

German Run-Off Case Study

Hamburger Internationale Rückversicherung AG (HIR)

Background

HIR was put into run-off in 1990, making it one of the first German companies to go down this route. The decision was due largely to organisational factors and followed the sale of HIR's parent company, German insurer Volksfürsorge, to Aachener und Münchener Group and La Fondiaria Group.

HIR did not fit into the acquisition strategy, since each of the new owners already had a reinsurer in the form of Aachener Re and Fenice Re respectively. In addition, almost half of HIR's business was Volksfürsorge Group business which the new shareholders wanted to transfer to their reinsurers. Consequently, they decided to sell HIR.

As no buyer was found, HIR was acquired by a sister company of run-off services provider Chiltern. The sale was approved by the regulatory authorities in the US and the UK and was also notified to the German authorities. The deal suited the owners of UK based Chiltern for several reasons. First, as a business in run-off, HIR represented both an ideal marketing base and a spring-board for Chiltern's expansion in continental Europe.

Second, HIR's employees were of particular interest to Chiltern, since they were ideally placed to conduct HIR's run-off. Moreover, running off HIR's assumed and ceded reinsurance portfolio would develop their run-off skills, which could then be applied to expanding Chiltern's presence in the European market.

In addition, Chiltern was already familiar with HIR, since it had entered into a joint venture with the German reinsurer in 1988. This led to the creation of Orlando based Chiltern America, which was set up to handle the run-off of HIR's property/casualty branch in the US. The branch had already been put into run-off in 1987.

In 1990 Chiltern Europe was incorporated with HIR as its first big client. As planned, over the coming years, Chiltern used the staff and skills within HIR to gain a foothold in continental Europe from which to develop its consultancy services with other clients in the region. In the mid-1990s, the remaining HIR employees were transferred into Chiltern, which continues to handle the ongoing run-off under contract.

Dr Wolfgang Eilers, who had joined Volksfürsorge in 1987 and worked with Chiltern on establishing the HIR run-off joint venture in Orlando, became member of the board of HIR in 1990 and also managing director of the newly established Chiltern International GmbH, which co-ordinated Chiltern's expansion in Europe outside the UK.

HIR'S book of business

HIR started operations as a reinsurer in 1965. By the late 1980s, more than 50 per cent of its business was in the form of German based risks, while the rest of Europe was in excess of 30 per cent, the US around five per cent and remaining countries around three per cent. The largest cedant of HIR at that time was its parent company with just under 50 per cent of gross premium.

The company's business mix was not unusual for a European reinsurer of HIR's size at that time. It was mainly motor, general liability, fire, accident, life and others. On the international side HIR had branch offices in Kuala Lumpur (Malaysia) and Italy, a subsidiary in the UK, plus a life subsidiary and a property/casualty branch in the US, the latter being in run-off already.

When it was acquired in 1990, Chilterton did not view HIR as a distressed business. Some problems existed in the US property/casualty branch, but this had been put into run-off as mentioned above in 1987 before the acquisition and the content of the book was known to Chilterton.

Run-off strategy

Following the decision to put HIR into run-off in 1990, the HIR board assessed the book of business and decided on a conventional run-off strategy centred on the twin goals of reducing liabilities and cutting costs. In keeping with that strategy, it took the following steps:

- Early on in the run-off, one block of business was identified as saleable and was transferred to Hannover Re (see below).
- Commutations were conducted with cedants where HIR considered the exposure to be very high.
- Administrative expenses were reduced.
- Staffing levels were cut, starting as normal in a run-off situation with underwriting personnel.
- Most remaining HIR employees were gradually transferred to Chilterton to become consultants. In this new capacity, they worked increasingly for third parties as well as for HIR as and when the need arose.

As a matter of priority, a commutation strategy was developed in the early days of the run-off to identify business the company was keen to commute. That plan is revisited on a half-yearly basis. Decisions to commute are taken based on the plan and HIR's cash flow situation, in other words whether it can afford to do the targeted commutations at that point in time.

On a day to day basis, the process of managing the HIR run-off is similar to that found in the London market. The company pays and manages claims, monitors reserves, makes actuarial studies, prepares reports for BaFin (Germany's financial services regulator) on an annual basis, holds normal and supervisory board meetings and carries out commutations, together with inspections and arbitrations where necessary.

Nonetheless, Dr Eilers believes one key difference exists between run-off in Germany and the UK. He maintains that run-off in Germany is generally conducted more prudently and thoroughly than in the London market. This distinction centres on the German approach to managing run-off, rather than any question of greater processing efficiency, he says.

'When we evaluate our exposures, we are not just looking at actuarial studies or at reserves,' he explains. 'We look at underwriting year statistics, business year statistics, the contract and the exposure of the contract. People evaluate each contract on an individual basis, what the exposure is to be, so that we also cover other potential liabilities which have not yet come up. That is how we are trying to manage the reserves and also manage commutation.'

Progress to date

Although HIR did not go into run-off as a distressed entity, some of its liabilities have since presented more problems than initially expected. In particular, liabilities in the US and some European countries resulted in larger than anticipated claims.

