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LEGACY ROUNDTABLE 2010

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11 June 2010
Possible offer

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was for £10 per share in cash. As previously stated, the Board of Brit Insurance reviewed this proposal and concluded that it significantly undervalues the Group. Accordingly, the Board

Brit Insurance's official response, RNS announcement to Stock Exchange, 11 June 2010

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New frontiers?

Dear friends,

What a difference a year makes! A tumultuous 12 months in both the live and legacy markets made for a dynamic and lively debate at this year's *The Insurance Insider* legacy roundtable, which coincided with the annual Cavell Commutations Rendez-Vous in Norwich.

Industry rainmakers considered a wide agenda of issues ranging from the impact of the Scottish Lion scheme of arrangement on attitudes in the market, to continental European growth opportunities and the pricing of run-off portfolios.

Top of the agenda last year was the impact of the financial crisis on the sector. One year later and there have been no major insolvencies as a result of the financial turmoil and no major portfolios to deal with for service providers.

But a general lack of new business from these developments has been partially counterbalanced by increasing activity in continental Europe. Here, (re)insurers with Solvency II in the back of their minds are increasingly willing to consider actively managing their run-off book like their London counterparts.

Roundtable participants argued that only local players will be able to tap markets as they open up. Others were sceptical over whether the largest European players would sell at all, and suggested they would prefer not to take a reputational risk. Instead, they could opt to manage run-off internally.

The discussion was energetic, and inevitably settled on the issue of pricing. It emerged that run-off books continue to be bought at a premium to net asset values (NAV), but uncertainty has reigned over legacy deals' true profitability.

Even the use of NAV as a measurement of pricing was put up for debate, with one participant labelling it a red herring. The industry may only find out if there is value in a deal when a business is sold again, the attendee asserted.

Most participants agreed, meanwhile, that creativity and innovation will be the name of the game for the legacy industry. Some suggested branching out of the live market was a prudent route, while others advocated diversifying within legacy.

As the industry looks to the future, the road ahead is far from smooth, with significant uncertainty still surrounding the final capital requirements under Solvency II. Claims volatility in asbestos run-off also continues to loom over the sector.

Whatever the future holds, this vibrant and thought-provoking discussion is essential reading for anyone wishing to stay up to date on the key issues occupying the legacy sector's business leaders of today.

It was a pleasure to chair this event, and I hope you enjoy the read.



Kind regards,
Helen Wright
The Insurance Insider

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Richard Askey
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at Lloyds
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Daniel Schwarzmann
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Pervin Sivanathan
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Mark Taylor
Director at Independent
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Peter Taylor
Partner at
Hogan Lovells



Mike Walker
Partner KPMG



John Winter
CEO of Ruxley Ventures

The Legacy Roundtable 2010

Helen Wright: Thank you very much for coming today, on this summer morning in Norwich. I'd like to go round the table with the first question, which is in essence a simple one. How does the legacy market currently look from your perspective?

Stephen McCann: The legacy market in Lloyd's looks very good indeed. Lloyd's closure mechanism, as most readers will know, is the reinsurance to close (RITC) mechanism, we don't really do Part VII transfers to any great extent and we have had no solvent schemes. The RITC market for run-off is very buoyant at the moment.

We have plenty of price competition, which is good from the perspective of the capital providers who have been released. Fewer syndicates are entering into run-off than are closing, so run-off at Lloyd's is getting smaller and smaller as the years go by.

Peter Taylor: I think the run-off market as far as my part of the industry is concerned is getting stickier. Some of the techniques that have been used in the past are now

sufficiently well known that anybody who wants to try to wind business down will do so. So we are seeing a lot more people, and not just the traditional so-called awkward squad, deciding that they are going to have a pop at any aggressive exit solution.

In terms of lawyers' involvement, we are certainly seeing things tightening up on the more aggressive solutions if I can call them that, such as schemes of arrangement. We are seeing a lot more activity there on the Part VII front. Part VIIs are of great interest and not just intra-group Part VIIs, but also hauling business onshore from places that you might not have expected to see Part VIIs come in.

Mike Walker: Statistically, I think the market is still absolutely huge. Between KPMG and PwC, we have surveyed most aspects of it. We found over £38bn in the UK and over EUR200bn in continental Europe. Having said that, from a service provider's perspective, whilst we have been encouraged by the level of commitment to schemes of arrangement from those still wishing to propose them, I think the current market for service providers generally is not without its challenges.

