

Legacy

Norwich Rendez-Vous 2010

From the publishers of

THE
INSURANCE
Insider

INSIDE

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Continental excursions

Dear friends

Some things are easier said than done, as anyone who has ever tried to figure out how to get around on the underground in Berlin without speaking German will appreciate.

Only a local would automatically know that the ticket you have just bought does not have the date or time printed on it, and you must stamp it using a separate, much less obvious, machine about twenty metres away on the platform first.

And if you thought the burly German ticket collector was going to turn a blind eye to yet another tourist who only understands “Bahnhof”, you obviously have no idea how many have come before you...

Local knowledge is crucial to avoiding calamities when abroad. And the effort you have taken in learning the language, for example – even if it is a simple greeting or a polite request for beverages – will carry you a long way.

Many practitioners in the legacy industry would agree that continental Europe represents a new frontier for run-off opportunities. The question is how to unlock this business.

One obstacle to closer harmony is a gulf between attitudes to run-off in the UK and in Europe.

Many practitioners overlook the fact that lots of European (re)insurers have a different view of discontinued books of business and are yet to identify and classify their legacy portfolios. This needs to be done before they can work on an exit solution for future non-core business.

“ONE OBSTACLE TO CLOSER HARMONY IS A GULF BETWEEN ATTITUDES TO RUN-OFF IN THE UK AND IN EUROPE”

But with the Solvency II regulatory regime looming on the horizon, along with the capital pressure that it is widely thought to entail, the feeling is that more and more discontinued business will come to the surface.

And with the same capital pressures likely to affect run-off acquirers, there can also be little doubt that the hunger for new, diversified business will increase.

Local knowledge of business culture, history and attitudes can go a long way towards making a deal work, as UK-based Randall & Quilter (R&Q) realised when it formed a strategic partnership with German outfit Global Re to bid for continental business in 2008. The hard work paid off in

May when R&Q bought a defunct French insurer on the back of Global’s negotiations.

Switzerland-based Axa Liabilities Management, German entity Darag and Malta-based Grafton have also been making targeted acquisitions of portfolios or entire businesses since the start of the year, all using local knowledge and expertise to gain leverage in the market.

Some may doubt that the German, Swiss or French run-off sectors are about to burst into life in a similar way to the Scandinavian and London markets, where portfolios are routinely bought and sold to investors or run-off managers, and they are prudent to do so.

Indeed, local markets may want to tackle the issues themselves with consolidations and their own solutions. However, if the value of the discontinued business on the continent is anything close to the EUR205bn it was estimated to be in 2009, perhaps it is time to whip out the dog-eared French dictionary and put a proposal together, en Français.

Enjoy the read!

Helen Wright



'If only everything was as reliable'

Commutations will top the agenda in Norwich, **Alan Prime** asks what lies ahead

You may recall the series of advertisements for Volkswagen from the 1980s, which presented a number of domestic dramas and always ended with the slogan: "if only everything in life was as reliable as a Volkswagen".

Commutation is the Volkswagen of the run-off world, reliably going about its business while its flashier cousins – Part VIIs, solvent schemes and outright sales – swing in and out of vogue.

A commutation is an effective means for a reinsurer to end its claims-paying obligation by paying the cedant an agreed cash lump sum to end its commitment to all future claims. The cedant in turn can invest the cash to settle unresolved claims as they emerge.

Commutation is effective for run-off as it achieves finality for the reinsurer on a line of business.

The received wisdom is that demand for commutations is being driven by the impending, if somewhat delayed, requirements of Solvency II. There is no doubt that the directive is focusing insurers' minds on reducing legacy liabilities to minimise their future solvency capital requirements.

As the implementation of Solvency II gets ever closer, the appeal of commutations is increasing as it is possible to

commute a line of business in a relatively short timeframe. Part VIIs or solvent schemes can easily take a couple of years or more to conclude. And it is now too late for these alternatives to take effect before Solvency II arrives.

Finality

But it is not just EU regulation that is driving demand, as reinsurers from jurisdictions unaffected by Solvency II are still using commutations to achieve finality.

Here, commercial drivers are playing their part, as reinsurers wish to free themselves from administering reinsurance liabilities.

Long-tail business may be responsible to cede and pay claims for many decades after the reinsurance contract terminated. This can be unprofitable, especially when older year reinsurance collections prove difficult to achieve. Brokers are also less interested in committing resources to administering legacy business as they focus their attention on reducing costs and increasing income.

The biggest driver is the need to reduce the amount of capital committed to run-off – and the desire to release reserves tied up in long-tail that could be directed to live underwriting.

