

The Run-Off market: A Regional Analysis

By

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Chilterton International Inc. is a global firm with offices in London, Hamburg, Madrid, New Jersey, Florida, Chicago and Buenos Aires, and which has been providing consultancy and outsourcing services to the insurance and reinsurance industry for almost 30 years. The administration of outsourcing services is a staple of Chilterton which was the first organization to successfully perform a solvent scheme of arrangement for a reinsurance company in the London market.

Abstract: It is common place to admit these days that times are changing the landscape of most industries. Insurance and reinsurance are no exception to this phenomenon. This article aims at exploring the latest run off developments in various worldwide markets, emphasizing a few cases that seem to have marked a new trend.

Introduction

It is never a bad time to review the status of the run-off industry. However, the current scenario with big corporate failures, changing regulation, and shifting strategies raises several questions. While it is too soon to reach conclusions about the future, some trends can be determined by looking at the latest developments in some of the most significant world-wide markets, which may help us understand what can be expected on the run off arena.

1. UK:

The UK run-off sector has seen a number of developments in recent times. The period has been marked by significant acquisitions, a number of legal developments, and change in the economic landscape. It has also been marked by certain predictions which did not yet come to pass.

In late 2008, Enstar acquired Unionamerica Holdings Ltd. This transaction caused some ripples in the run-off acquisition market. In a deal worth \$341 million, Enstar paid a premium on net asset value. This transaction was seen at the time as the high water mark in the pricing of run off portfolio acquisitions. Shortly before this deal was publicly announced in October 2008, Lehman Brothers had been forced into insolvency. In the six months from 8 October 2008, Bank of England Base Rate fell from 4.5% to 0.5%, and in the USA, the Federal Funds Rate fell to 0.25%. This drop in rates and the corresponding drop in commercial interest rate have made it increasingly difficult to develop adequate returns to investors.

Some might say the market for run-off portfolios has not been the same since. Certainly there have been no transactions to match Unionamerica in value and in premium on net assets. Subsequently, albeit smaller deals, have been deemed a return to normality in pricing. For example, Enstar acquired Copenhagen Re (\$2.5 billion) and British Engine (\$28 billion) and Catalina acquired Alea UK (circa \$80 billion), all prices apparently at a discount on book value.

There is, however, no widespread prediction that prices will fall further, given the number of potential acquirers still in the market.

The Lloyds market should not be overlooked in this analysis, although the form of acquisition is different, being through the process of Reinsurance to Close (“RITC”). Over a number of years prior to 2008, various Lloyd’s Syndicates had been, for various reasons, unable to close their open years of account through RITC. By the end of 2007, the number of open years of account had reached 54. This number fell to 37 at the end of 2008 and to 22 at the end of 2009. It is not expected that this part of the run-off market will regain its 2008 peak of activity for the foreseeable future. The number of Syndicates with open years is very much reduced, and in the current state of consistent profitability of the Lloyd’s market, a significant number of fresh open year syndicates should not emerge. Nevertheless, this has been a very active sector and should remain more active than was seen prior to 2008.

The most high profile transaction in the period under review is the acquisition of Equitas by Berkshire Hathaway. In June 2009, \$7.8 billion of Equitas’ remaining liabilities were transferred to a new company (Equitas Insurance Ltd) controlled by Berkshire. This was accomplished by Part VII transfer described by Equitas as “the largest and most significant of its kind ever undertaken.” Through this transaction, the past liabilities of Lloyd’s names in respect of all business written prior to 1993 have been removed from the Lloyd’s market, a process which commenced with the creation of Equitas in 1996.

The question now is whether any change in the operating philosophy will emerge, and whether any such change will have wider market ramifications. Equitas led many claim settlements and commuted many reinsurance involvements. This approach led to a greater than 50% reduction in Equitas’ liabilities between 2000 and 2005.

What is known about how the Berkshire controlled Equitas will operate in 2010, results from its legal success against a former Cigna Re entity, now part of R&Q. This case commenced prior to Berkshire’s acquisition of Equitas. With the High Court in England having upheld Equitas’ use of models to estimate LMX recoveries from the Exxon Valdez and Kuwait Air losses, Equitas

has publicly stated that it will be seeking to use that modeling to pursue other non-paying reinsurers in the LMX spiral.