Asbestos filings – the staple diet of the legacy industry – have dropped off. There have been no major insolvencies as a result of the financial crisis, those that are currently being dealt with are walking the road to finality, and there have been no major outsourcing deals.

As a consequence I think service providers are being much more creative about how they deploy their talent. They are looking at the live, Lloyd's and life markets, they are looking at supporting the intermediary space, and of course they are all waiting with bated breath to see what will happen once Solvency II is implemented.

Peter Hughes: I have a feeling that over the few years that I have been watching the legacy market there have been some huge challenges for those organisations within it. And I am watching some interesting developments as they try to re-invent themselves.

And I think that there is an enormous skill base of very intelligent and capable people in the legacy market and there is no reason why that skill base can't offer its services in lots of different areas that are not strictly to do with APH and the traditional areas that they have been involved in.

Mark Taylor: I am a claims manager by trade - we are in the run-off business and we are not seeing a lot of run-off going on. We have seen a lot of buying, but in reality there is too much risk falling in the hands of too few companies. And

"We are seeing a significant inflow of projects in Germany and its neighbouring countries"

Arndt Gossmann



schemes are a good part of the toolkit but at the end of the day, in order to take money out of run-off you have to close the book down. And it is actually proving quite hard.

I also don't think that people have thought enough about the difficulties of buying books and then absorbing them into your business. I don't see how some of the companies that have been buying these books of business are actually going to make money out of them.

I also think that there is a gap over price expectations that the vendors have when they are selling books of business. I think that they have quite successfully stripped a lot of the fat out of the deals that subsequently come to the market and hope that people will come in with nice big offers. That isn't happening though – people are a lot more switched on.

There are a lot of challenges on the acquisition side. The market is very tight and I think people are working very hard. For our part, we are diversifying because we want to continue to grow the company.

John Winter: Well, Ruxley Ventures is a purchaser of run-off, which it then closes down using schemes of arrangement. I think that there isn't as much around as there was, but the market is still there. You just have to be a little sharper, by that I mean cleverer.

Pervin Sivanathan: I agree with you on the acquisition side. I think that there are a number of ways that people can manage the next slump in run-off business, and different solutions are being looked at. It might be partnering with somebody with the experience to make acquisitions, but it might be more proactive claims management as well. And, particularly, I think within legacy there will be greater focus on the growth of efficiencies. From our perspective, the reinsurance asset is invaluable, particularly in this kind of climate.

We have sought to re-engineer the collection process, through automation and by dealing principle to principle via our system, Stripe.

Dan Schwarzmann: It is still a very exciting market and it is going to continue to grow.

The word I would use to describe the market at the moment is "confident". In terms of the recession and what has been going on generally in the outside world, the run-off market has proved pretty resilient.

So Peter, I don't see companies having a pop at some of the solutions, which I think is the term you used. I see parties engaging much more when solutions are proposed and doing so much earlier. There is much more knowledge and much more certainty, and hence confidence, in the market.

The problems that parties are looking for are getting much more complex though. So I think there will be much more innovation in this market. And I think probably the tool that will be most used over the next 12 months is Part VII transfers, as groups look to consolidate what they have before deciding on their ultimate strategy. I foresee more internal Part VIIs as companies prepare for Solvency II. I also predict more M&A activity and solvent schemes of arrangement.

Stephen Bailey: As a buyer of run-off entities, I think it is quite a difficult market to be in. There have been a number of purchases that have taken place recently that we considered to be expensive. And we are not prepared to pay very, very high prices. If there is something that we can acquire discretely, we will do so, but I don't think that we are going to get involved in any major tenders going forward.

And, to a degree, we have moved our focus away from the pure companies in run-off and are now much more focusing on the captive market, which we consider to be a fairly untapped area from a reinsurance perspective.

Arndt Gossmann: Speaking as a continental European run-off acquirer, I see it completely differently. There is currently quite an attractive market situation within Europe. We are seeing a significant inflow of projects in Germany and its neighbouring countries. They are, overall, rather smaller transactions, but they represent high profitability.

Overall, I believe that the market has significantly grown – my feeling is of a larger market and definitely a significantly greater readiness to look for external solutions, which is fantastic for us.

