some clients say they don’t want to antagonise companies they have a good relationship with by carrying out a forensic inspection but I say to them “look you’ve got an inspection clause and I’m pretty sure if I can see the

records then I will find some issues there which will reduce the price for a commutation” which nine times out of 10 is what my clients are looking for,’ says Pooley.

Coleman agrees that it can be frustrating when a client decides not to follow through with discovery, but stresses that ‘at the end of the day, an auditor is a service provider whose job it is to identify issues and anomalies, educate the client as to their scope and value and support the issue should it become contentious. The auditor usually does not know all of the background issues that exist within a client’s office.

‘If there is an on-going relationship with the cedent, many issues may be swept under the carpet as consideration for preserving the relationship between the parties. As auditors, we need to get over it and be satisfied that we have done our jobs to the best of our ability.’

Prager agrees: 'Yes at times for commercial reasons purely, deals get struck resulting in payments to reduce down books of business where it may start to become or has become a drain on resources. This is a fine line against the cost of taking legal action against the time saved by cutting a deal which satisfies both parties. Equally the parties may be situated in unfavourable jurisdictions and not necessarily have the benefit of an exclusive jurisdiction clause and therefore questions arise as to potential costs of taking matters forward in unknown territories.'

Coleman also points out that what has changed has been the fear from the law firms for discoverable intermediate work product between clients and auditors: 'Much of this fear, in my opinion, is justified given the ease of the use of email to communicate – all of which is discoverable unless protected by privilege.'

So what impact have these changes

'Audits and inspections remain an effective tool in resolving legal disputes and establishing a third party view of business transactions'

Tom Whittingdale, Compre

and developments had on the way in which audit and inspections work is priced? According to Pooley in the last two or three years there has been a change in attitude towards charges: 'Clients are very keen on keeping costs down, which is nothing new, but now there is a lot of pressure on companies who have charged on a fixed fee or hourly rate to reduce their fees. That's not a big issue for me as I've always pushed contingency as a way of showing clients we are sharing the risk with them.'

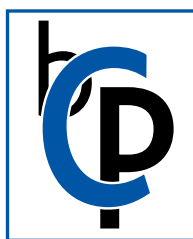
'I charge a small upfront fee to cover the pre-audit then it is based on a sliding scale of success fee. Of course

if the client just wants a claims audit and nothing else it is not in my interest to go down the success fee route. However, since we know details about a lot of companies we have come across we may already know there are likely to be some issues to be found and would push for a contingency fee basis.'

Not all service providers are keen on the contingency fee base however. Coleman, for example, prefers a fixed fee: 'Contingencies, while sounding sexy leave all parties asking questions at the end of the day. Did the auditor take all factors into consideration or simply work on those issues that

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would generate a contingent fee? Does the client give away the issue in exchange for something else thus devaluing the contingent fee to the auditor? I would stay with the fixed fee to protect all interests.'

Klivan says he tends to leave the question of fee structure to the individual client: 'For our own bottom line we prefer the contingency basis. However this isn't always the best option for the client. The problem with a contingency fee is that it removes the "independence" aspect from the equation. The client doesn't wish to go to proceedings and it be discovered that the "independent" examination wasn't independent at all.' Whittingdale agrees: 'It very much depends upon the specific circumstances. Most of our services con-



'Once you have an understanding of what you're doing, within a week or so you have an idea of how long it will take' Keith Pooley, Global Reinsurance Consultants

to charge when and only when the client believes we can add value and allowing for the client to discuss our proposals moving forward with his own management.

'It is always hoped that an inspector adds value to the client's objective through reducing the claim request/reserves down and or enabling the project to allow a sensible commutation to take place. As we can see from recent economic outlooks there are no guarantees and the audit and

bring in work and do not have the overheads of the larger firms. Thus they can afford to keep their prices low. On the other hand, these auditors are typically functionally focused (accounting, claims, etc.) and do not really have the ability to do a full inspection.'

According to Whittingdale, there has always been a high level of interest in obtaining audit work from the London market and at the same time there are more audits being assigned both in the UK and overseas. Pooley agrees: 'The market is quite competitive now and I think that what people are looking for now are results rather than report writing. There is a lot of pressure on companies which have been run-off in London for example, who have staff there, just ticking over and senior management are now saying "let's get this moving and off our books".'



'There is an increasing demand for more focused audits of shorter duration, in terms of regular business'

Andrew Klivan, NRC

tinue to be on a billable hour basis however we are amenable to offering our services on a contingency fee basis where terms are equitable.'

Pooley stresses the importance of knowing exactly what the work will involve in order to price the job accurately: 'I always insist on having a full picture of what we are looking at - I want to know what books and records they have. Once you have an understanding of what you're doing, within a week or so you have an idea of how long it will take.'

Prager agrees: 'We are frequently asked to intervene where an outside unconnected party can independently review the problems. It is extremely important that we understand exactly what the problem is and the positions from an early stage and we take pride in not charging clients for what essentially is a consultancy, preferring

inspection arena is no different than any other area,' he adds.

So what is the outlook for the audit and inspection sector?

Says Klivan, 'more companies are offering the service and some clients even prefer to perform traditional non-contentious audits themselves. There is an increasing demand for more focused audits of shorter duration, in terms of "regular" business. If the matter is in litigation or arbitration then the remit hasn't changed drastically.' But, he adds, in his experience 'most clients simply wish to know what happened that the business has developed as it has.'

As Coleman sees it, 'there are a lot of small firms and sole practitioners in the market that have the need to



Land of opportunity

The US wants answers to its legacy issues. The choice of exit routes is increasing, and a creative approach is what's required, say **Jerry McArthur** of Tawa and **Chris Reichow** from Pro



With the US coming out of recession, albeit slowly and with federal debt concerns still making headlines, the climate for dealing with legacy business, for both live re/insurance entities and more traditional run-off portfolios, looks to be slowly improving. It is still a tough environment to do business in, but for companies that can offer real creativity in what they offer, in addition to traditional run-off, there are opportunities as carriers look for financial solutions to help them utilise their capital more efficiently while refocusing on their core business lines.

What makes the US an exciting place for legacy business is its sheer size and variety. Fifty states means

50 different regulatory agencies, and while that's a challenge in itself, the multiplicity of regulation does have the happy consequence of delivering an element of competition, with some states wanting to deliver progressive and innovative options in the re/insurance segment.