Low cost

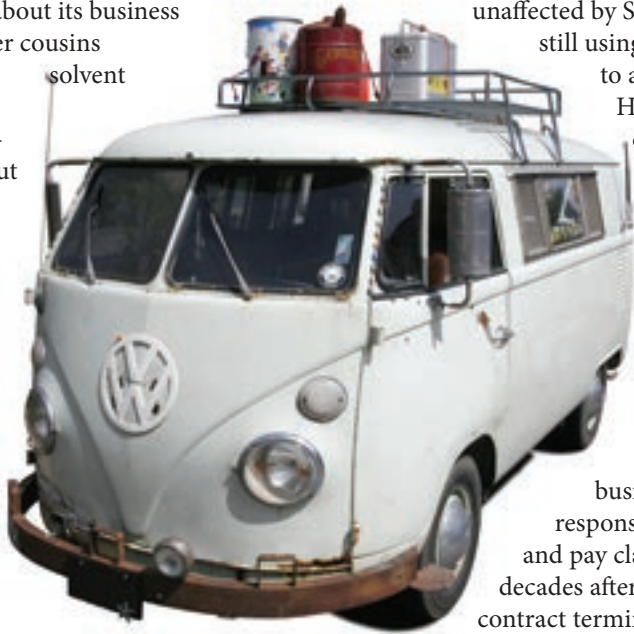
While there are a number of other finality options – such as Part VIIs, schemes of arrangement or an outright sale of the run-off

book – the commutation remains a popular solution for both cedant and reinsurer. It is relatively low cost and straightforward.

But its great strength is the ability it gives both parties to negotiate a fair settlement based on known facts. In comparison to other routes to finality with an element of compulsion, a commutation is a negotiated settlement between two willing parties. The fact that both sides reach an agreed outcome eliminates the risk of the agreement being challenged or overturned.

Will lower interest rates damage the demand for commutations? This has not proved to be the case for long-tail business. The argument is that the cash payment made to the cedant to invest to pay future claims, would only achieve low rates of interest, damaging long-term returns and making the financial agreement less viable. There is evidence that short-tail commutation business has been affected by lower interest rates, due to the short period over which funds could be invested, the impact on long-tail business has been negligible. This is due to the longer-term nature of the investment – and the potential for the cedant to realise a profit once all claims have been settled.

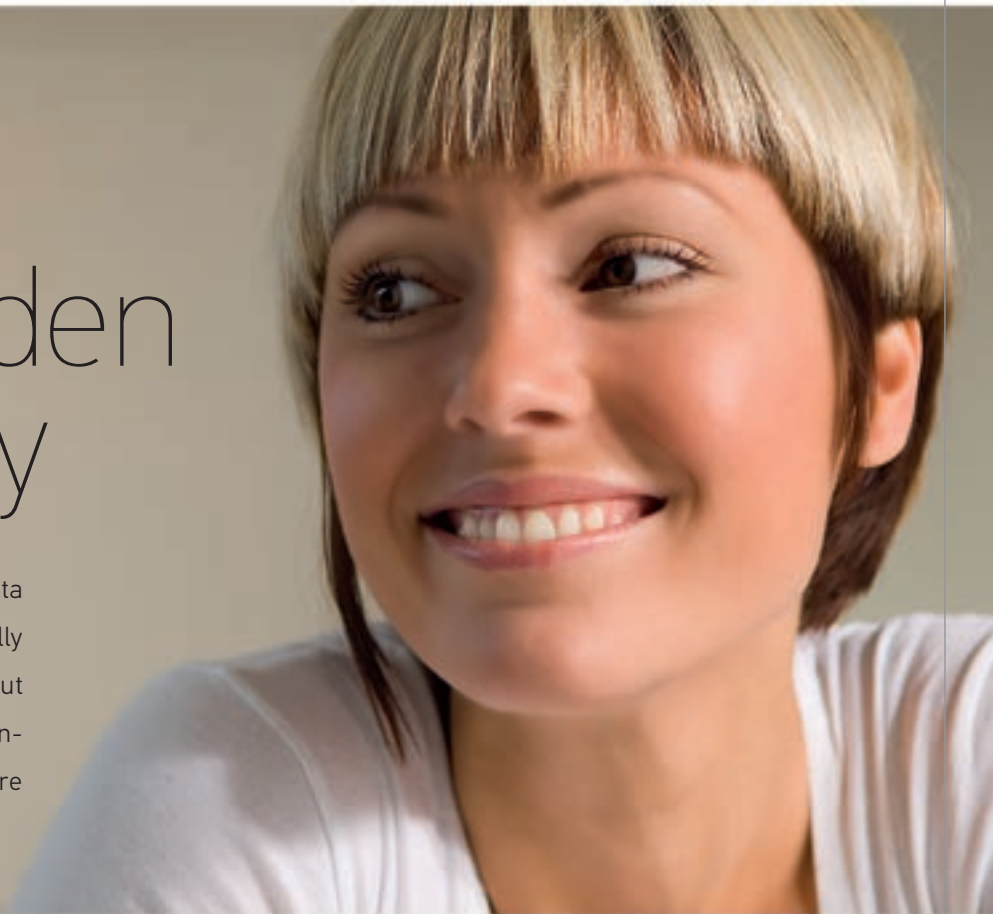
Commutations have been a well-established and effective means for reinsurers to achieve finality for many years. Their appeal remains undimmed, despite the threat of lower interest rates and the challenge of other means for achieving finality. Like the Volkswagen advertisement – a commutation may be a little unexciting, but it is reliable and efficient and gets both cedant and reinsurer from A to B with as little fuss as possible.



Alan Prime is director of Charles Taylor Insurance Services

The burden of legacy

The issue of how to deal with Legacy data and Systems is faced by insurers globally where decisions must be made about system replacement, sourcing, and investments to extend and integrate core systems.



Most insurance and reinsurance companies, whether active or in run-off, maintain a number of ageing systems and applications in a variety of environments.