The extent to which activity will unblock what remains of the 1989-1991 LMX spiral remains to be seen. Certainly, these two disputed losses have affected other losses, slowing their recoverability. Of course, over the last twenty years, commutations and insolvencies have created gaps in the reinsurance chains, and reduced the number of companies involved in the remains of this spiral.

One interesting operational result of Berkshire's acquisition of Equitas is their decision to transfer the handling of the US claims from London to Boston. This gives rise to a number of questions for the future; will Berkshire follow this model for their other entities?; how will the claims approach change?; and what will the effect on the London market be, where Equitas led many major claim settlements?

No discussion of the UK run-off market can be complete without reference to Solvent Schemes of Arrangement and Part VII transfers, which have gradually become a significant part of the UK run-off market. The first scheme in the UK for a run-off insurer was carried out in 1997 (the HIR scheme). For a few years, the use of schemes was limited, but eventually became much more widespread, and used in situations not necessarily contemplated by those who pioneered the technique. In 2009, the Scottish Lion court hearings in Scotland gave impetus to much fresh debate about the future of schemes and seemingly greater opposition, particularly from US based insureds and cedants. However, the demise of schemes would appear to have been over stated. There has been considerable activity in recent months, with the approval in March of the scheme for Minster, and the calling of creditors' meetings for the English and American pools in April and the Camomile pool in June. Scottish Lion is somewhat unique, having being heard under the separate Scottish legal system, and also being a scheme in which many have recognized flaws in its design and execution.

Turning now to what has not occurred; there are two areas to review. Firstly, there have been no recent significant insurer insolvencies in the UK. Despite the economic crisis, insurers have ridden the storm comparatively well, particularly in contrast to the banks.

Secondly, the predicted migration of European run-off to the UK in order to achieve final exit via solvent scheme of arrangement has not occurred. There have been two transactions of note, which to date have not been repeated. The solvent scheme of arrangement for Globale Rück AG (formerly Gerling Globale), a German company, in respect of its business with a connection to the UK was commenced in December 2008. In June 2009, Deutsche Rück UK implemented a solvent scheme, which included two portfolios of business which had been transferred from its parent company in Germany in October 2007. In summary, the techniques to complete the run-off of at certain types of business emanating from the EU have been proven, but the predicted flow of similar transactions has not yet taken place.

2. Continental Europe:

In Europe, the subject of run-off has significantly increased in importance in recent years. Since the end of the 1980s, not only have certain professional reinsurance companies stopped writing active reinsurance business, but many primary insurers have also discontinued their own reinsurance portfolios written alongside their own direct lines of business.

Most notably, the whole subject of run-off was thrust into the limelight by the decision to put the non-life business of one of the country's most prestigious reinsurers – Gerling Globale Rück (which has since been renamed Globale Rückversicherung and no longer belongs to HDI/Gerling) – into run-off. However, many other German reinsurers have ceased active underwriting in recent years. A sensation was caused when Hamburger Internationale Rückversicherung ceased underwriting in 1990, but a decade later, people had become accustomed to such news. By comparison, at the 2004 Baden-Baden convention, the fact that Gothaer Rück had gone down the same path did not cause the same reaction. Back in 1990, “run-off” was almost a dirty word. Nowadays, it's largely just a matter of splitting up the business and looking at the consequences for the renewals. Run-off in Europe is accepted as a normal part of

business, and the approach to the subject has become much more professional. In the face of the ongoing and active consolidation process within the European insurance industry, together with international economic developments, the volume of run-off is likely to increase further.

The decisions to put reinsurers into run-off, however, were made for a wide range of very different reasons. Problems with the respective US portfolios (Gerling Globale), “fundamental strategic assessment” and the reconstruction of a company’s future (Gothaer), not keeping a daughter company with a separate business model (Victoria Re), consolidation within the public sector (merger into Sparkassenversicherung), highly risky aviation portfolio (Feuersozietät Berlin-Brandenburg), “reinsurance no longer fitting with the group’s core activities” (Wüstenrot & Württembergische), or sale of the parent company (Hamburger Internationale Rückversicherung) are just a few of many more reasons. Therefore, no recognizable general trend or even a particular market development can be identified as being a typical cause of these decisions, at least in the German market. It is much more accurate to say that the above decisions were each the result of individual circumstances.