This may be specifically related to legacy business, or to the re/insurance sector more generally, as they look to attract carriers to set up business in their state, encouraging competition and spurring on the development of a wider range of risk transfer solutions. Take for example Rhode Island's recent signing into law of legislation that allows the creation of captive insurers; while a handful of states, starting with Florida and New

York and now most recently Indiana and New Jersey, have moved to relax collateral requirements for alien reinsurers.

Scant resources

Against this encouraging regulatory backdrop, the economic downturn has also raised the imperative on risk carriers to return profitable results across their entire portfolio of business. Managements are not only facing pressure on their balance sheets, but also have pressure in terms of the scant resources available – be it capital or manpower, or both.

A company wants and needs its people to be working on projects that are critical to the organisation and generate solid financial returns – anything

else is simply a distraction. If a book of business isn't performing and perhaps is also not a core activity, why should a company carry on servicing and supporting it?

Senior management will want to look for solutions to help them refocus and exit from areas that are no longer seen as core to their overall business strategy. This has opened up the door in the US to conversations on dealing with legacy amongst live groups that might not have happened pre-credit crunch.

Given a growing willingness to deal with legacy, or even orphan business which is profitable and viable but perhaps just not core to a particular carrier, what options are out there in the market? The good news is, the number of exit routes are on the increase, ranging from the sale of the whole book or only the renewal rights, to companies looking to a reinsurance solution or alternatively going down the path of an outsourcing or insourcing arrangement. Whichever route the carrier chooses, their overriding principle will be a maximising of their capital with minimal rating risk.

Here is an example of a creative solution to the run-off issue. Earlier this year, Tawa set up a specialist run-off reinsurer in Bermuda to provide protection for Penn National from adverse development, specifically arising from lead paint exposure related to real estate cover in Baltimore, Maryland being run off.

The reinsurer was funded with a

premium payment by Penn National and an equity injection by Tawa. Penn National additionally entered into an Administrative Services Agreement under which Pro IS, Inc manages the adjustment of claims, the collection of related reinsurance receivables, the pursuit of subrogation or other recoveries and any other required services relating to the reinsured portfolio. Penn National benefits by moving a piece of business, which is no longer core to its operations and which allows them to focus resources elsewhere, over to a specialist unit within Pro.

Penn National has chosen to remain involved by monitoring the programme through monthly reporting, but it could have chosen to continue managing the day to day functions with the reinsurance solution or alternatively drop all involvement and simply receive quarterly or annual reports on the run-off. Creativity and flexibility to adapt to the needs of the company were critical in finding the right solution.

Open minds

The growing creativity in this market is to be welcomed, but despite signs that the regulators are becoming more open to ways of dealing with run-off, aside from traditional receivership, there are still regulatory hurdles to be cleared. A white paper, launched with some fanfare by the National Association of Insurance Commissioners (NAIC) in 2009, in an attempt to respond to criticism at the lack of options available to insurers

not entering receivership, did little to advance matters and simply seemed to outline how equivalent mechanisms work in UK/Europe. That said, some states have led the way, for example Rhode Island's adoption of its 2002 Restructuring Act, which could provide a potential major boost for solvent run-offs.

The recent test of this Act earlier this year with GTE Reinsurance's application to wind down operations, which saw a Rhode Island state court uphold the statute allowing GTE to purchase back their liabilities, could well be a major tipping point in the trend towards dealing with legacy business in this way. Critically of course, this was essentially a business to business transaction and does not affect the man on the street with a workers' compensation claim, for example.

It is difficult to say that state regulators and judiciaries would look as favourably on the same sort of blanket commutation for policyholders if it involved the general public. A question that is always going to be raised is why should a policyholder accept that a company, that is not insolvent, withdraw from offering the insurance protection that a policy, bought in good faith, provides? The US of course loves a good litigation and there is no shortage of lawyers willing to take on this challenge.

Ultimately, however, no state wants insurance insolvencies as they're not good for the economy, employment and overall reputation of the state.

There are signs that, while there has been no dilution of capital requirements allowed by the regulators, some are more open to dealing with solvent run-offs. Pennsylvania, for instance, has many companies in run-off and has adopted a practical and efficient approach to looking at commercial solutions, with the overriding principle that policyholders are protected.

The US challenge

Given this context, is the market for acquiring run-off companies or portfolios becoming more attractive in the US? The short answer is no. There has always been a market for run-off as part of the natural cycle and nothing has really changed to make it more or less attractive, except perhaps the more practical approach coming from the regulators. To an extent, there is a bit of wishful thinking going on, as the UK/Europe run-off market reaches maturity and players look hopefully to other markets, such as the US, to ply their trade.

The US lags behind Europe, and particularly the UK, when it comes to risk based capital such that organisations may not appreciate the true capital supporting their run-offs at the firm's target internal rate of return (IRR) which would then allow them to assess what options there are plus any financial impact. First step is for a company to build a run-off model which will show the level of unallocated loss adjustment expense (ULAE), cost to the organisation and length of time required. This exer-

cise requires input from various areas within a company including actuarial, finance and operational risks.

Solvency II is driving this in Europe which in turn is leading to many orphan run-off books being disposed of, due to the adverse economics the results show when compared to retaining them. There is a chance that US firms will experience similar behaviour and may experience difficulties balancing their positions, creating opportunities to relieve them of their own orphan run-off books.

A challenge to a successful run-off is the alignment between buyer and seller and/or the run-off provider. There is no one solution or model that fits each situation. Depending on the circumstances, there is a range of solutions, including:

- An outright sale or reinsurance cover.
- Buyer financing or partial secured vendor financing, given the vendor should be well acquainted with the portfolio's risk profile and solvency confidence margins.
- Profit sharing where the buyer makes a reasonable return, but excess profits are shared back with the run-off provider.
- Success based fees where the run-off provider does not receive hourly fees, but is rewarded on performance based on portfolio owner's objectives and interests, such as descaling the book of business.

High barriers to entry

The growing sophistication in the US

run-off market is not to be downplayed and those offering high quality consultancy services have an opportunity even though barriers to entry in the US are still high. An overseas entity needs to be able to offer something very different from the locally based consultancies or else risk being seen as simply more expensive (by virtue of the higher cost base in setting up an overseas infrastructure) and not as knowledgeable.

An exception could be if the US entity is looking for help with a specific area outside of the US, whether that is London market driven or in Asian markets perhaps. For US consultancy providers, it is still a tough market as carriers look to keep things in house where possible, to keep costs down and maintain control.