Dr Eilers comments: 'We never thought that the US would cost so much and it is still costing us. Some cedants just do not want to commute. If you are solvent, that is just a fact. This is also true for some European countries, such as Italy, Spain and France, where we had difficulties when we started doing commutations.'

HIR has also had to increase reserves above its initial estimates for APH (asbestos, pollution and health) exposures in the US, credit, bond and motor liability in Italy and France and for its exposures to Lloyd's and other London market businesses.

By 2004, much of the German business had been run-off, with the exception of some motor liability contracts (see Table 1).

Table 1. Development of provision for outstanding claims and funds for life benefits – German business only

Branches	1990	1995	2000	2003
Motor	4.9	3.0	2.6	1.9
Liability	1.7	0.6	0.4	0.0
Fire	3.1	0.4	0.2	0.2
Accident	0.4	0.0	0.0	0.0
Life	32.6	26.0	3.2	0.0
	42.7	30.0	6.4	2.1

(Figures in € millions)

However, it is on the international side, where the riskier and more difficult business is concentrated, that the bulk of the outstanding liabilities remain. HIR continues to strive to close or commute what it can of this international business and has had some notable successes.

Back in 1990, the Italian and Kuala Lumpur branches were sold to Hannover Re as was HIR's Orlando based US life subsidiary. This deal was reached after Hannover Re expressed an interest in acquiring part of HIR's ongoing active portfolio. A sale was agreed on condition that the reinsurer acquired the run-off part of that business as well as the ongoing cedant relationships. The assets covering those liabilities, for example the branches in Kuala Lumpur and Italy as well as the life subsidiary in Orlando, were also transferred as part of the deal.

The UK subsidiary, HIR (UK), was closed down in 2001 in a solvent scheme of arrangement handled by Grant Thornton and Chilton and was the first solvent scheme of arrangement to be completed. In 2002 HIR completed its US run-off and closed down its Orlando branch with the consent of the Florida Insurance Department. HIR believes this is a unique achievement.

Personnel and pensions

By mid 1996, HIR's staff had been scaled down to 16 from more than 100 in 1990. At that point in time, the remaining employees were transferred to Chilton where some of them continued conducting the HIR run-off. Today HIR has only three staff members including two board members. This reflects the change of the business HIR is conducting, being a finance holding company and only controlling its assets and making acquisitions of discontinued companies.

The reductions in staffing levels have required more effort and resources than is the case, for example, in the UK, since German insurers and reinsurers have much greater legal obligations to their employees. Consequently, when HIR went into run-off, one of the biggest challenges facing management was the need to comply with German employment laws. One of their first tasks was to draw up a comprehensive social plan in conjunction with HIR's employee council to make adequate provision for those staff who were made redundant.

The biggest single cost of run-off for HIR almost certainly stems from its obligations to provide pensions for many former staff. Pension reserves have had to be increased in line with increased life expectancy and changes in interest rates. Funding pension provision is a particular challenge when in run-off because the only source of funding for such obligations is interest income. Interest income on the other hand is also the only income source to pay for run-off expenses and to increase provisions for hitherto unknown liabilities surfacing under non-commuted reinsurances.

Run-off duration

Although HIR has made considerable progress in reducing its liabilities since 1990, it is not yet possible to predict when the process will be completed. Dr Eilers believes it could continue for anything from five to 20 years. That uncertainty is due mainly to APH exposures in the US where cedants are unwilling to commute, even on liabilities where the reserves, including IBNR (incurred but not reported), are below \$50,000.

However, once HIR's liabilities reach a point where employing full-time staff is no longer cost effective, Chiltington will be able to take over all claims management and accounting functions.

Separate from the technical run-off, under existing German law HIR itself cannot be closed down until it has fulfilled its pension commitments, which is likely to mean after the last pensioner has died. Pension obligations can be transferred to another company, but at the moment the cost of doing this is prohibitive. Consequently, HIR's obligations to its former employees could last longer than those to its policyholders.

Benefits for Chiltington

Acquiring and managing the run-off of HIR has worked well for Chiltington, says Dr Eilers. From the initial foothold of HIR in 1990, Chiltington has steadily developed its presence, not only in Europe where it has a large client base, but also in the US, Latin America, Australia and Asia.

Having the first hand experience provided by HIR staff was a key element in Chiltington International's success, says Dr Eilers: 'We gained unique experience because we did it with our own company. We know about all the different problems which one has to face if a company is put into run-off. So, we have the ability to advise clients before they take the decision right up to when they put a company into run-off and can assist in developing a run-off strategy or even can take over the run-off by way of insourcing or taking responsibility for the discontinued company.'

Finally, as one of the first run-offs in Germany, HIR has set an efficient example for others to follow and has helped to change the attitudes. In the very early days of HIR's run-off, Dr Eilers recalls a certain unease among others in the industry and notes that he was jokingly referred to as 'the undertaker' on occasion. 'It was very difficult at that point to even talk about run-off. People were very reluctant. Nobody wanted to be seen with you.'

The situation has changed considerably since then, he adds: 'I think we are respected in the German market as in the rest of the world. We have not lost reputation. On the contrary, we have gained reputation. HIR is an example of how run-off can be managed successfully, without deteriorating or going into insolvency and without jeopardising the liabilities or the obligations towards cedants or employees.'