

## Managed Exits – The Solvent Scheme Solution

By Dr Wolfgang Eilers

HIR (UK) Limited is a London Market company owned by HIR- AG in Germany. It was set up in 1979 to underwrite non-marine direct and facultative business. In 1990 we decided that this subsidiary should cease underwriting and the book of business should go into run-off.

Under most policies, particularly in reinsurance, new claims can continue to be reported many years after the policy period. Even known claims can take many years to settle. The usual method of alleviating this problem is commutation with cedants. However, unless commutation can be accomplished with every policyholder, further claims can arise in the future, with the result that the run-off can take an extremely long time to be truly complete.

Run-off is therefore a necessary but unsatisfactory state for the shareholder. Capital is locked into an unproductive investment until the run-off is complete, without any certainty as to when this might occur, and management time and costs continue to mount. HIR's run-off costs became a significant element of the claims reserves as those reserves diminished, increasing the unattractive economics of protracted run-off. Moreover this locked in capital also created a currency exposure for the German shareholder.

The run-off of HIR had clearly matured by the mid-1990s and the question arose of how the run-off could be concluded and the balance of capital repatriated.

Our principal concerns as shareholders were:

1. Policyholders' rights had to be protected
2. The regulator should not object to any proposal
3. Business reputation had to be maintained
4. Insureds', cedants' and reinsurers' needs had to be satisfied
5. The run-off had to be concluded speedily and with finality
6. Capital repatriation had to be tax efficient

We instructed accountants Robson Rhodes, lawyers Davies Arnold Cooper and reinsurance consultants Chilington Intermediaries Limited, to advise on possible exit routes and strategies.

Chilington carried out an analysis of insurance assets and liabilities. They analysed the different types of risk, both direct and indirect, the policy and claims profile of insureds and cedants and the nature of reinsurance protection. Their objective was to facilitate a clear and objective view of the insurance liabilities and assets, with particular emphasis on the source of exposure to further claims by policy type and the options for estimating those claims by policy.

Davies Arnold Cooper looked at the different contracts, both inwards and outwards, and the regulatory and legal issues relating to various available exit strategies. We also asked them to consider whether there was a legally effective mechanism for achieving our aims.

Robson Rhodes co-ordinated the multi-disciplinary team. They analysed the non-insurance elements of HIR's balance sheet and using the work performed by Chilington reviewed the solvency of the company. They also considered the financial aspects of various exit strategies and the tax consequences of each of them.

Together they considered a variety of possible exit routes and reported that all the shareholders' objectives could, in the case of HIR, be best met by the use of a Scheme of Arrangement, a process set out in Companies Act legislation which enables a company and its creditors to agree a method of dealing with its liabilities. The Scheme of Arrangement process is often used in corporate reorganisations outside the insurance industry and Schemes of Arrangement have been used successfully for some time with insolvent insurers. However I believe this is the first time that one has been designed and purpose built for use as a managed exit for a solvent insurer in the London Market.

We asked our advisers to consider the key elements necessary to implement a solvent scheme of arrangement.

There are two key features in the Scheme which our advisers created. First it contains a mechanism

which facilitates the valuation of all liabilities on a fair and consistent basis, enabling them then to be paid in full and obtain finality. Secondly it is designed to maintain the ability to recover from reinsurers.

Robson Rhodes devised a range of commercial incentives that would encourage creditors to accept the benefit of a final accelerated payment in exchange for giving up the right to submit future claims at a later date. They used modelling techniques to assess the balance sheet impact of different combinations of commercial incentives for policy holders and to seek an acceptable balance for us as shareholders between the benefit of finality and the cost of accelerated payment of liabilities.

Chiltington used market knowledge to form a subjective assessment on the acceptability of different combinations of valuation and incentive proposals for the various groups of insureds, cedants and reinsurers.

Davies Arnold Cooper devised the legal format to implement the entire resulting structure.

Because of HIR's creditor profile, the HIR scheme utilises both actuarial and loss adjusting techniques to value direct insurance and facultative reinsurance claims. Unusually it also allows for any legal disputes to be referred to an independent barrister. By procuring that independent experts with relevant skills arbitrate on any disagreements the scheme produces speedy resolution of disputes at minimal cost.

We also required our advisers to consider in some detail how policyholders' interests would be safeguarded and any regulatory concerns satisfied. The DTI was consulted at each stage of the process.

First Robson Rhodes, having carried out the due diligence exercise with Chiltington and Davies Arnold Cooper, formally confirmed the directors' view that the company was solvent, and based on the business and claims profile likely to remain so.

Secondly, the proposal envisages the operation of the Scheme will be supervised by partners who are licensed insolvency practitioners in Robson Rhodes as well as authorised controllers of insurance companies, who will become the Scheme Managers when the Scheme is approved.

Thirdly, the Scheme envisages a regular monitoring of solvency by the Scheme Managers and a "whistle blowing " mechanism if they ever regard solvency as being in doubt.

The first Court hearing to approve the advertising programme and the calling of the meeting of creditors has already taken place. The groundwork to establish the viability of solvent schemes in the London market has therefore been completed and I believe other solvent companies will adopt this mechanism as a planned exit route from the run-off sector.

The key elements for us as shareholders in this case were a clear and comprehensive review of the book of business that enabled a confident assessment of the tail; an unequivocal opinion that the company was solvent, and innovative commercial design and scheme drafting - all carried out in conjunction with regular dialogue with the Regulator and the Market.

At the completion of the Scheme, the balance sheet will be a shell free of liability. This will enable dissolution of the company and final return of the invested capital to the shareholder, many years earlier than we had previously contemplated.