Creativity with a cutting edge

So it's back to the original point; only the most creative consultancy providers will be in with a chance of making the most of what is undoubtedly a vast and potentially exciting legacy market in the US. If they can ally that creativity with cutting edge full service consulting operations, whether it is claims management, the billing and collecting of reinsurance, reporting to the regulator, or actuarial work for example, that risk carriers increasingly want to access, the opportunities will come. Much will depend of course on how the regulators arrange the red tape, but if recent activity is anything to go by, the outlook is encouraging. ●

Solvency II will drive disposals



As Solvency II edges closer, DARAG's CEO **Arndt Gossmann** finds European re/insurance groups increasingly willing to dispose of their discontinued business

Q How has DARAG's business developed since you moved your HQ to Hamburg?

A During the past year we have completed three transactions, derived from 16 due diligences. In the remainder of 2011 we expect to undertake another three to four transactions and we further expect to increase the average size of our transactions. We are seeing an increasing demand for our finality solutions and a significant level of interest in our business model and its associated value proposition.

In the light of the upcoming implementation of Solvency II, insurers across Continental Europe have to rethink the contents of their finality toolbox. The transfer of closed books to trusted partners, ie. to run-off specialists, is one of the instruments of the future.

This is a much more important business driver than the relocation of our HQ to Hamburg. However, being in Hamburg has proved an advantage in that we have much better access to resources with highly qualified expertise.

Q What are the drivers behind the disposal of run-off companies/portfolios? Is Solvency II the main factor? Or low interest rates /ROI?

A We should make a distinction here between our past and ongoing transactions. None of our actual and completed acquisitions were driven by Solvency II. At the same time, none of our pending transactions are uninfluenced by Solvency

with regard to the transfer of non-life business. In contrast, decisions on the transfer of life run-off business are interest rate driven.

Q Has the field of potential buyers become more crowded?

A Our focus is on Continental Europe. The field is not crowded, but neither is its tremendous potential exclusive, as can be seen from

'No-one will voluntarily keep liabilities in run-off - ie. business which has been closed for good reasons in the past - if capital will have to be allocated to it'

II. And furthermore, we find that discussions around potential and upcoming transactions for 2012-2013 are solely driven by Solvency II.

Interest rates and the consequent returns on investment are not a factor in the decision making process

the transactions conducted by new entrants. I personally welcome this development. Emerging segments within established industries grow best in oligopolistic conditions, rather than in near-monopolistic conditions.

Q Are you chiefly looking at acquiring portfolios or whole companies? Which are more attractive?

A Our objective is to assume risk connected to discontinued business. We do not have a preference with regard to the structure. The transferor of the risk usually has a preference and we are keen to meet the transferor's expectations.

Over time, we expect that portfolio transfers will predominate. The reason for this is obvious: Solvency II will drive the optimisation of liabilities. No-one will voluntarily keep liabilities in run-off – ie. business which has been closed for good reasons in the past – if capital will have to be allocated to it.

However, the closed business is usually not contained in a separate legal entity; very often it is part of the normal book. As a consequence, portfolio transfer is the tool of choice. In summary, it is simple, cost effective and it provides security as it requires regulatory approval.

Q Have sellers of run-off become more sophisticated, or more realistic about pricing?

A I would say sellers have never been unsophisticated about the evaluation of run-off. The simple fact that in Germany and Continental Europe there have been few transactions in the past was not connected to valuations. In our experience sellers have a pretty good understanding about the quality of reserves and about any impact they may have on a transfer. Our pricing approach fully reflects this fact.

Based on a best estimate, claims settlement duration and volatility we determine a risk premium. The risk premium is the price we expect as a remuneration for assuming the risk, ie. in return for finality.

The eventual transfer includes reserves at best estimate plus risk premium. We transparently display

both. So we usually have little discussion about the adequacy of the reserves, and the ceding insurer can decide whether he is willing to share some of the inherent over-reservation in return for finality.

Q European insurance groups have long had reputational concerns over run-off portfolio disposals. Is this still a barrier?

A Reputation is an important factor and it needs to be addressed. We have so far never found it to be an issue, as we ourselves are very concerned about reputation.

In this respect, being a fully regulated, German domiciled direct insurer and reinsurer helps. It may

to be treated in any way other than that in which he would treat them.

We do not do things the cedant would not do; if they transfer their risks to us they place their confidence in us. We will not scheme the relationships the next day – nor any day after that. If we are invited to scheme with a reinsurer we will check carefully before doing so.

Q Do you use or intend to use third party services for any aspect of managing the run-off of your acquired businesses?

A We use third party support for claims settlement, usually in countries where the portfolio does not justify a presence on the ground, or

'We realise that we will only be able to develop and maintain a constant stream of transactions if we respond fully to any reputational concerns'

sound old fashioned, but we will not put our 60 years' reputation at risk. And we realise that we will only be able to develop and maintain a constant stream of transactions if we respond fully to any reputational concerns.

Last but not least. Our pricing approach means we are not dependent on squeezing profits from claims settlements. We make our margin from the risk premium.

Q You have said in the past that DARAG will not use schemes of arrangement for its acquired businesses – is this still the case, and why?

A I can confirm that we do not use solvent schemes. Nor will we transfer risks to a third party. An insurer who wants to achieve finality and who wants to protect his own reputation will not want his liabilities

in lines for which specialist knowledge is required. During transactions we use advisors where appropriate. At the same time we have a very experienced transaction team and outstanding valuation skills in place. So we have need of external support only on a selective basis.

Q How do you see the market for run-off acquisitions evolving over the next two-three years?

A The number of transactions will continue to grow. In five years' time such run-off transactions will have become a normal instrument by which to optimise the structure of liabilities. Solvency II will accentuate this development. However I do not foresee a tsunami of transactions, rather a constantly growing flood. ●



The merits of mediation

Dispute resolution is itself a source of dispute as to which is the best way to go. **Paul Moss*** of Inrem** explains why he is convinced that mediation rather than litigation is the most cost and time effective way to resolve reinsurance disputes

Overall, in terms of costs, it is probably still too expensive to litigate or arbitrate to resolve many small to medium value disputes. As a consequence, there is a tendency among many reinsurers to settle or overlook genuine issues, either through market pressure (brokers) and/or internal inertia. To my mind, this is plainly wrong. If a ceding company has deliberately misrepresented the facts, or ceded losses

by claims handlers working in tandem with law firms rather than ‘outsourcing’ would produce more satisfactory overall results and long term benefit. Properly staffed, trained, empowered and motivated claims departments would be an investment in saving both claims leakage and related legal spend. The tools for resolving disputes cost effectively are already there: what is missing is an industry-sponsored, active willingness to shape the

cheaper rates through a procurement process. But are panels helpful in driving down rates? I think opinion is divided upon whether better and/or more cost effective outcomes are achieved as a result.