Even in the primary insurance market, the idea of “closing to new business” is no longer an unthinkable option. In the past, the focus among European primary insurers has been on closing down the business of small, overseas subsidiaries or individual branch operations. It should be noted that the life insurance sector, which accounts for around 50 percent of the European primary insurance market, currently finds itself in a difficult position, since companies can no longer achieve the minimum rate of return laid down by law. Moreover, new legislation has the potential to create further uncertainty.

Europe has also not escaped the 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 have many direct insurers which, 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 from those companies seeking to withdraw from specific lines of business.

In 2007, non-life run-off volume in Europe was estimated with about 204 billion Euro (Source: Unlocking Value in Run-Off, PWC 2007). A large part with (about 75.2 billion Euro) is related to the German speaking countries, with another large part (about 56.7 billion Euro) pertaining to UK operations. (Source: Run-off-Study 2007, KPMG Germany Another misleading information). These figures seem to suggest the consequence that roughly 200 billion Euro of non-life run-off volume in Europe, or 75 billion Euro in the German speaking countries are open for service providers to be acquired; e.g., for conducting Solvent Scheme of Arrangement procedures under English Law. That's not true of course. A major part of those 75 billion Euro belongs to players such as Munich Re, Swiss Re, AXA LM, Hannover Re, Allianz, and other such players. It can be challenged if such companies will provide their portfolios for Schemes or even for administration through service providers. The volume which is effectively available for professional run-off solutions may be 10% of the said numbers, perhaps even less.

Furthermore, the willingness to hand over run-off business to third parties differs among European legislations. In Continental Europe, (re)insurers are rather reluctant to transfer run-off portfolios to experienced consultancy firms. The situation is quite different from that in the UK, where a number of run-off specialists have existed for some time, primarily to serve the much larger needs of the London market.

A comparison of the run-off situation within Europe does, though, throw up certain major differences. In the UK, but also in France or Scandinavia for example, many companies which go into run-off have finished by going insolvent. 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 now at least, shareholders have ensured either through reinsurance contracts or the injection of new capital that insolvency can be avoided, including the fact that reserving, especially for long tail liabilities, is carried out on a more conservative basis. Of course, it is probable that a company in serious financial difficulties has hidden behind an acquisition, merger or transfer of business. However, in spite of legal and regulatory rules and supervision,

insolvencies even among German insurers cannot be ruled out in the future, especially bearing in mind market deregulation, although such insolvencies are likely to remain isolated cases.

3. USA:

Exit solutions in the U.S. market have not developed in the same manner as its counterpart in the U.K. This variation can be attributed to a number of reasons, one of which is the current legislative environment. The fact that the U.S. has state regulation of insurance as opposed to federal regulation tends to thwart the possibility of the solvent scheme of arrangement being implemented in the U.S. It is a well known fact that Rhode Island has put legislation in place to allow a commutation plan similar to the U.K. schemes. To date, however, no company has entered the Rhode Island plan due to the very real possibility of being exposed to almost certain lawsuits from other states that would follow.

While the basic tools of run-off, commutations and audits, have not changed in the past five to seven years, we have seen fundamental changes in the way in which run-offs are organized in the U.S. Where companies would once out-source the administration of a run-off, thereby keeping the liability but reducing administrative costs, they now look to sell the book of business and remove the liability entirely from their books. Some of the more well known players such as Berkshire Hathaway, R&Q, and Enstar have transacted large purchases of insurance portfolios, the most notable being the previously discussed Berkshire acquisition of Equitas. There have been significant amounts of money from private equity firms seeking investment opportunities in the run-off segment of the insurance industry. While this helps to drive up the price due to the finite number of such opportunities, the need for appropriate rates of return creates an ever increasing pro-active approach to eliminating liabilities.