As a result the business owner loses control of the business process, with the legacy systems dictating what can or cannot be done. The ability to react to market and regulatory changes is diminished, flexibility and agility are lost consuming resources that would be better utilised elsewhere.

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Europe: the new frontier?

Is continental Europe the new land of plenty for the run-off market? The deals struck this year are a flavour of what is out there. Many in the UK, however, remain sceptical. There are a few essentials if firms are to tap this potentially lucrative market

Legacy merger and acquisition (M&A) activity has kept a steady pace since last year's Norwich Rendez-Vous in June 2009, with at least 18 significant deals, including five since the start of the year ([see deal file](#)).

Continental Europe has been the focus of much of this activity in 2010, with German start-up legacy buyer Darag, expansive London run-off manager Randall and Quilter (R&Q) and Malta-based start-up (re)insurer Grafton all booking new business in the region.

And the run-off pot is large. Auditor PricewaterhouseCoopers (PwC) has reported that the size of the continental European run-off market swelled to an estimated EUR205bn in 2009, compared to EUR196bn in 2008.

The key market, says PwC, is Germany/Switzerland, with a combined value of approximately EUR81bn.

In May, Darag secured its first deal in the legacy market by purchasing the majority shareholding of discontinued Hamburg-based insurance company HVAG from its principal shareholder Mitsubussan Insurance – a subsidiary of Japan's Mitsui & Co.

Backed by alternative investor Augur Capita, it was no surprise that Darag made its inaugural step in its local market. With its German roots, Darag is hungry to acquire all types of run-off in Europe, and we understand that it has lined up at least seven further transactions also focused on local markets ([see box out](#)).

What needs to be done to gain a piece of the action?

Berlin-based Darag froze out the competition for HVAG by using a transaction structure that focuses on transparency from the start.

Local knowledge

But there can be no doubt that speaking the local language and knowing local customs was a key deal breaker too. Speaking to *The Insurance Insider*, Darag executive Arndt Gossmann said the volume of opportunities in Europe had taken the firm by surprise somewhat.

"We will have to accelerate our recruiting efforts dramatically," said Gossmann.

"Market response is clearly beyond our initial expectations."

Knowledge of the local market is a factor that R&Q has picked up on too, as it teamed up with Germany-based Global Re to bid for continental European business.

R&Q's role in the strategic partnership is to provide the capital for acquisitions and be the 100 percent risk carrier. Global Re acts as the key contact to the sellers, performing due diligence and negotiations and managing the run-off portfolio or company after the transaction is concluded.

After a failed bid for German federal state-owned run-off group BF Rückversicherung in 2009, the partnership delivered in April after R&Q sealed a EUR3.2mn deal to take over French reinsurer La Licorne Compagnie de Réassurances. The

Darag: tapping the continental market

In May this year, start-up German run-off acquisition platform Darag made its inaugural transaction in the market, just over a year after the firm was first bought and transformed by alternative investor Augur Capital.

And the HVAG deal will be the first of many. After over a year of planning and negotiations, Darag is poised to announce a further seven transactions in the pipeline.

Legacy buyer Darag is involved in run-off sale talks in Germany, Austria, Switzerland, Belgium and Scandinavia, as well as one overseas transaction relating to German business.

Most of the negotiations are focused on portfolio transfers. At the time of going to press the run-off platform was understood to be in final negotiations

with an Austrian firm approximately the same size as HVAG and another German entity understood to be a bit bigger, according to sources.

HVAG's claims reserves amounted to EUR5.4mn on 31 December.

And beyond the ongoing transactions in the pipeline, we understand that Darag's radar screen has picked up on over 30 opportunities across Europe. The size of transactions vary from EUR1mn to EUR90mn in technical liabilities.

Formerly an indirect subsidiary of American International Group through its affiliate Wüba, Darag was acquired by alternative investor Augur Capital for \$26mn and received approval from German regulator BaFin in April 2009.

acquisition of La Licorne was the company's first insurance investment in France.

Ken Randall, CEO of R&Q, said: "This transaction is proof of the value of the strategic partnership we have developed with Global Re in continental Europe, where local expertise and knowledge are vital."

Market forays

This is not R&Q's only expansion so far in 2010, and is far from the last with diversification at the fore for the company at present. R&Q impressed analysts in January with its first foray into the live market – the acquisition of London-based JMD Specialist Insurance Services for £1.3mn.

R&Q is also branching out deeper into the broking world.

After buying the former broking operations of RK Carvill & Co in August last year, we understand that R&Q is now looking to build its presence in the broker run-off London market. Talks are advanced to buy Lloyd's broker FirstCity's legacy business, following AJ Gallagher's purchase of the live entity in April (see table).

Audley Gilroy-controlled start-up (re)insurer Grafton, meanwhile, has received a warm reception in Europe since the firm's inception in January. Grafton (Europe) was launched with capacity to write more than £420mn of cover. It provides capital relief to European captives with long-tail legacy liabilities, and sources suggest it enjoys "strong demand" in the region.

Grafton (Europe) is supported by a 50 percent quota share from Berkshire Hathaway's National Indemnity Company (NICO) alongside its own capital. Institutional investors also include Jacob Rothschild's RIT Capital.