In my view, a ‘horses for courses’ approach should be adopted, with tried and trusted specialists in firms with proven track records. In the non-commoditised sectors, you generally get what you pay for. Driving too hard a bargain may lead to breakdown of traditional client loyalties with firms being more prepared to act against insurers/reinsurers. A range of costs, as between firms, is healthily competitive but, as with underwriting, if it sounds too cheap, then it probably is. For those who believe that buying in services can never be too cheap, think again. The next time you see your favourite firms, could be when they are representing the other party against you!

‘The tools for resolving disputes cost effectively are already there: what is missing is an industry-sponsored, active willingness to shape the process to meet the problem’

that are clearly excluded under the reinsurance contract, not challenging the matter devalues the underwriting process in terms of the pricing of the risk and makes a mockery of the need to seek contract certainty at time of placement.

However, the culture of settling non-covered claims may not be solely due to the charging rates of lawyers. More active technical claims handling

process to meet the problem, rather than merely moaning about the legal costs and driving down rates.

For example, there exists a significant breadth of costs between the UK law firms servicing the reinsurance sector. This may range from £250.00-£450.00 per hour for partners, with some rates being volume-driven. Many large reinsurance groups seek to leverage their position to achieve

Hurricane Katrina

The comparative lack of litigation following Hurricane Katrina may be indicative of a sound and sensible process in handling catastrophe claims, allied to a willingness to be pragmatic in bending over backwards to obtain resolution of issues, rather

than allowing too much litigation to become entrenched too early. In previous years, there had been a great pressure, mainly stemming from the US, to 'feed the machine'.

Sensibly, insurers and reinsurers are beginning to pick and choose which disputes to litigate or arbitrate – coupled with an invariably poor appetite for litigation or arbitration. The key to managing differences between the parties is for the reinsurer to exercise 'pre-loss' due diligence; to reach an understanding of each party's duties and obligations under the contract and to agree, in advance of a loss happening, the level of information required to help facilitate the timely payment of valid claims.

Suitability for mediation

Disputes which are most appropriate and suitable for mediation are those where continuity of trading relationship is important, particularly in a marketplace. Genuine disputes, where the parties are seriously interested in finding a quick, flexible solution, through confidential, facilitative and independent mediation, are best suited to mediation. Also, where values are sufficiently significant to be the subject of a different resolution process, but not too significant as to require a binding and adversarial process, are well suited.

Less suited are disputes where a strong legal/technical analysis is required, either for precedential reasons, or to demonstrate the exercise of appropriate due diligence and/or rights and/or where interim remedies are important. If a reasoned analysis of a complex difference of construction/interpretation or intent is needed, which has more far reaching ramifications than the individual dispute itself, such disputes are better

resolved in court.

In any dispute involving serious allegations of breach of utmost good faith, misrepresentation and/or non-disclosure and/or fraud, particularly if a significant amount of documentation needs to be reviewed, complex witness evidence absorbed and tested and difficult legal principles applied, these should be reserved for decision amongst trained and expert judges. Good examples of such disputes are the World Trade Center litigation in New York and the series of cases from Kuwait Airways onwards, involving aggregation and/or allocation issues.

Policy wordings

Before there are changes to policy wordings, to facilitate the use of mediation, there must be a change of mindset involving the (reinsured and reinsurer) contracting parties. If the parties wish to have a tailored wording to reflect the terms of the risk or portfolio of risks being transferred, it seems reasonable that they should spare some thought, pre-contract, to deciding how disputes should be resolved.

This decision would be based upon a number of factors, including, but not limited to – the commercial relationship between the parties and their relevant bargaining positions; the nature of the business ceded and the extent of the exposure of the parties; whether or not publicity/confidentiality is an issue; or, whether a reasoned judgment intended to have precedential and/or deterrent effect is the major objective. The best thing which those responsible for adjusting and negotiating claims settlements can do is to inform themselves about

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Does the trend for alternative dispute resolution ignore the real benefits of litigation? **Bill Perry*** of Carter Perry Bailey argues the case for having one's day in court

A good scrap clears the air

One of the results of the Woolf Reforms of what had been the Rules of the Supreme Court and the County Court Rules was, quite intentionally, to reduce the amount of litigation. The conventional wisdom was, and remains, that litigation is the last resort. By definition, therefore, it was felt that other methods of dispute resolution such as arbitration and mediation (all those alternative methods called ADR) were preferable.

It is hard to challenge the view that

But for that very reason, no lawyer worth his salt ever recommended litigation as the primary method of trying to deal with disputes. Negotiation is always best.

The fact is that people want to do the best deal possible. So from a very rational sense of cost benefit, they want the strongest possible position before starting a negotiation. Accordingly, litigation immediately becomes a strong player in the dispute resolution game.

It gets you disclosure of the other

exposed to public odium and derision. Justice, in a much wider sense than simply paying over sums of money, is thus served.

There is a great deal to be said for this point of view. What both sides, and society, want for the resolution of disputes is justice. Too often, hole and corner methods of dispute resolution do not serve the community interest that justice should not only be done but should be seen to be done. Too often, the mere payment of money in settlement leaves people's wounds unhealed, whether those be psychic wounds in personal disputes or business wounds for which money can never really compensate because first mover advantage has been lost, market share has been lost and/or reputations have been damaged.

Arbitration

Seen against that background, arbitration is a peculiarly inadequate method of resolving disputes. Practiced the English way it is as expensive as, if not more expensive than, court proceedings because the procedure is the

'No lawyer worth his salt ever recommended litigation as the primary method of trying to deal with disputes. Negotiation is always best'

litigation is a last resort (though it is no doubt preferable to trial by battle or ordeal). Litigation is expensive, time consuming, public and uncertain. No-one knows this better than the lawyers who practice in the field.

side's documents. It provides the threat that people you reckon are at best shading the truth and at worst lying their heads off will be subject to cross-examination. It means that all their nefarious practices will be

same but one or, more often, three arbitrators' fees have to be paid, and a venue paid for, where a judge and court come free after the writ fee.

