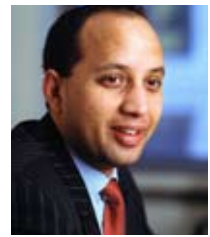


Developments in the run-off market over the past year, not least the opinion on the Scottish Lion scheme, mean the relative merits of the various finality options may need to be reassessed, say **Alan Augustin** and **Simon Hawkins** of PricewaterhouseCoopers*



Alan Augustin



Simon Hawkins

Time to review finality options

In recent times the principal options available to insurers facing long tail liabilities have generally remained fairly constant in the run-off market. Sell, scheme, reinsure, manage the run-off either proactively or passively, or a combination of the above, covers most of them. Nevertheless, the facets and drivers behind many of those solutions have seen some interesting developments over the past year, meaning that evaluation of the options from a shareholder perspective may require some rethinking.

The Opinion of Lord Glennie in the recent application to sanction

the scheme of arrangement for the Scottish Lion Insurance Co Ltd is without doubt a significant development in the solvent scheme market. In forming his view that 'a solvent scheme is an instance where, subject to other considerations, creditor democracy should not carry the day' Lord Glennie has effectively sought to introduce an additional test for solvent insurance companies considering proposing a scheme. In short, it has been suggested by the Scottish Court that a solvent scheme should only bind the minorities voting against a scheme where there

exists 'a problem requiring a solution' where 'it is in the interests of the creditors (or classes of creditors) as a body that a solution should be found and implemented.'

The ruling has far-reaching implications for any company, insurance or otherwise, wishing to use the legislation provided under the Companies Act 2006 to reach a commercial arrangement with its members or creditors. The commercial terms of the Scottish Lion scheme offered creditors payment of long tail IBNR claims without any discount for the time value of money, which represented a significant premium when considering the expected payment patterns for future asbestos and pollution liabilities.

Whilst around 90 per cent of creditors in the Scottish Lion case voted in favour of the scheme on this basis, rather than face uncertain and gradual recoveries from a long tail run-off, the Opinion provided by Lord Glennie makes such commercial arrangements unlikely in the face of any opposition. An appeal is currently underway on this fundamental legal point.

Whilst the Opinion does not create a legal precedent in the High Court of England & Wales, it does act as a persuasive authority. It is therefore interesting to note that whilst the appeal is underway, a number of companies are continuing the promotion of their own solvent schemes in England.

The current uncertainty in Scotland does not yet appear to have hindered the appetite of the London market to consider solvent schemes as part of the toolkit available to offer closure and certainty to policyholders, cedants, reinsurers and shareholders alike. Given that very few run-off companies are actually based in Scotland, clarity from the High Court of England & Wales will be critical in addressing whether solvent schemes in their current form remain an effective solution to the

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challenges presented by long tail liabilities concentrated in the London market.

What is clear however is that both solvent and insolvent schemes have continued to develop since the mechanism was first used for discontinued insurance business, and this evolution will no doubt continue as the law develops. A case in point was the ruling by Justice Warren in relation to the WFUM Pools scheme in 2006, which led to a separate class of voting creditors for IBNR claims in many schemes.

Whilst this may, on the face of it, provide an increased challenge to the promotion of a solvent scheme, many schemes have, through careful management and communication, achieved approval from both classes of creditor far in excess of the required 75 per cent (by value) threshold since that ruling.

Insolvent estates seeking closure via a scheme have also had to consider how best to address in a scheme the priority for claims arising from contracts or policies of direct insurance as opposed to contracts of reinsurance introduced by the Insurers (Reorganisation and Winding-Up) Regulations 2004. The recent approach taken by Highlands Insurance Co (UK) Ltd, a company in administration, is one example of how this can be achieved.

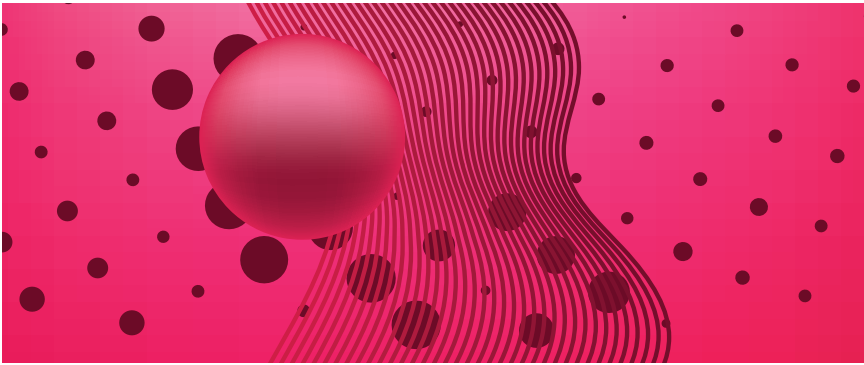
It seems unlikely that developments in the law will necessarily provide an insurmountable barrier to the use of schemes of arrangement, whether in their current form or revised to account for such developments; after all schemes of arrangement have been at the heart of corporate reorganisation for over