Its success so far in Europe has less to do with any particular

"I DOUBT THESE DEALS WILL BE ANYTHING MORE THAN MODEST SIZE TRANSACTIONS"

local roots and more to do with its pioneering business model, which involves targeting captives and their corporate parents and offering to take on long-tail liabilities.

The idea is that captives can increase the business they write by resolving their historic, capital-intensive liabilities with Grafton, which also releases capital back into their corporate parent.

Grafton began life with an A- financial strength rating from AM Best, which described the

proposal as "innovative".

The rating agency also noted that the new firm identified an untapped market opportunity and may enjoy first mover advantage.

Grafton has ambitious expansion plans to build on this initial foothold, and is setting its sights on the US as the next potential pot of opportunity for its business model to cash in on.

Audley Gilroy is understood to be planning the launch of a US version of Grafton at the end of 2010, with up

Continued on page 8

The Eurosceptic view

We also caught up with Mark Taylor, director of London-based run-off services provider and acquisition firm Independent Services Group (ISG), to canvass opinion on the market. ISG is an independent service provider and acquirer in the (re)insurance sector. With offices in London and the US, the firm offers broking, run-off, IT and consultancy services to both the live and discontinued markets. It most recently acquired Shared Services Insurance Group, a Pennsylvania insurance company, in December last year.

Do you see evidence of increased preparations for run-off disposal on the continent in the run-up to Solvency II?

We have not seen anything coming through as yet. I remain terribly sceptical about Solvency II providing opportunities from Europe to the London legacy market. Germany has the greatest potential but never delivers because the German market wants to fix it themselves. I think it's more likely we will see German insurers merging to get round the capital penalties and then pooling their run-off internally. The local players should be able mop up anything that comes on the open market because they have both the language and the run-off skills, but I doubt these deals will be anything more than modest size transactions.

ISG has formed joint ventures in the past with local players – is it a good acquisition model?

The joint venture model has worked for us because having local expertise and resources were fundamental to making these acquisitions

work. Joint ventures can allow you access into a new market and can provide some degree of protection against the vagaries of that market. However, you must pick your partner carefully and keep working on having a trusting relationship with them.

Where are there other opportunities for legacy?

We are concentrating on the US right now.

Do you think we may see the end of the pure run-off manager in future as these players seek to diversify into new areas?

To an extent the end of the pure run-off manager has already happened, almost all service providers now offer acquisition, broking, audit and consultancy in addition to run-off. The degree of competition is still too high, the market is over supplied, with the bigger players buying work which ultimately is not sustainable. For our part, ISG are moving into the live market, supporting both broking and underwriting entities.

What would you like to see occur in the legacy market over the next 12 months?

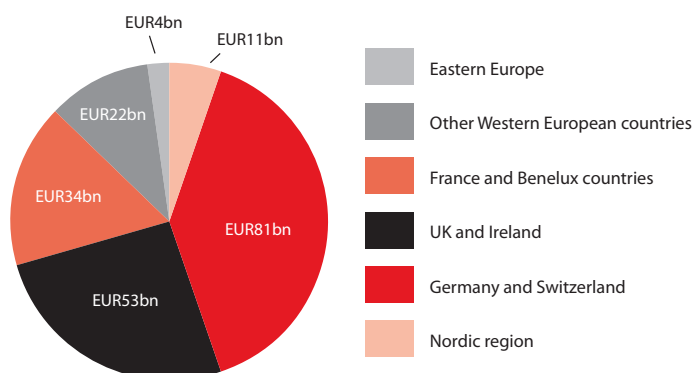
With all the competition for work, it is important the legacy market does not lose sight of actually doing the work. Protecting reputation and providing a professional service is still important to customers and vendors. I would hate to see a return of the bad old days when companies stopped servicing accounts properly because they had mispriced the work.

to \$1bn of capital behind it.

But, with its complex 50-state regulatory system and a myriad of hurdles in the way of transferring discontinued business, branching out into the US is altogether another challenge.

Before the run-off market looks across the Atlantic, it will want to assess just how things will pan out first in continental Europe.

European run-off: market size in 2009



Legacy M&A since Norwich 2009

For sale:

Carrier	Business	Potential buyers	Comments
Novae	All 2002 and prior discontinued business, consisting of casualty treaty, healthcare and third-party liability	Novae has variously been in exclusive talks with Enstar, Randall & Quilter, Berkshire Hathaway, Catalina Holdings and RITC Syndicate Management. Most recently, Enstar were looking at the business, but the exclusivity period lapsed in April	The Lloyd's (re)insurer is looking to pay a premium of £15mn or less to shed its discontinued liabilities. It underwrote direct errors and omissions and directors and officers in the late 90s, and suffered in the fall-out from those years affected by Wall Street IPO liabilities and the collapse of Enron and WorldCom

In the bag:

Date	Portfolio/Company	Buyer	Price	NAV	Liabilities	Comments
May '10	HVAG	Darag	Undisclosed	NA	EUR5.4mn**	Start-up Darag made its first acquisition with the purchase of the Hamburg-based insurance company, and we understand there are at least three further transactions in the pipeline...
April '10	Scottish Lion	Berkshire Hathaway	Undisclosed	£12.3mn	£58.4mn	Berkshire Hathaway swooped in the buy the discontinued insurer, effectively stopping its proposed solvent scheme of arrangement in its tracks
April '10	FirstCity (legacy)	Randall & Quilter	Undisclosed	NA	NA	R&Q is understood to have taken over the FirstCity legacy business after it was sold to AJ Gallagher
April '10	La Licorne Compagnie de Reassurances	Randall & Quilter	EUR3.2mn	EUR3.7mn	EUR8.3mn**	R&Q bought the business in a strategic partnership with Global Re. The price is a discount to NAV
January '10	JMD Specialist Insurance Services	Randall & Quilter	£2mn	NA	NA	R&Q stepped out into the live market to extend its service offering. Paid £1.3mn in cash and allocated 650,000 existing R&Q ordinary shares to former owner BP Marsh
January '10	Providence Washington Acquisition	Enstar	\$25mn	NA	NA	The transaction is expected to close in Q2 2010
December '09	Shared Services Insurance Group	Independent Services Group	Undisclosed	NA	NA	The Pennsylvania Insurance Department has approved the deal
December '09	PMA Capital Insurance Co	Armour Re	\$100,000	NA	NA	PMA's parent paid \$13mn to Armour as part of a capital contribution to the run-off operations
December '09	BF Rückversicherung	Axa	Undisclosed	EUR18.2mn*	EUR72.4mn	ALM's first external acquisition on the market since the legacy unit was founded in 2001
November '09	Forsakringsaktiebolaget Assuransinvest	Enstar	\$11.1mn	\$11.1mn	NA	The transaction is expected to close in Q1 2010
November '09	Goldstreet Insurance	Randall & Quilter	\$3.375mn	\$9mn	NA	R&Q bought a 70.18 percent stake in the US reinsurer
September '09	British Engine	Enstar	\$44.03mn	\$44.03	£107mn	Fair value to NAV
October '09	Copenhagen Re	Enstar	\$29.9mn	\$29.9mn	\$113mn	Fair value to NAV and an approximate \$1.8mn discount to shareholder equity
September '09	Pro Group	Tawa	£4mn upfront, maximum consideration of £38mn	£20mn***	NA	Tawa paid an upfront sum of £4mn and deferred cash of up to £12mn, Pro will also pay dividends of up to £22mn to Swiss Re prior to completion of the deal
August '09	Carvill Group	Randall & Quilter	Undisclosed	NA	NA	R&Q bought the discontinued operating subsidiaries of the reinsurance broker
June '09	Equitas	Part VII transfer to Equitas Insurance Ltd	NA	NA	\$7.8bn	The final phase of a deal first struck in 2006, which also saw Equitas buy a further \$1.3bn reinsurance from National Indemnity Company
June '09	Alea UK	Catalina	Undisclosed	\$83.8mn*	\$357.9mn	"Slight discount" to book value
June '09	Woolworths Insurance (Guernsey)	Randall & Quilter	Undisclosed	£1.2mn	£7.5mn**	R&Q acquired the captive insurance company of Woolworths Group from its administrators, Deloitte
June '09	Copenhagen Re	Enstar	\$28mn	\$29.6mn*	£76.1mn	Slight discount to NAV

*Shareholders' equity **Insurance reserves ***Pro disclosed net assets of £20mn in 2008

Source: *The Insurance Insider*

Riding the rollercoaster

Practitioners of solvent schemes have faced a rollercoaster through the Scottish Lion proposal. We talked to **Dan Schwarzmann**, partner at PricewaterhouseCoopers and scheme adviser to Scottish Lion...

For a number of years schemes of arrangement have been used as the primary tool of insolvency practitioners in the insurance industry, and more recently by an increasing number of solvent (re) insurance companies looking for a planned exit from the market.

Solvent schemes have evolved to address each situation and set a company on track to wind down, but it has not always been a smooth ride. In 2005, the UK High Court threatened to derail the mechanism by ruling not to sanction the British Aviation Insurance Company Limited (BAIC) solvent scheme of arrangement. The decision sent tremors through the UK run-off industry, which has become increasingly reliant on schemes to run-off (re)insurance companies.

The courts went on to sanction a number of solvent schemes post-BAIC (which was also advised by PwC), and the judgment was beginning to look like a one-off.

That is until last year, when a proposal to subject discontinued insurer Scottish Lion to a solvent scheme of arrangement hit the buffers with a first instance dismissal by an Edinburgh judge. Scottish Lion appealed the decision at the start of 2010, reverting the sanction hearing to first instance again.

A surprise move in May by US investment giant Berkshire Hathaway to buy Scottish Lion suddenly rendered the prospect of continuing down the scheme route and a second sanction hearing unlikely.

Q: Are you pleased with the outcome for Scottish Lion?

I am delighted for the client because we seek to deliver value and finality. I was really pleased that the appeal was heard before the sale – it could have been a different solvent scheme landscape if the company had been sold and the appeal had not been heard. The Scottish Lion appeal was a huge result for the market but I would have liked to have seen the solvent scheme of arrangement go the whole way to full sanction.

Some parties in the market have overplayed the BAIC judgment for too long and the Scottish Lion case will now help extinguish some of those lingering doubters. The outcome of the court case proved categorically that a cut-off scheme for a solvent insurance company is fair and I don't think that anybody can argue that the appeal verdict is anything but crystal clear.

The Scottish Lion case is a huge and welcome step in the life of solvent schemes, it has been a very good year for the mechanism.

Q: What does the landscape for solvent schemes of arrangement look like this year?