Yet the absence of the majesty of a judge in open court may mean that witnesses are less willing to admit error. The secrecy of arbitration means that respondents can do wrong without fear of public exposure. The fact that arbitral decisions do not give rise to precedent means that the law remains undeveloped and the position remains uncertain, thus prompting further disputes where a judicial ruling would have prevented future disputes because the law was known. The fact that there is (usually) no appeal from an arbitral ruling means that an arbitrator can be unfair or stupid in his decision without fear of being overruled.

Arbitration conducted the civil law way (under maybe the ICC or UNCITRAL rules) means all of these things but without even the ability to obtain access to the other side's documents, and without cross-examination, as well.

Mediation

To some, mediation is the great white hope. The mantra says that presence of a third party forces unwilling lawyers to the table; the good offices of a neutral third party help parties see common ground and ensure that psychological objectives are met. The reality is rather different (and I speak as a veteran of two 15 hour mediations over the last year alone).

The mediator is a highly interested party: if he is to carry on mediating, he needs a 'successful track record' so he badly wants a settlement – any settlement. He will try to keep people sitting there until exhaustion or starvation lead to their judgement being warped, so that they agree something which they would never normally have agreed – and are furious when they realise what they have done.

If they had done it of their own free will, with the support of lawyers they

'Too often, hole and corner methods of dispute resolution do not serve the community interest that justice should not only be done but should be seen to be done'

know to be loyal to them, in upfront negotiation that would be one thing. To be 'over-persuaded' under the psychological pressure of a long mediation and a mediator is readily perceived as unfair.

The suggestion that experienced lawyers are either incapable or unwilling to settle disputes is absurd. The successes attributed to mediation would almost all occur anyway in ordinary negotiation during litigation. This might be at a different time – probably before a hearing or a trial because that is when the parties' minds are most concentrated – but there would be as many settlements. This would be without the fees payable to the mediator and for a mediation location – and without the residual dissatisfaction which always lurks after what far too many parties perceive as a bargain which is pushed upon them despite their wishes and better judgement.

And this is if the mediation works at all. Quite apart from those mediations which actually 'fail' in the sense that nothing is ever signed up, there are far too many mediations where deals are supposedly done (in the sense that Heads of Terms are signed on a without prejudice/subject to contract basis) which never then translate into a deal. This is because when the parties have time to consider carefully what they have done, they realise that what has been 'agreed' is unworkable or inappropriate.

So all that time and effort and money is a complete waste: they are back to square one even though the mediator is able to trumpet a 'success'. And how the blame game then gets going at inordinate cost and diversion of time, to show who is to blame

and responsible for the fact that the Heads of Terms never made it to a true agreement (and/or to make sure that it stays without prejudice so that nobody can use it in that way)!

Even to get to that point, of course, litigation is needed. Parties try not to mediate any more than to negotiate unless they have a fair idea of what they are mediating about. Sometimes this can be done before close of pleadings or disclosure. Much more often, it has to wait until after those are complete, and therefore under the new front loaded costs of the Civil Procedure Rules, after a majority of costs have already been incurred. Mediation without prior litigation, in other words, is virtually unheard of and has a much lower success rate even than the highly doubtful 'success rate' claimed by mediators in the course of litigation.

Litigation v ADR

Many claim that the benefits of arbitration and mediation are that, because things are kept out of the public eye and/or agreement is reached, reputations are preserved and thus business relationships which would be shattered by the battle of litigation can be kept intact. The opposite is true. The knowledge that justice is not being seen to be done is corrosive and likely to upset at least one party and maybe both.

In mediation it is worse: a freely negotiated agreement, one into which a party does not feel obliged to enter, can be an excellent springboard from which to restart a relationship; a settlement due to which one party feels a grudge, let alone both as is often so in mediation, is the worst possible platform for the renewal of a relationship.

Unfashionable though it may be, there is much to be said for the proposition that a good old fashioned stand up knock down fight – that is to say litigation – is one in which the wounds are seen to be inflicted fairly, hence are the least difficult to bear (if you were that scared of them you should have settled earlier and agreed a secrecy clause). It gives people the opportunity to say their piece without fear or favour protected by absolute privilege in court – to have one's day in court is as cathartic for as many

businessmen as for individuals – and is accepted as being fair because there is an appeal system. It is therefore the outcome from which the wounds heal fastest and best.

I have known many cases where companies have had serious disputes litigated to first instance and/or appeal decision, throughout maintaining not only successful but amicable business relationships. It is a great British tradition that people can square up for a fight, it can end in a knockdown, protagonists meet afterwards, shake

hands, go for a drink and genuinely be friends. Litigation, a good open honest fight in court, is often the best way of ensuring that this happens in business too. ●

** Bill Perry is the senior partner of Carter Perry Bailey, a niche re/insurance law firm. He is a member of the Chartered Institute of Arbitrators and has sat as an arbitrator, has engaged in a number of (successful and unsuccessful) mediations, and believes that dispute resolution is a question of 'horses for courses'.*

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the core techniques of mediation and other forms of alternative dispute resolution, their objectives and how they can be used to ensure that this method of dispute resolution is a client-driven rather than an adviser-driven process.

With that understanding, and with a predisposition to put some effort into finding a solution, market participants will be able to choose from a variety of different types of mediation language, suitable to their particular circumstances, ranging from simple CEDR/ARIAS (UK) core mediation clauses to more complex 'hybrid' mediation clauses which require the parties to commit themselves to an escalating basis of remedy, depending upon the nature of the dispute, and the amounts involved, and any other all important factors identified by the parties. Such sample clauses appear in the new IIL ASG 263 publication on Alternative Dispute Resolution in Practice – available from all good bookshops!

Costly bandwagon?

It is in my experience completely untrue that mediation can end up being as costly and lengthy as litigation. Whilst the odd exception may prove the rule, it is unlikely that those involved in such disputes have any settled intent to try to resolve the dispute

by mediation and/or that they have the necessary knowledge and training or the appropriate legal advisers, to make sure that parties in dispute found a quicker and more cost effective, mutually acceptable and enforceable resolution, than would otherwise have been the case.

As a general observation, the timing of the mediation is key to achieving a successful outcome. Get the timing wrong then the mediation effort is doomed to fail.