One of the reasons behind outsourcing run-off was the inability to retain the better employees if the entire company was going into run-off. If only a portion of business was being put into run-off, then the issue was allocation of staff between the run-off and ongoing businesses. In the current economic times, companies cannot afford to use their best staff to administer a book of business that is no longer producing revenue at the expense of the on-going operation. More

companies have now decided to create a profit center for the business that may have previously been outsourced, and using the current infrastructure to handle additional run-off business from other sources.

A major development in the run-off arena is the status of Kemper. This company went into voluntary run-off in 2004 and now, six years after a state approved plan for voluntary run-off, it looks as though the company will go into liquidation sometime in 2010. The surplus of the various companies in the group has been depleted to the point where the state will probably take over the remaining \$1 billion in liabilities¹. The surplus of Lumbermens Mutual Casualty, the lead insurance unit in the Kemper group has dropped from \$113 million at the end of 2008 to \$8.1 million as of December 2009. While this case is considered to be a successful run-off, as Kemper has been able to reduce liabilities by almost \$4 billion, many of the remaining insureds have opted to not settle as they feel they may get more in a liquidation. This may or may not be true, as liquidation rules may be more rigid than run-off. Another concern may be whether state guaranty funds will pay outstanding claims. With the possibility of liquidation on the horizon, we may see a rash of negotiations and disengagement arrangements².

4. Latin America:

The main run-off activity detected in Latin America has been related to European or US companies that decided to leave the market and run-off either the whole operation, if it is a direct insurer, or the local book of business if it is a reinsurer. These situations have been triggered by the volatility of the Latin American economic environment that forced companies in the last decade to exit the region.

Cases like those of Employers Re, Gerling, and ReAC, are examples of companies that decided to cease operations in Latin America. Some of them adopted a commutation policy in order to accelerate the run off process.

¹ Business Insurance

² Business Insurance

An alternative situation in the last decade was for a number of international reinsurers to close part of all of their Latin American operations and control all the new business from a regional office elsewhere in the world. Such decision, however, generates the need to run off the local operations smoothly in order to maintain a good reputation and preserve commercial relationships.

Another source of reinsurance run-off in the Latin American region has been former reinsurance monopolies and/or locally owned companies that were either discontinued or acquired by another company. Among the former, some examples are INdeR (Argentina) and Reaseguradora Peruana, former reinsurance monopolies that were discontinued and put into liquidation, leaving several open relationships that are still unresolved. On the other hand, companies like Caja Reaseguradora de Chile, Reacol (Colombia), and Alianza de Mexico were acquired by Mapfre and Swiss Re, respectively, thus generating a run-off that was dealt with by the acquiring company in an orderly fashion.

With all this in mind, and looking at run-off activity in Latin America, it becomes clear that run-off has not been widely adopted as an exit strategy in the region due to a number of reasons. One of them is that there is very little, if any, run-off regulation. Companies are required to comply with the same conditions as an active company, which can become burdensome when it comes to minimum capital requirements. Moreover, in most countries there is no need for companies to get regulatory approval to enter into run-off.

As an additional reason, in the last few years, the regulators have become much more aware of the need to monitor solvency. As a result, in a number of cases those companies that were on the verge of insolvency have either opted for self-liquidation or were declared insolvent by the regulator and immediately put into mandatory liquidation. This leaves very little room for run-off to develop as a viable exit strategy in Latin America.

5. Conclusions:

The analysis of recent developments in the world run-off markets does not offer common trends, even at times where clearly the dynamics of change are in motion all around the globe. A crucial dynamic of this situation is the role of regulation, ranging from practically nonexistent in Latin America to very much developed in the UK and Europe. Of critical importance is that the latter two arenas offer alternatives for companies to successfully achieve finality, which is a key element of run off. However, the US, being one of the key worldwide markets has not been able so far to replicate some of those alternatives due to the complexity of differing state regulation.

Nevertheless, it is interesting to highlight the diversity of run-off drivers in each region, which clearly shows that run-off decisions are determined by local factors, which cannot be ignored when deciding to discontinue an operation.