There are new opportunities and we are looking at a few new proposals at the moment. The market as a whole has seen the numbers of new solvent schemes hold fairly steady if we don't count every single company named in underwriting pool solvent schemes. What we will see is more and more complex businesses looking to use a solvent scheme to obtain finality.

Q: What about fresh enquiries?

I have definitely been having more conversations with clients about exits and restructurings, focused on solvent schemes and otherwise. The main driver is capital, with Solvency II looming in the background. When these situations are considered further it is clear that regulatory and tax friction, for example, are normally additional benefits from a restructuring or exit.

Europe is where the most interest is coming from at the moment. We have looked at the US in terms of schemes of arrangement without much luck – there is some interest, but it is just not the right time at the moment and it is not that easy a market to access. When you are doing something slightly new, there is commonly some resistance and the key is to wait for the right case.

Q: In terms of insolvent schemes, Highlands broke new ground. Is this a sign of things to come?

I think Highlands showed that you can use a UK process to protect a US corporate where there are common creditors. We resolved a long-standing legal dispute between Highlands Insurance Company in the US and Highlands UK using a scheme of arrangement in combination with Chapter 15 relief; prohibiting any policyholder from taking action against Highlands US and Highlands UK. It was clearly innovative and attracted attention in the US.

Highlands was a stepping stone, but this situation won't be found in all US/UK groups where there isn't commonality in creditors. However, it demonstrated the flexibility of solvent schemes in yet another part of the market.

Blue sky thinking

You do not drive a car by looking in the rear-view. We look ahead with **Nigel Montgomery**, partner in Sidley Austin's London office

Montgomery and his colleagues specialise in restructuring, merger and acquisitions (M&A) and even insolvency in insurance. Their focus is on schemes of arrangement and business transfers, run-off reorganisation, risk transfers for and reconstruction of UK and international insurance and reinsurance companies.

Q: Capital and run-off are preoccupying the European giants, not least because of Solvency II. How will the big players react to the initiative?

Solvency II is one of many reasons why the European giants will be scrutinising their business for areas which are hogging capital and creating operational risk.

The current economic environment for investment returns and the need to be able to do more underwriting when rates harden also make bigger players sensitive to how their resources are tied up. Many (re)insurers that have grown by acquisition in the last decade now have a lot of run-off on their books, often spread throughout their group rather than consolidated.

These firms want their capital in the right place and their operational risk minimised in order to be strong and agile in the market going forward. We are definitely seeing evidence of run-off consolidation and disposal already happening. It is under

active consideration in a lot of companies – we are on the cusp of seeing books of business moved into consolidating entities and business streamlined in a way that we have not seen in the last 12-24 months.

Additionally, some companies with limited business lines may now seek a diversification benefit through buying business that others regard as non-core.

Q: Any 'black swans' for the legacy industry?

Perhaps not directly. I guess that sovereign debt will be watched closely; notwithstanding the recent European agreement, many commentators seem to be saying that it remains a risk. If, heaven forbid, there were to be a default, this would be likely to have an impact on major (re)insurers, to the extent that they hold government bonds as part of their investments. If their balance sheets are impacted they will need further capital, and dealing with run-off books may be a way of releasing it.

Q: Is the run-off industry an attractive investment?

There seem to be two kinds of buyer/investor these days: one is the type that obtains its return by continuing the run-off, managing claims and harvesting investment income; the alternative is the kind of buyer that would like to close the business quickly and make a capital gain.

These two are contrasting ends of the same market. In the end, both kinds of investor want to make a return on funds they manage and anyone sitting on a large pile of money these days is facing a conundrum: how to make a sensible return in the current economic environment without facing the same risks across a portfolio in these uncertain times.

Run-off still has the potential to offer a favourable return to a well-equipped buyer and has the added advantage of representing an uncorrelated risk. However, it is a specialist form of investment and realistically a hard one for new entrants to break into. It is also a market in which buyers' and sellers' price models can be hard to reconcile.

Q: Any investment with a return carries a risk. How does the volatility inherent with asbestos liabilities affect the attractiveness of run-off portfolios?

Without detracting from the human cost involved, I think investors regard that as a pricing issue. Investment of this kind is a calculated gamble. I believe that buyers currently feel differently about asbestos risks in Europe compared to the US, and there may be some who simply wouldn't do a European asbestos deal because they regard it as just too uncertain at present.



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Throwing light on scheme statistics

Despite legal controversy and the emergence of alternatives, solvent schemes have continued to grow, say **Mike Walker** and **Rob Margetts**

Statistically speaking, it can be argued that solvent schemes of arrangement for insurance companies have been in decline for the last couple of years (see [table by pool](#)). The technique for collapsing books of business has had its opponents, but is the appetite for proposing schemes on the wane, as they lose their lustre in the glare of other exit solutions? Or are schemes, to paraphrase Dan Quayle, on an irreversible trend that can change? What factors are contributing to this apparent slowdown?

It would seem run-off is one of the leading causes of statistics in the modern age, with a number of helpful analyses in the market examining all aspects of discontinued business from the UK and across various divisions of continental Europe. However, as has been observed in the past, statistics can be used like a drunk uses a lamppost – for support and not illumination. The numbers deserve greater scrutiny.