Comparisons worldwide

The Inrem model is in its infancy. However, already, there have been a significant number of interesting enquiries by industry professionals seeking access to all or part of the Inrem tool kit – not necessarily confined to individual mediations of pre-existing disputes but also, assistance in avoiding disputes, pre-emptive portfolio analysis, strategic overview of existing litigation and facilitation or consummation of potential commutation deals.

We are in the process of establishing sister organisations in other jurisdictions as we continue our efforts to put Inrem firmly on the map. For example, we have just announced that Pierre Charles (ex Scor) has joined us and will be establishing Inrem in the French market. In addition, we will be taking the opportunity to meet with

contacts in Spain, Germany, Switzerland and Scandinavia and we have already established a significant interest in Sydney, Australia. We do not believe that there is any comparable organisation to Inrem yet in existence worldwide in which industry-led market professionals, covering virtually all technical disciplines involved in reinsurance business, are represented at one table, blending to common purpose.

We deliberately sought to establish a strategic alliance with ReMedi, a US-based organisation of highly respected, like-minded people. We have a common ideal, and that is to convince the industry that there is a better way to resolving claim difficulties, whether by mediation, or other form of alternative dispute resolution process. We all believe that speaking as one voice, we will be able to change the way that disputes are resolved, which can only be to the benefit of the industry as a whole. ●

** Paul Moss is group head of claims at Montpellier Re and a co-founder of Inrem*

*** Inrem is a grouping of experienced claims professionals, underwriters, lawyers, accountants and actuaries who provide mediation services, not only to the UK market, but also to the global industry by co-ordination with similar groupings of mediators in other markets and jurisdictions*

The shark lurking under Solvency II



There is a shark circling the good ship run-off, beneath the surface of Solvency II. Patrick Nolan, deputy chief actuary with Pro, says the group capital

requirement threatens to scupper the business model for run-off acquirers

This article concerns a shark lurking in the sea of Solvency II. It threatens to attack the life rafts provided by the specialist run-off industry and may, taken to its logical conclusion, result in the ship-wrecks of distressed companies being left to sink on their own.

And yet it is a threat that has so far been largely ignored. Until recently, I encountered a general feeling that it could not be the case. It appears,





however, that the threat is real even though, as I hope to show, I believe that it goes against the Financial Services Authority (FSA)’s fundamental principle of protecting the policyholder. But what is this lurking menace?

Set-up

In order to understand the problem, it helps to consider a simple example. But first it is crucial to understand the motivation of a specialist acquirer of run-off. Why is this actively traded in the first place?

Suppose an acquirer of run-off has two companies in run-off, A and B. They each have reserves of 100 and they each have capital requirement of 50. Furthermore, suppose each company actually has assets of 175.

Each company, then, has a balance sheet that looks like this:

| | |
|---------------------|-----|
| Assets | 175 |
| Liabilities | |
| Reserves | 100 |
| Capital requirement | 50 |
| Excess capital | 25 |

Each company can now look to release their excess capital of (up to) 25 meaning the owner of the run-offs can make a total payment to shareholders of (up to) 50.

As payments and commutations are made (at the expected reserving level), the capital requirement reduces. The freed capital then also becomes available for extraction.

This gradual release of capital (capital extraction) is the basis for the market in run-off. If company A is bought for less than its total capital of 75 (ie. 50 + 25) then the aim over time will be to release the total capital of 75 quickly enough to justify the acquirer’s return on the price they have paid.

For example, an acquisition price of 50 and releases of 25 in year one, 15 in year two, 10 in year three and five in years four to eight gives a return on capital of 15.6 per cent¹

¹ This is given by the rate of interest j that solves:
 $50 = 25/(1+j) + 15/(1+j)^2 + 10/(1+j)^3 + 5/(1+j)^4 + 5/(1+j)^5 + 5/(1+j)^6 + 5/(1+j)^7 + 5/(1+j)^8$. The answer to that equation is $j = 15.6\%$ – try it and see!

The lurking shark

Suppose the run-off specialist is interested in buying company C, a large and distressed insurer. Imagine that company C has reserves of 1000 and a capital requirement of 500.

But this company only has assets of 1250. This might be typical of a large company that has suffered serious distress, for example through systemic historic problems in its reserves – exactly the kind of company a regulator should want a specialist run-off manager to acquire and bring back to health!

Company C has the following balance sheet:

| | |
|---------------------|-------|
| Assets | 1,250 |
| Liabilities | |
| Reserves | 1,000 |
| Capital requirement | 500 |
| Excess capital | -250 |

This shortfall in its capital should not be a problem to the acquirer. The company is still solvent and, run off correctly, should ultimately yield releases of 250 (ie. 1,250 assets less 1,000 reserves), which should have a value to the acquirer.

But here comes the shark. Its name: ‘group capital requirement’.

Solvency II requires groups to calculate and maintain a group capital requirement too. The actual group capital requirement will depend on the level of diversification between the companies within the group, but it’s a mathematical certainty that it will be at least as large as the largest individual company’s capital requirement, which in this case is 500.

For the sake of illustrating the point, we will suppose that the group capital requirement is 550 (more than 500 but less than the sum of the individual capital requirements of 50 + 50 + 500).

The group balance sheet after acquisition will look like this:

| | |
|----------------------|---------------------|
| Assets | 1,600 |
| | (175 + 175 + 1,250) |
| Liabilities | |
| Reserves | 1,200 |
| | (100 + 100 + 1,000) |
| Capital requirement | 550 |
| | (as above) |
| <hr/> Excess capital | <hr/> -150 |

So at the group level, the combined entity fails to meet its capital requirement test. This would mean no company in the group – including A and B – will be able to extract any capital!

So what? Isn't this providing long term security to policyholders?

I would suggest not, at least not in this case. A, B and C will typically be completely separate companies acquired from completely independent original carriers, with absolutely no legal ability to make calls on each other's capital. They merely happen to have been gathered under the overall umbrella of a single specialist professional dismantlement unit.

The whole notion of the group capital requirement in such circumstances has no logical consistency because even if C fails, there is nothing A and B can do about it. There is no more capital to come to company C – it will always just have to make do with what it has. This is precisely why it needs a specialist manager in the first place.

The purpose of a group capital requirement should be to protect the policyholders of live insurers. For example, it stops live insurers getting round capitalisation problems with old books by setting up new subsidiaries. For such purposes, it is good regulation. But where we have completely independent companies that merely happen to have been gathered under the banner of the same group via acquisition, there is no logic for forcing a group requirement onto them.

