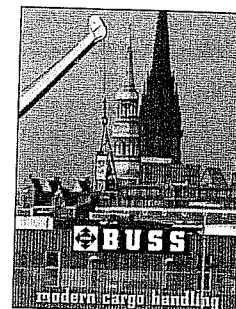


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The run-off market in Germany

(Re)insurer insolvency is virtually unknown in Germany, but there is still business to run-off. Dr. Wolfgang Eilers and Dr. Hubertus W. Labes, Chilton International.

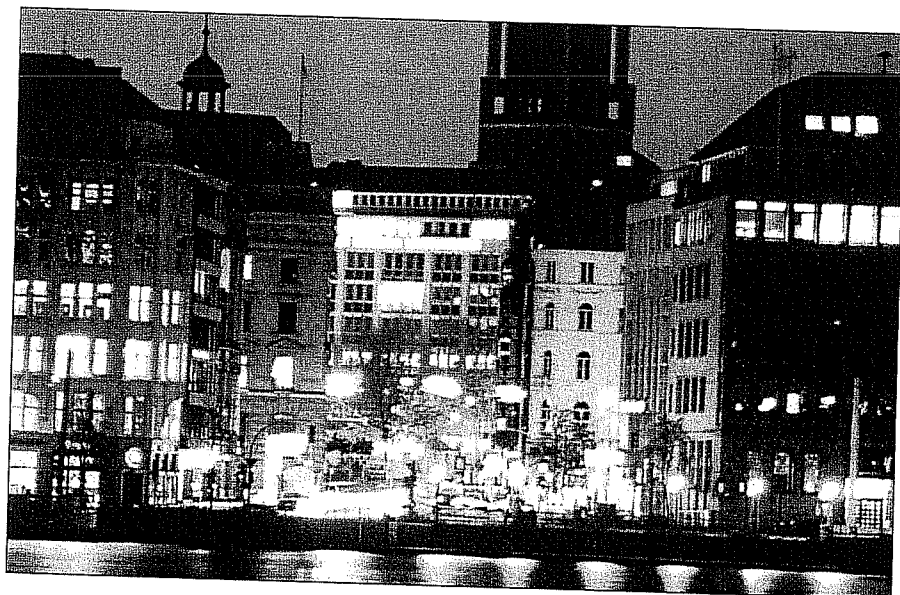
Around the world, no fewer than 700 insurers and reinsurers have gone into run-off since the late 1970s, with a few eventually having to be declared insolvent. This has resulted in a considerable increase in the number of insurance and reinsurance contracts which are now in run-off. In the last four years, the total amount of business being run off has risen from around \$220 billion to over \$400 billion, of which some 30% is reinsurance.

Events in the insurance industry have contributed to this trend. Following an above average rate of expansion in the 1970s, the industry experienced a slew of catastrophes and major claims in the 1980s and 1990s, losses on the technical account as well as a flood of latent claims which forced many companies to quit the market.

Since then, nothing has changed. Around the world, insurers and reinsurers must either cave into ever greater cost and competition pressures and follow rates down, cease writing new business or pull out of certain market segments if they want to grow their core business. Widespread consolidation within the industry in recent years has intensified this trend. Consequently, the amount of business in run-off around the world is expected to increase.

It should be pointed out, however, that a company does not have to cease active underwriting altogether to have some of its operations in run-off. Any company which has been involved in the writing and management of (re)insurance over a number of years will have at least a part of its portfolio in run-off, either because it has been cancelled,

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not renewed or ended for some other reason.

The following comments apply, therefore, as much to companies which have ceased active underwriting as to those which continue to underwrite, but also have a closed book of business to manage. Any (re)insurer in this situation will face the same challenges, especially where the long-term run-off of motor liability is involved.

There are many reasons why a company may cease to write new business. As well as legal developments or structural market changes, causes are likely to include unfavourable claims experience or poor underwriting decisions. In addition, it should be remembered that, even with good management and sizeable claims reserves, it is not always possible to plan for every eventuality associated

with some high risk exposures.

The aim of every run-off is to provide finality and remove any exposure to future liability. This means that, as well as managing run-off in house, there are a number of other options:

- The sale of the company;
- The transfer of a book of business to another company;
- Various forms of liquidation (e.g. scheme of arrangement);
- And, unfortunately increasingly as a result of going into run-off, taking the decision to declare a business insolvent.

Also to be considered are the many technical solutions for capping liability available through various forms of financial reinsurance.

The situation in Germany

Germany has not escaped the above-mentioned developments in the

international insurance and reinsurance markets. Since the end of the 1980s, several specialist reinsurers have withdrawn from the active reinsurance market, as too have many direct insurers, who in addition to their own business, were also involved in the reinsurance market.

In the direct insurance market, the fall-out has been most widespread among small subsidiaries and branch offices of foreign companies as well as the withdrawal from specific lines of business. The scale of this business in global terms is small, but could increase in the face of the spread of consolidation in the German market. This consolidation trend could also lead to some companies not actively trading forward.