Paul Corver: Wearing my hat as chairman of ARC, I can say that the ARC community – which consists predominantly of the pre-'93 run-off, the distressed toxic years from the 70s and 80s – is maturing, as we expect. We have seen our membership beginning to dwindle because of consolidations, acquisitions and mergers of companies and managers themselves.

“Service providers are being
much more creative about
how they deploy their talent”

Mike Walker



But we are now beginning to also see an interest from what I would call live legacy – live companies in the market who have significant levels of legacy in their books. There is now a shift of interest in ARC across from what was distinct and separate run-off to the embedded run-off.

Stretching across into Europe, and I am now popping the R&Q hat on, we are seeing plenty of opportunities. We have recently acquired a company in France, we are looking at a number of other opportunities over there, but on a small-to-medium size scale. Picking up on threads that have been covered, I think Solvency II could lead a drive towards divesting companies and old books of business.

Richard Askey: From a banking perspective, historically we have funded acquisitions of books of business. So I would echo some of the comments that Mike made though there have been less transactions over the last 12 months and there have been fewer opportunities for finance. I would probably draw back and say the financial crisis I don't think has impacted to a huge degree banking appetite for financing these kind of transactions.

And I think the structure of the financing and the level of leverage will be less than it was a couple of years ago, but there is still supply of capital to finance acquisitions in the future.

On the investment side of the balance sheet, there are significantly lower returns and thus considering the overall investment assessment this needs to be reflected in more appropriate pricing of transactions.

Helen Wright: Well there are some very interesting threads to pick up on. One of the subjects that has punctuated the last year and inspired a lot of discussion was exit mechanisms and in particular the issues surrounding Scottish Lion. In the light

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in any major tenders
going forward”

Stephen Bailey

of Scottish Lion, which has now as we all know been sold on to Berkshire Hathaway, what is the future for the schemes of arrangement?

Dan Schwarzmann: You are going to have to limit me on time on this one. It was a fantastic result for advocates of solvent schemes. Given that the appeal court sat for four days and heard arguments surrounding the fairness of solvent schemes generally rather than specific Scottish Lion matters, the decision was always going to be a very big. And the judgment was very clear, it was crystal clear – solvent schemes can be proposed for solvent insurance companies.

So from a solvent scheme perspective it was fantastic news. And it has created a lot more certainty in the market. We are certainly seeing much more confidence from our clients but, having said that, this is not the only mechanism they are looking at.

It is also worth highlighting that Scottish Lion is one of the largest solvent schemes to be proposed for a company and has been sanctioned. Minster, on which PwC advised and which was sanctioned in the English Courts at the same time as Scottish Lion, is another major watershed in the solvent scheme market and shows how very complex direct and indirect books can be schemed if approached properly.

Mike Walker: The debate over fairness has always been present and people have got strong and valid views on both sides of the fence. I don't feel that the Scottish Lion decision changed the debate, although it certainly is helpful having the appeal decision on record.

I have heard a number of commentators claiming that new solvent schemes have slowed down and that it could be evidence that they are dying out. I couldn't disagree more. Rather than look at the statistics relating to the number of schemes, the real news about current schemes 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 of schemes have changed.

If you look at the last five schemes of arrangement that have been done – EW Payne and Minster, for example, were huge schemes of arrangement. They are characterised by being very complex, with lots of stakeholders and issues to be dealt with. And that is the reason why there has been a slowdown. The low hanging fruit has been picked. The issues that are being dealt with now are generally more complex, they are bigger, they tend to be multi-jurisdictional and often multi-participant based.

John Winter: I think the sale of Scottish Lion is an important decision for completely different reasons than have been stated round the table. In my opinion, those that oppose schemes are not driven by a desire to change the law, they are driven by potentially lucrative settlement deals – nothing wrong with that, I can understand it.

But it seems to me that the line of attack has always been on the fundamental issue of schemes, the question as to whether schemes are legal under UK law. And I think they are wasting their time and Scottish Lion told us that. Schemes will be

allowed in insurance forever.