The end of the endgame?

This group capital requirement means that those companies regulators have

wanted, and should want, specialists to acquire and manage will be exactly the same companies specialists will have to avoid at all cost! This is because they could prevent the specialist from extracting ANY dividend from ANY group-owned company, even if these are perfectly overcapitalised from their portfolio. This would obviously be an unacceptable situation for the professional run-off managers and owners.

Run-off acquirers will have serious problems in acquiring large distressed run-offs. To do so will essentially prevent them from pursuing their capital extraction business plan for the entire rest of their group! It will be many years before a carefully managed company C reaches a healthy enough state to mean that the group as a whole passes its group capital requirement and so can extract from the heavily overcapitalised A and B. In fact, A and B may essentially have no liabilities left at all by the time their capital can be extracted.

Far from being just a theoretical example, this is a situation that we know very well. When Tawa acquired CX Re, it had reserves of \$2 billion and would have fallen well short of a Solvency II capital requirement. Through careful management, it clung on to its solvency – even through a period that turned out to be more difficult than anybody had anticipated – and, ultimately, emerged as a resilient run-off.

Thanks to hindsight, we now know with cold, hard certainty that without the actions undertaken by Tawa, CX Re would most definitely have become insolvent.

But under Solvency II, neither Tawa nor any other specialist player could have taken over CX Re. It was so massive (the second largest run-off after Equitas in the London market at that time) that it would have swamped the rest of the business and prevented the operation of the extraction business plan for years to come.

So the CX Re policyholders would

have lost out. They would have become policyholders in an insolvent company. How is that in their interests? How can that possibly sit with Solvency II's aim to first protect policyholders?

Nor is this restricted to the EU. The group requirement acts across the whole group, for any companies that sit below any EU holding company. That means if an EU parent buys a US run-off subsidiary, the US company becomes part of this group capital requirement. Even distressed US carriers start to impact the extraction from totally independent EU sister companies.

What can we do?

This is not an issue which appears to be solely in the FSA's hands. If it were, and given the perfect understanding the FSA has of the benefits of professionally managed dismantlement of run-off books, it could be dealt with rationally. Unfortunately the waters in which we are all fishing are part of the Solvency II Directive. Given the potential severity of the consequences, however, I would like to think that there is still time for the insurance sector in general, and the run-off sector in particular, to lobby EIOPA to have the group requirement revised to take these concerns into account.

Failing that, it would seem that the only option for an acquirer is to contain the problem within the EU by ensuring the parent is not EU-regulated and that all EU risk carriers are funnelled into a single EU holding company. This still leaves recently distressed EU insurers in the position of being left to sink alone. However, at least it means that the run-off specialists can concentrate their efforts beyond the EU without ultimately being fed to the sharks. ●

The role of the FSCS

Perhaps best known for its work on behalf of personal finance customers and policyholders, the FSCS is the UK's compensation fund of last resort. *Run Off & Restructuring* asked Karl Jefferies, insurance manager with FSCS, to explain the role it plays when commercial insurers go into insolvency

Q What is the FSCS and how does it operate with relation to the commercial insurance markets?

A The Financial Services Compensation Scheme (FSCS) was set up following the Financial Services and Markets Act 2000. The FSCS is the compensation fund of last resort for customers of authorised financial firms. If a firm becomes insolvent or ceases trading the scheme may be able to pay compensation to its customers.

This includes authorised insurers where the FSCS safeguards policyholders, as well as covering claims for compensation from private individuals, where an authorised insurer fails, or is unable to meet its liabilities. The FSCS is funded by a levy on firms authorised by the Financial Services Authority (FSA).

Where an insurer is declared 'in default'* the FSCS would work closely with the appointed insolvency practitioner to determine the scale of FSCS involvement. The scheme would also ensure that policyholders have clear instruction and guidance on how to make a claim on their insurance policy and what to do should they need assistance.

The claims handling is then dealt with by a run-off agent who is appointed by the insolvency practitioner; the FSCS is heavily involved in overseeing and monitoring protected claims to ensure that appropriate compensation is paid and that the interests of levy payers are looked

after. This is achieved through an extensive audit programme, regular liaison with the run-off agent and insolvency practitioner, together with the representation of the FSCS on creditors' committees, which the insolvency practitioner is required to put in place.

Currently there are 29 insurance companies in insolvent run-off with which the FSCS is involved. Some of the largest are:

- Independent Insurance Co. Ltd: the FSCS has paid out over £405 million since its failure in 2001.
- Chester Street Insurance Holdings Ltd (formerly Iron Trades): the FSCS has provided £269 million of funding.
- KWELM: £190 million of FSCS funding.
- Drake Insurance Co Ltd: £132 million of FSCS funding.
- Builder's Accident Insurance: £51 million of funding.

Q Can firms as well as individual insureds bring a claim for compensation?

A For individuals and small businesses with an annual turnover not exceeding £1 million, and where the insurance policy is a non-compulsory class, the FSCS is able to offer protection at 90 per cent of the total claim (with no upper limit other than the need to properly reflect the limit of indemnity within the policy).

For compulsory classes of insurance (ie. employers' liability or third party

motor risks) claims are protected in full for the compulsory element of the claim, with no upper limit, subject to any limit of indemnity contained within the policy wording.

FSCS protection does not extend to reinsurance policies.

Q How does FSCS interact with brokers?

A In relation to protected policies, brokers may submit claims on behalf of their clients to the relevant run-off agent. The FSCS may have dealings with brokers when assessing their clients' eligibility.

Q In what circumstances should run-off managers contact the FSCS?