A comparison of the run-off situation in Germany with the UK or the US does, though, throw up certain major differences. In both the US and the UK, most companies which go into run-off finish by going insolvent. This is because, in most cases, the companies do not have sufficient reserves or investment income to cover their liabilities. So far this has not happened in Germany, and it is hoped that this will remain the case. Until now at least, shareholders have ensured either through reinsurance contracts or the injection of new capital that insolvency can be avoided.

One reason for this is that reserving, especially for long tail liabilities carried out on a more conservative basis in Germany than in other countries. However, this has had the consequence that the financial authorities are increasingly questioning the size of and legal justification for incurred but not reported reserves in particular. Only by working with auditors, and supported by expert opinions, can tax inspectors be persuaded that it is necessary to carry such reserves forwards for periods in some cases as long as 30 or 40 years.

In the past, shareholders or management of a troubled German company were rarely willing to hand over its run-off or part of its business to third parties. Only in exceptional circumstances was active reinsurance business in run-off transferred by direct insurers to large specialist reinsurers, which could offer appropriate services or use an experienced consultancy firm. Such expertise has been available in Germany only in the last 10 years.

However, as experience of run-off has developed in Germany, more companies have become willing to consider outsourcing the management of some of their run-off business to specialists in this field. This reflects the general trend towards outsourcing in the

field of insurance as a whole. The situation is quite different from that in the UK and US, where a number of run-off specialists have existed for some time, primarily to serve the much larger needs of the London market and especially of Equitas. These specialists have on occasion been used by German companies, which usually accept business in the UK through subsidiaries or underwriting agents, to provide local run-off services.

The different approaches to run-off between Germany and the main foreign markets are even more apparent in the field of insolvency law. In the US, the liability crisis of the 1980s and Hurricane Andrew in 1992 kept insolvencies up at record levels for at least a decade. In the UK, the concentration of natural catastrophes at the end of the 1980s combined with the soft market of the early 1990s led to enormous losses, which in turn fuelled a wave of insolvencies. In France, the property crisis of the early 1990s was a major cause of insolvencies.

By contrast, Germany has been protected from insolvencies in recent decades by the maintenance of a strongly regulated insurance market until 1994. Not since the 1930s has Germany seen a single insurance insolvency, apart from small regional companies or private clubs, which have had no impact at national level and are statistically insignificant. Of course, it is probable that a company in serious financial difficulties has hidden behind an acquisition, merger or transfer of business. Even then, only direct insurers would fall into this category. There have been very few cases of German reinsurers being acquired or transferring books of business. This is due to the fact that the successful transfer of reinsurance contracts can only occur with the approval of the cedant, something which is normally a difficult and costly process.

In spite of legal and regulatory rules and supervision, insolvencies among German insurers cannot be ruled out in the future, especially bearing in mind market deregulation, although they are likely to remain isolated cases. It is clear that the risk of insolvency has grown in the face of more intense competition. Especially at risk are new companies with limited capital resources. For example, the minimum capital requirement for a new life insurer is just 1.6 million marks. As a result, in 1998, three small insurers almost went bankrupt but were bailed out by other companies. That sort of intervention cannot always be relied on.

A solvent scheme of arrangement, or

the voluntary liquidation of a re/insurer as laid out in the UK Companies Act 1985 (sections 425 onwards) in the interests of the insured, shareholders, regulators and reinsurers, is unknown in German law, despite a recent modification of insolvency legislation and its successful application on a number of occasions in the UK. This is probably because current laws in Germany guarantee an insurer's creditors a sufficient minimum level of protection. German lawmakers have made it clear that they intend to continue to protect the interests of the insured.

However, protecting policyholders' interests must also be considered in the light of growing cross border activity by insurers within Europe. The Council of Europe has recognised the increased need for regulation as well as the fact that policyholders do not have sufficient legal protection at a European level in the case of their insurer going bankrupt or into administration.

A proposed new law covering the forced insolvency of insurance companies has been under discussion for decades, but activity has been on the back-burner in recent years. Even so, once the EU resumes its works, it is hoped that the insolvency of German insurance companies will remain a rare occurrence.

Conclusion

It is hard to predict how run-off will develop in Germany. If the consolidation process continues, it is possible that some smaller companies will be unable to survive alongside their larger competitors (as is the case with regional or niche players). This could result in the underwriting of certain lines being discontinued, at least in some areas. It remains to be seen whether such business will be acquired by large insurance companies, handled by existing management or whether third party managers will be brought in to run it off.

It is clear, though, that based on past experience, Germany's insurance industry will do everything it can to prevent companies which are in run-off having to be declared insolvent. Their motivation for this is to protect the untarnished reputation of German insurers and to maintain the confidence of insureds. This is clearly a competitive advantage for German insurers, which they must exploit to set themselves apart from foreign competitors.

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