The issue I think the opponents of schemes have overlooked is I believe particularly important for schemes – the fairness in voting arrangements. By and large, I don't think the voting processes in schemes, with greatest respect to the people round the table, are fair. I think each vote should be valued independently before the meeting and counted. That means that it is not OK to value a certain amount of votes – enough to win a majority – and get the scheme through and then leave the rest. I think every vote has to be valued for the scheme.

But this process costs money. The last scheme that Ruxley did, we spent £250,000 on this process. But I don't think you should be in this business unless you are prepared to spend that sort of money.

Making sure that voting is fair will get a scheme through pretty much every court, because that is what the judges will understand.

But what I am pleased by with Scottish Lion is that it has tackled the fundamental question of whether schemes are legal in Great Britain: the answer is yes they are.

Stephen Bailey: I would very much endorse that particular point, having lived through Scottish Lion almost as much as Dan did I think. And I certainly think that the whole legality question surrounding schemes has been dealt with. That it is going to benefit proponents of schemes – it is going to make those that are attacking them merely as a means of leverage think a lot harder before they launch into any objections in the future.

The fact that Scottish Lion was subsequently sold will have some impact on those who are opposing, because one of the things that the scheme does do is it very much clarifies the state of the book – you have to go through everything in such detail.

And if there is someone who is opposing and you say we are not going to pay that because your claims are not due for 10, 15, 20 years or even longer, they can suddenly find that they are facing the possibility of getting absolutely nothing if the company is sold subsequently.

And it becomes quite an easy task to sell, once you have gone through the entire scheme process, because you are unlikely ever to see quite such a fully understood balance sheet.

Paul Corver: I do think the more interesting twist is the sale of Scottish Lion. From my dealings with schemes, I am certainly aware of a number of policyholders in the US who don't like schemes but are not particularly enamoured with having to try and get a claim paid by Berkshire Hathaway either.

And that has made it quite an interesting equation. Whether that means that those proposing schemes of arrangements have the potential to say: "right we are going to do a scheme, if the scheme fails, we are going to sell it – take your choice." That dynamic has got to be in the back of people's minds now.

Peter Taylor: If I could just come back on one thing - there is actually a tried and tested way, if you want, to take the pressure off: opt-out schemes.

Dan Schwarzmann: Now there's a debate around the ease by which solvent schemes can be sanctioned versus the financial results for all shareholders.

Peter Taylor: I am conscious that may open a big can of worms but...

Helen Wright: Well, let's have a go.

Peter Taylor: You can actually make it a great deal easier by having an opt-out version. Clearly, the reward may not be as great and you don't have your finality uncertainty, but you may clear off a huge workload and you can redeploy that capital elsewhere.

Helen Wright: John, does that sound viable?

John Winter: Well, at least it would take care of those policyholders that argue that they are losing coverage. It would winkle them out. Commercially, it wouldn't suit me to have that but it is one of those things that you have to do, you can always have an arrangement with Berkshire Hathaway if the scheme doesn't work out.

Helen Wright: Now, it is difficult to know what factors are at play in influencing the price of books of business and indeed portfolios. What do you see happening with pricing at the moment – Arndt, how do you see the situation in continental Europe?

**"The spectre of Solvency II
is looming on the horizon,
and that is capital focused"**

Peter Hughes



Arndt Gossmann: I think in terms of Europe, we are still on a relatively high pricing level and schemes of arrangement are not destabilising this, but rather increasing the readiness to make an attractive proposition to a potential buyer.

Helen Wright: As a gauge, are you talking about a premium to net asset value?

Arndt Gossmann: Yes.

Mark Taylor: I think net asset value it is a red herring. At the end of the day, it is the exit price, not the entry price. We don't know what happened on Scottish Lion, we don't know whether many of these deals were good deals – we speculate. I think people will spend money that they are free to spend. I don't actually think we will ever know whether these deals made a profit or not until they are sold again

Arndt Gossmann: So are we all purely betting? You should have an opinion on the price when you buy something.

Peter Taylor: Well you are trading something the price of which will go up and down. And I agree with Mark – how much you get out of a sale is the test of whether you are a good trader or not.

Arndt Gossmann: I am not a trader. We buy and we bring it to finality.

Helen Wright: Mark, what do you think about the appetite for buyers and the opportunities in particular in continental Europe?

Mark Taylor: I think Arndt is in a good position as are R&Q and Global, and Grafton as well. They have set their stall up in Europe and they have got capabilities – the language skills etc – and I think those are key ingredients. Certainly, you have to be part of the German market if you want to buy business there.