First of all, it could be argued that the actual number of solvent schemes has risen dramatically in the last two years (see [table by entity](#)) with the sanctioning of the EW Payne and Trimark pools schemes. These two sets of underwriting pools accounted for some 130 individual schemes – each company in a pool requires a separate scheme (surely then, schemes are on an astronomical upward trend).

But statistics are not always illuminating. These pools were in essence two scheme documents and, despite the strict legal definition, two large schemes. The proposals are, however, typical examples of what has been promoted in the last couple of years. Rather than look at the number of schemes, the real news is that they are complex, large, often multi-company and multi-jurisdictional proposals designed in innovative ways to deal with genuine market issues. The typical characteristics have changed.

Schemes have not just retained their attractiveness and utility, but have evolved over a period of years to reflect the challenges they are designed to tackle. For example, schemes are now regularly proposed to assist an increasing number of non-UK companies in dealing with elements of their legacy portfolios. More than 70 of the companies proposing schemes in the EW Payne pools and over 40 companies in the Trimark pools were not domiciled in the UK. The recent Deutsche Ruck scheme followed an innovative cross-border portfolio transfer from Germany into the UK and other overseas companies, for example Global Re, have taken advantage of the scheme legislation.

The use of “allocation schemes” – where incurred but not reported (IBNR) is allocated to creditors – as opposed to “submission schemes”, where creditors submit their own IBNR, has risen in the context of major pool schemes. The practical nature of the allocation methodology has enabled large and complex pooling arrangements to be collapsed with relative

simplicity, to the benefit of all stakeholders.

The scale of current schemes is significant. The recent Minster enterprise claims to be the biggest single solvent scheme of arrangement promoted to date. The English & American Underwriting Agency schemes, whose meetings of creditors were held in late April, have over \$1bn of estimated liabilities included across three major, complex pools with 16 pool participants (13 solvent and three insolvent). The EW Payne scheme included 82 separate scheme-promoting companies. Many of the early schemes, by contrast, were small in value with limited numbers of stakeholders. The scale of current schemes is affecting the speed they are brought to market.

Statistics also show that, despite the BAIC case in late 2005 being hailed as the death knell for schemes from some quarters, 2006 had the same number of proposals sanctioned in the year (nine) as the average for the three preceding years. The following year, 2007, had 10. Statistics could lead us to believe that “opposition” to schemes had little impact on the rate they were put forward.

Again, this does not reflect reality. There will continue to be a serious debate on schemes’ impact on policyholders and cedants. For some elements of the market schemes are, frankly, anathema. Despite this, the vast majority of schemes have succeeded in gaining the creditor support required under the dual voting tests set out in the legislation, as well as the support and sanction of the court. Even in the supposed hiatus caused by the much discussed Scottish Lion decision at first instance and its reversal on appeal, schemes continued to be sanctioned by the court in the full, explicit knowledge of that decision. The initial decision in Scottish Lion was surprising, it flew in the face of the statute wording and many years of legal precedent. Many

commentators were not surprised that it did not stand up to the scrutiny of the appeal court.

These large, complex, multi-jurisdictional proposals are being debated – and consulted on – in much greater detail, with a wider and far better scheme-educated stakeholder base than at any time since the devices became popular in the insurance industry. Schemes continue to be promoted and sanctioned reinforces the belief that, despite vocal opposition, there is still significant policyholder appetite for this process in the right circumstances.

The popularity of other finality solutions has undoubtedly also had an impact on the number of schemes being brought to market. The run-off acquisition market grew seemingly voraciously in the period up to 2008, with new acquirers entering the market on a regular basis. Some of the earlier acquisitions were completed with closure through a scheme in mind.

However, many of the acquiring entities active at present operate a business model where “finality” is not an overriding concern. Rather, the longer term run-off of the business is the aim. This has had two impacts on the scheme market: (i) those acquired companies, as creditors in proposed schemes, were less inclined to support the “finality” offered through the scheme process, although support can be obtained as each proposal is looked at on its individual merits; and (ii) there were fewer companies to propose schemes.

There is one issue on the horizon that many commentators have suggested could act as a



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catalyst if not for schemes, then certainly for entities seeking exit solutions: Solvency II. Capital management is coming under increasing scrutiny from insurance executives, regulators and rating agencies as insurers prepare for the onset of the regulatory regime.

In the UK, the Financial Services Authority has been managing insurers’ transition from Solvency I to Solvency II through the individual capital assessment process. For run-off operations within large groups, planning has been underway for some time. With the prospect of significantly higher capital charges for “legacy” business – particularly those with latent risks – an increase in entities seeking an exit from certain business is certainly possible. Whether this leads to a marked increase in the number of schemes coming to market remains to be seen, as techniques currently being considered to deal with such portfolios are not limited to the scheme solution.

Part VII Transfers and equivalent continental European enactments are a popular way of moving business from one entity to another and are an attractive merger and acquisition tool. Acquirers are fixing their attentions on European business as a way of expanding their run-off portfolios.

There is a statistical maxim that says “when in doubt, predict that the present trend will continue”. That is a reasonable assumption to make in the context of solvent schemes. They will be proposed, they will be large, complex and multi-jurisdictional, and they will continue to be debated.