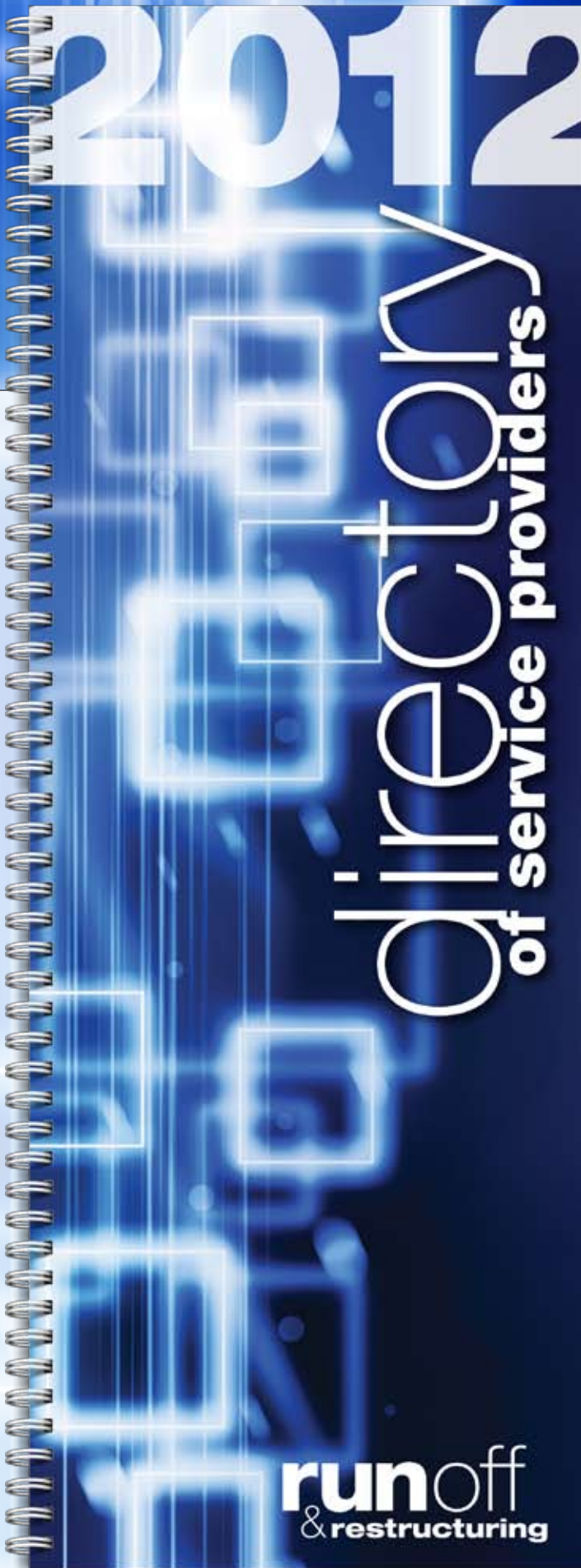
A Run-off managers should contact the FSCS if they believe that they are likely to become insolvent and that their claims portfolio includes claims that are protected under FSCS rules. It is however likely that any insurer in solvent run-off would have already been in regular communication with the FSA over their financial position and, as such, the FSCS would be well aware of the position through liaison with the regulator. ●

** From the perspective of the FSCS, for an insurer to be 'in default' it must be unable to meet a protected claim. Therefore the term 'in default' can only apply to insolvent firms*

For more information please visit: www.fscs.org.uk

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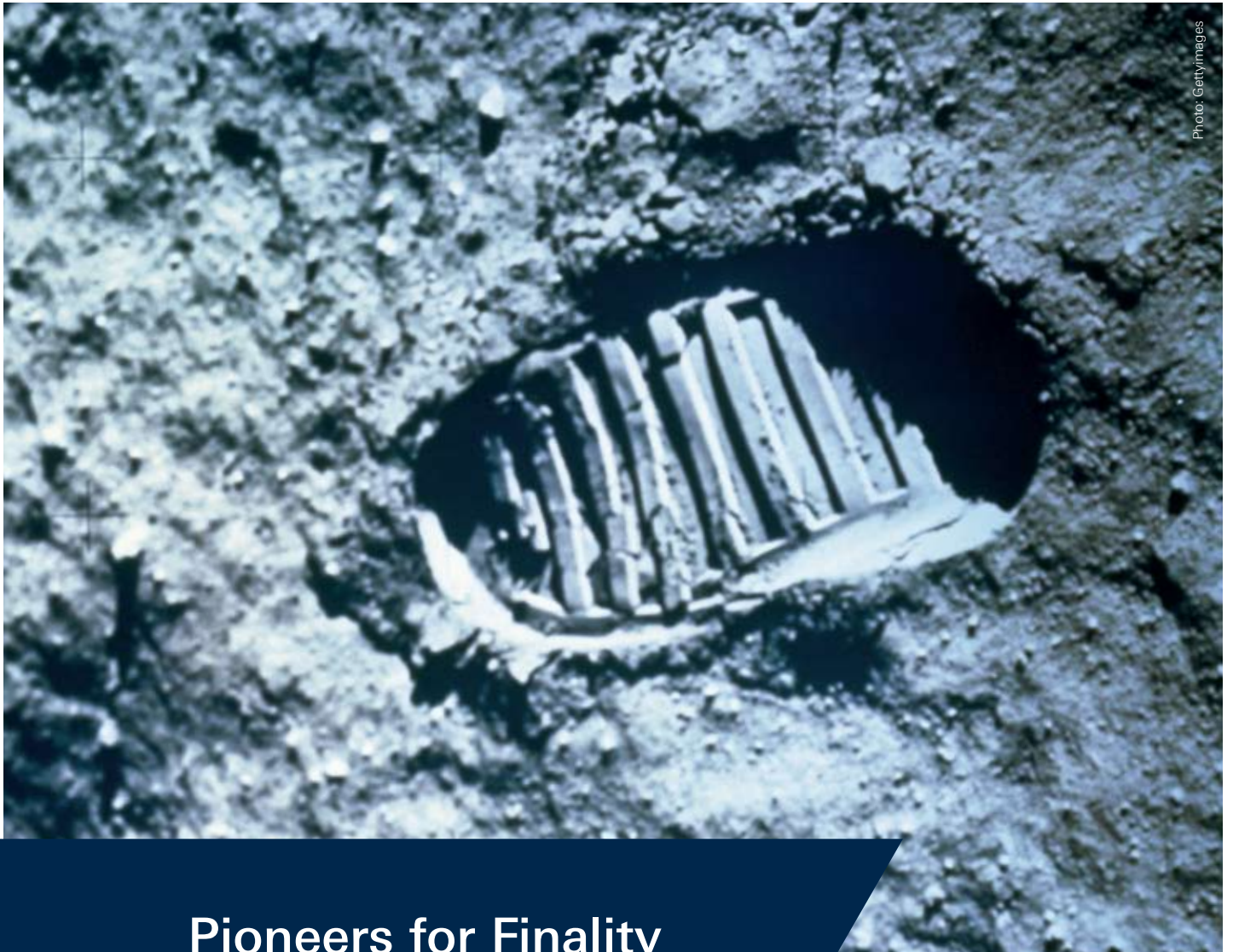
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