But again, I also think that the German market is still developing in terms of how they really want to deal with getting rid of their business.

I think one of the challenges, particularly in Germany, is that the people they are looking to acquire the business from are highly capitalised, highly solvent companies. And to do meaningful transactions, you have got to go into places like Munich Re and try and surgically remove their run-off from them and I am not too sure how keen they will be on doing it.

Mike Walker: I think one of the challenges for people looking to acquire business in Continental Europe, particularly in France and Germany, is that the “run-off” is buried in highly capitalised, highly solvent companies. To do meaningful transactions, you have got to go into these companies and try and surgically remove their run-off from them. I am not too sure how keen they will be on doing it when they have reputations to consider.

Pervin Sivanathan: I think it is more of an engagement and a discussion as opposed to an automatic reaction to sell. And certainly I agree that, particularly with Europe, it is about relationships and how, as an acquirer, you can't just assume that a sale will be open to you, it is about developing relationships.

Peter Taylor: I think there have been interesting developments over the last year in Germany in particular. Some of the major reinsurers have set up dedicated run-off units within their operations, and that is new. And that indicates to me that people are not so much necessarily looking to dispose but to acquire, which is going to put some interesting pressures on pricing, if indeed part of their business plan is to acquire other businesses.

Pervin Sivanathan: I disagree. I don't think it is necessarily to acquire or sell. It could be just to manage. And I think particularly when you look at the global companies such as Axa or Munich Re, you are looking at internal arrangements where they may choose to centralise their run-off in a particular country. So they would look at how they are going to restructure their business and operate in the most efficient way or to extract capital.

Peter Hughes: Isn't this driven to a degree by capital efficiency? The spectre of Solvency II is looming on the horizon, and that is capital focused. And organisations on the continent are saying to themselves: “well we are going to have to respond to Solvency II, we want to be more capital efficient.” And that might mean disposing of some legacy and re-organising themselves, or actually managing it rather better than they have in the past.

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developing relationships”

Pervin Sivanathan

Stephen Bailey: I think major European reinsurers are very fickle when it comes to legacy. They really don't seem to be able to make up their minds as to whether they want to be in or out, but I certainly don't see them being major disposers of their legacy business because they look upon themselves as being long-term players with a duty of service to their clients.

And I think they take the view that anything that they do to be seen to be disposing of something once it gets old and a little bit uncomfortable will hurt their business model going forward.

Dan Schwarzmann: There is no question that Solvency II is now driving much more internal deliberations about what books should be in run-off and about whether it is sensible to keep books of business in run-off or diversify more by acquisition. And I think Peter, the point you made about some major international insurers now looking to buy books of run-off business is significant.

The run-off industry is attracting more investment. Out there in the general financial world there is a lot of uncertainty. Hedge funds are looking to use their funds and many are attracted to the legacy world as they have seen exceptional returns being made in certain cases. That is impacting pricing.

Stephen McCann: About four years ago at Lloyd's we wanted to attract different capital to write third party reinsurance to close in order to provide exit solutions and increase the number of RITC providers. We actually had to change our rules to make it more attractive to non-trade capital to come in to write RITC business.

And now we have got non-trade capital in there supporting the RITC syndicates and the effects are very evident in our figures. We are getting capital from places that would never have normally joined Lloyd's.

Peter Taylor: From a lawyer's perspective, I think there is a degree to which one has gone through all of these decisions and this process, one of the top priorities has always been protecting reputation.

Stephen McCann: Absolutely

Peter Hughes: And I think that is the kind of approach that we are going to see from the continent – more so than we have seen in other run-off entities over the last few years in London, where it has not been about reputation, it has been about getting rid of stuff that people don't want any longer. That is a whole different ball game.

Stephen McCann: That is why we won't let an insurance company close a Lloyd's syndicate. It has to be a Lloyd's-syndicate-into-Lloyd's-syndicate transaction. That way we overview the business plan, we approve the management, we approve the strategy. We can make sure that they uphold the brand values, the claims handling standards, the risk management standards, so it doesn't go off into somewhere that goes to sleep for six months on claims settlements.

John Winter: The biggest challenge for a reinsurer nowadays is cycle management – working the way through the cycle, and the cash flow issues involved in that.