Solvent schemes by pool/portfolio

Year	2003 & prior	2004	2005	2006	2007	2008	2009	Total
Number	9	11	7	9	10	6	6	58

Solvent schemes by entity

Year	2003 & prior	2004	2005	2006	2007	2008	2009	Total
Number	14	16	24	9	27	87	53	230

Source: KPMG LLP 2010

Future fortunes?

After a fertile period for run-off merger and acquisition (M&A), in 2008 the future did not look so rosy with the number of deals looking light.

The flow of deals has dried up, with Enstar making only three acquisitions in 2009, compared to eight in 2008. What is the impact on the market and what could influence the future flow of deals?

There has been a shortage of books of business put into run-off, and a successful 2009 for much of the non-life sector has perpetuated the trend. Seasoned books that had been in run-off for some time were the subject of the boom period for legacy M&A, for example Unionamerica. The cost of capital has also increased through the financial crisis, potentially impacting the viability of run-off business models. Global low interest rates are limiting the investment returns once capital is deployed.

New direction

Run-off companies clearly cannot remain idle and the market is seeing some move in new directions.

There has been the rise of specialist firms offering reinsurance-to-close at Lloyd's, such as RITC Syndicate Management and Shelbourne. This spin-off sector has provided good opportunities, with both firms growing their reinsurance liabilities in 2010. With 22 open years remaining at the end of 2009, there are still opportunities. The lack of syndicates in run-off over recent years has reduced options, particularly as there were 105 open years of account at Lloyd's as recently as 2005.

Randall & Quilter (R&Q) has broadened its business. The purchase of RK Carvill took it

into the London market for the first time and talk suggests that FirstCity's legacy business could be its next foray. R&Q also announced it has received "in principle" approval from Lloyd's as a turnkey managing agent and entered the live market through its JMD acquisition.

Is this run-off firm leaving its roots behind or is there merely a lull in activity?

There is no certainty over its overall impact, but the broad consensus is that capital requirements will increase. This could be a positive factor, as (re)insurance groups with legacy segments may choose to deploy their capital in ongoing underwriting activities, and selling these run-off books might provide an appealing exit for such companies.

Captive insurers may also find support dwindling as their cost becomes too great, leaving carriers available for sale or facing run-off. Lloyd's entities are not immune either, as small syndicates are backed only by Names capital.

There is an elephant in the room. Solvency II may increase the supply of legacy opportunities, but will the M&A run-off model stack up in a new capital-hungry world? Acquisition prices for legacy books will have to come down to offset the cost of capital. The key will be balancing between the low price tag while offering capital providers an attractive exit solution.

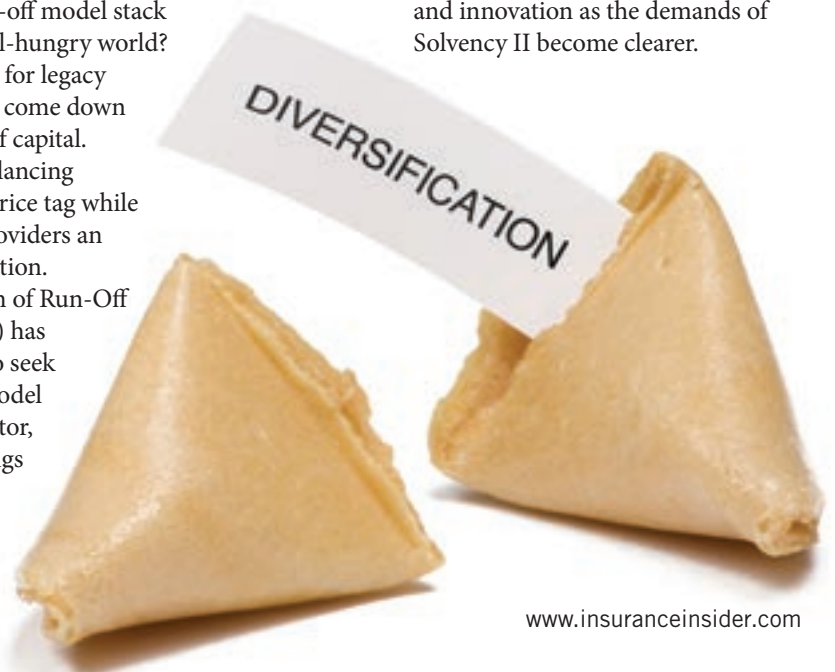
The Association of Run-Off Companies (ARC) has lobbied the FSA to seek a non-standard model for the run-off sector, revealing misgivings over Solvency II's impact on legacy.

Other considerations

The cost of capital has increased and leverage levels have normalised since the financial crisis, impacting the efficacy of run-off models. In the bank market, debt pricing came in from the highs of early 2009, giving some optimism. Availability of bank debt has remained strong, suggesting that the bank market may represent an attractive source of capital to support future M&A activity.

Legal appetite for solvent schemes of arrangement has come under the microscope through Scottish Lion, raising questions about the sector as the outcome of the second sanction hearing looms. Berkshire Hathaway's surprise acquisition shows that investors remain confident that run-off offers profitable opportunities. A High Court approval on the scheme for Minster and the hearing for Camomile also indicate continued activity. In addition, there are the possibilities offered by Quinn Insurance and the European legacy market.

This is a very interesting time for the run-off market. It will continue to find opportunities – the key will be access to capital and innovation as the demands of Solvency II become clearer.



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