

VIEWPOINT

Shareholder value: as companies strive to increase the payback to stakeholders, the decision to put a company in run-off can have myriad implications, not least of which will depend upon who is managing the run-off



Final phase of a company's life

THE decision by shareholders or management of an insurance or reinsurance company to cease underwriting is the end of one phase in the life of the company and the start of the next.

The run-off phase is an easy one to enter, but absent insolvency is an endless tunnel from which escape is elusive. This is borne out by the statistics; over half the approximately 180 London market companies are in run-off, not including the many companies which have parts of their business in run-off.

Other than through insolvent liquidation and Schemes of Arrangement, the number of companies exiting run-off is minimal. A handful have accomplished portfolio transfers, which move the run-off elsewhere.

Some have done capital reductions to release surplus funds. HIR (UK) Ltd, which is managed by Chillington International Ltd, has recently implemented the first UK Solvent Scheme of Arrangement.

A solvent scheme is not a "tool" to be used by shareholders to help them to escape their responsibilities and maximise the return of capital that they have invested in a company which has been placed into run-off.

The HIR (UK) scheme appoints scheme managers, who are licensed insolvency practitioners. They have a duty to act in the interests of creditors and to monitor the continued solvency of the company, thereby ensuring policyholders receive full payment of all valid claims against the company.

Once this has been achieved the scheme terminates and any remaining funds in the company can be returned to the shareholders.

Should the run-off cease to be solvent before final exit, another now well-trodden path will probably be followed, using the same mechanism.

The implementation of a Solvent Scheme of Arrangement should therefore be seen as the final step in a well considered and properly planned exit strategy. It will not necessarily be the best solution to achieving finality in all cases.

When shareholders initially take the decision to discontinue the operation of a company, they clearly have a problem. In a solvent situation there may be significant invested funds tied up which could be put to better use in their other ongoing areas of the groups' business.

On the other hand it could take between 10 and 50 years before all the claims arising on business accepted by the company in the past

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have been settled, depending on the classes of insurance or reinsurance which have been accepted.

The run-off period is likely to be longer than the period during which the company was actively underwriting. Shareholders' funds are therefore trapped and, for many companies, there is no way out of the run-off process. What then can the company's management do to meet its shareholder needs?

The regulator and shareholders will almost certainly require the company to prepare a business plan setting out the company's approach to the handling of its run-off following the cessation of underwriting.

In addition, the previous release and current exposure draft of the ABI's Statement of Recommended Practice on Accounting for Insurance Business requires companies to recognise the full administration cost of running off the business to completion taking account of investment income.

These external disciplines alone should encourage the run-off to be administered in a planned way. The plan should not only address how the run-off will be conducted, but also how and when it can be exited.

Key elements of the initial run-off plan would typically include:

- Reassess claims handling policy;
- Develop commutation plan and targets;
- Appropriateness and timing of outsourcing;
- Reassess reserve adequacy;
- Identify system needs.

The run-off plan can best be carried forward once an in-depth business review has been performed. Unless the strategy adopted is to sit and wait, such a review would seek to identify exceptional areas which require close control in order to stabilise the run-off, both from underwriting loss and cash drain.

This should focus on major contracts and relationships, both assumed and ceded, direct and reinsurance and develop a strategy for each.

This action could range from gathering exposure information from the cedant, taking greater control over claims management by the cedant, commutation, novation or maintaining the status quo.

A commutation strategy alone cannot achieve finality, but will play a part in con-

trolling exposure and cost. An integral part of the run-off plan and its control should be the financial model.

Even if only a part of the business is in run-off, this should form the framework for a number of decisions on:

- Capital surplus or deficiency;
- Required investment return to maintain cash flow;
- Sensitivity to loss deterioration;
- Economic value;
- Timing of major commutations;
- Timing of planned completion and capital releases.

The model should seek to project in at least annual increments, the cash flow from each financial element of the run-off portfolio. The main elements will generally be claim and commutation payments, administration cost, reinsurance recoveries and investment income.

In the current environment of risk-based capital, particularly for active underwriting companies, the measurement and monitoring of capital required for the run-off can avoid the inadvertent subsidy of the run-off by the active business (and visa versa).

This will, therefore, provide management of an active company with a discontinued portfolio with the complete tools to control the run-off.

Following these steps, the run-off plan will be implemented and the targets and financial models reassessed at least annually. This will need to involve periodic review of reserve adequacy.

As the major exposure areas are controlled, the completion of this phase of the run-off plan should provide greater stability and certainty over the degree of solvency. This will be characterised by more stable loss development, commutation of targets on both assumed and ceded business and identification of all principal to principal relationships.

It is at this point in the run-off process that consideration can be given to implementing a

variety of exit strategies, one of which might be a Solvent Scheme of Arrangement.

Others however would include:

- Sale of the company based on its net present value;
- Interim capital reduction;
- Portfolio transfer of the remaining liabilities followed by solvent liquidation;
- Reinsurance by a third party.

All available options would need to be considered by management and the company's shareholders in order to determine the exit route best suited to the circumstances of the company. Unfortunately there is no universal solution to the problem of run-off.

There is certainly no doubt that implementing a Solvent Scheme of Arrangement will be an ideal solution in many situations. It will enable early and equitable crystallisation and payment of liabilities to take place and certainty to be established.

This has been achieved in the HIR (UK) scheme by use of a bar date after which no further claims can be admitted for payment. Such a scheme is, however, unlikely to receive regulatory and creditor approval unless it is clearly seen to protect the interests of policyholders and to contain sufficient protections to ensure that all the company's creditors are paid in full.

It is suggested that this is only likely to be the case if such a scheme is implemented as the final part of a planned run-off strategy and financial model, which has been implemented and monitored over a period of time.

Indeed, the feasibility of applying a scheme of this type, the timing of its implementation and the consequent release of shareholder funds depends crucially on the successful application of the run-off strategy.

Unless this is properly conceived and implemented, the end cannot be achieved.

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OPINION