And diversification is the name of the game in terms of the ability to manage cycles. I just wonder whether actually having other areas to their business helps them to manage the cycle rather better. That may be the driver for them to be acquirers.

Richard Askey: I think it depends whose capital they are using. Demand for their own internal capital, I agree, will go towards live underwriting in the right market. I think that is absolutely right. Whether this partnership view is plausible – coming back to the point about hedge fund money coming in, let's say, to fund some of their existing run-off – I am not sure. I don't think it is a consistent play because hedge fund money traditionally in our market has come in for a short term, taken a good return and then it has left. That doesn't really fit the long-term nature of a lot of these books of business, sat in a Munich or sat in a Hannover. So I tend to feel that they are more likely to be sellers than buyers.

Dan Schwarzmann: I tend to agree that there will be more disposals than there will be acquisitions. But what is great about this is I think if you had asked this question 12 months ago there wouldn't have been this level of debate. We definitely see continental European insurers consolidating their books and thinking about divesting certain businesses

Helen Wright: My impression is that Solvency II is looking like a little bit of a double-edged sword. On the one hand, there is this debate about whether it is going to fuel business for the legacy industry and, on the other hand, it seems to me that it makes no concession for pure run-off acquirers.

“We are seeing a lot more people deciding that they are going to have a pop at any aggressive exit solution”

Peter Taylor



Paul Corver: It will inevitably have an impact. At ARC, we have a working party looking at the impact of the regime for run-off companies. One of the challenges we have at the moment is getting any comment from the FSA as to what they expect to do for companies in run-off that cannot meet additional capital requirements imposed by the regime.

And I agree that Solvency II is a double-edged sword. Yes, it may give rise to a lot of books of business becoming available from companies who want to dispose of old legacy, but also the factors in Solvency II may give them diversification credits by keeping it. Similarly, consolidators might want to start bringing in business of different types that they already have, in order to get greater diversification themselves within the Solvency II model.

Mark Taylor: And we don't really know how these countries and their regulators are going to enforce Solvency II. One issue really is will the regulators be consistent? And I suspect they probably won't because they will each want to look after their own markets.

Peter Hughes: Yes, I broadly agree. There are only two things that I think we can be sure about with regard to Solvency II. One is that it is going to be a driver for more capital efficiency, and two, it is going to be a driver for change.

And the organisations in this market that are capable of grabbing hold of that opportunity from change will be the ones that survive and succeed going forward – those that position themselves properly for that change and help companies become more capital efficient.

Peter Taylor: But as Paul says, you have a finite amount of capital at the moment. You are in run-off, nobody is looking to invest in you and all of a sudden, the rules change and the goalposts move. How far are they going to move?

Arndt Gossmann: I think Solvency II basically increases the awareness and the understanding of the business. It

is not as simple as deciding to sell some run-off because your solvency position is not good, but rather gaining an overall understanding and all the parameters of the business, whether it is direct business, whether it is reinsurance, active or in run-off.

Paul Corver: Solvency II could also be one of the factors driving an interest in diversification among run-off practitioners themselves. From an R&Q perspective, we took a view that we needed to extend beyond legacy and move into markets that will give a more frequent and regular income stream.

This involved a whole number of fields - going into Lloyd's with a managing agency and a turnkey syndicate, developing a delegated underwriting authority and MGAs, moves into the captive management zone etc.

We benefited from our experience of managing legacy over a number of years. We bring something different and something fresh. And certainly the captive area – which I am sure Stephen would agree with as well – is ripe for the innovation that comes from the legacy sector.

Peter Hughes: I remember one of our old gurus at Standard & Poor's saying that the greatest cause of corporate failure is concentration risk.

But of course, on the other side of the coin is the phrase "diversification or di-worsification", and you have to try and balance the two.

So it is a question of whether run-off organisations can diversify without actually getting themselves into areas that they perhaps find are even more difficult than the run-off market.

Helen Wright: Thank you all very much. This has certainly left me with a lot to think about and I hope you found it constructive as well. It is just left for me to thank heartily our sponsors, Darag and Hogan Lovells, for making this possible.

"The Scottish decision was
crystal clear – solvent schemes
can be proposed for solvent
insurance companies"

Daniel Schwarzmann



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