a century. Uncertainty however can often slow the pace and increase the cost of implementing such an option, and those considering a solvent scheme to release tied-up capital may either wish to take the initiative in achieving clarity from the court, or pay close attention to those that do.

Historically, solvent schemes have produced a win-win in managing to provide policyholders with attractive undiscounted payments of their future liabilities, as well as providing capital returns to investors. A basic question for investors has of course always been whether the price achieved from disposal of their portfolio can compare with the expected results of either a long tail run-off or closure via a solvent scheme. Factoring in the current uncertainty around schemes adds a further layer of complexity to that calculation.

Whilst the legal developments take their course, those choosing not to consider a scheme as a viable exit option still have a number of alternative options to achieve finality. The appetite for run-off acquisition remains strong with a number of transactions having taken place over the past 12 months. The availability of capital (particularly debt finance) as a result of the current economic climate was anticipated by many to lead to a fall off in the number of acquisitions of discontinued books of business. However, a number of significant transactions have been completed as demonstrated by the recent acquisitions of Alea by Catalina and of Copenhagen Re and British Engine by Enstar.

While disposal remains an attractive option in terms of finality, the



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terms for disposal may no longer be quite so attractive, partly because acquisition finance is likely to be harder and more expensive to obtain and in a low investment return environment (at least in the short term), investors may seek a higher premium to generate their required rate of return in the books of business they bid for. The current environment may also favour those acquirers with stronger balance sheets and a lower cost structure.

The decision whether to continue with a run-off or sell to a third party has in some respects become more marginal, particularly if the overall exposures and volatility in the book(s) of business can be managed down through commutation and unit costs reduced, for example, through effective outsourcing to an efficient run-off manager. However the costs and uncertainties of run-off still make finality an attractive option; in that respect it is also likely that the advent of Solvency II will add to the administrative and compliance burden of those insurers in run-off who do not enjoy exemption, regardless of the assertion by policymakers that the requirements of the directive will be proportional to the nature, scale and complexity of each business.

Reinsurance, and in particular loss portfolio transfers (usually combined

with the transfer of the run-off management), remain a popular if expensive means of transferring the risk in books of business to third parties and have been used as a prelude to legal transfer of the business, as was seen in the case of the transfer of business from Equitas/Lloyd’s Names to Berkshire Hathaway. Where the reinsurer is domiciled in a jurisdiction with lower capital requirements, pricing may be more competitive, although under the UK’s prudential regulations there may be higher credit risk charges to be borne by the ceding company.

There are however means to mitigate this risk charge. Such arrangements may be of benefit, at least at a solo level, and may also enable capital tied up in run-off to be released more quickly. Although further alternatives do exist, some of the more inventive attempts to release capital through securitisation arrangements have not developed, not least because of the recent dislocation of these markets.

In terms of those wishing to maximise value from their portfolio through proactive management of the run-off, one area of the run-off market that has seen an interesting change is the consolidation taking place amongst service providers. The drivers for these transactions would appear to be:

- Desire on the part of vendors to raise cash/ focus on core business.

- Run-off managers seeking economies of scale.
- Using acquisition of run-off managers as a way of acquiring business not least as (managed) books run-off to expiry.
- Opportunities continuing to be created to provide run-off services where books of business are placed into run-off.
- The market for discontinued books of business being too competitive or too costly to generate sufficient returns on invested capital.

The recent service provider acquisitions appear to be driven by the value and income generated by existing and potential future service contracts, (for example the PRO (to Tawa) and Axiom (to Charles Taylor Consulting) acquisitions). These transactions may presage a move towards the original models seen in the run-off market, where outsourcing of run-off books was the favoured approach. It may be that these acquirers have concluded that there is more value in servicing run-off rather than purchasing books themselves.

All of this could lead to an increase in demand for specialist expertise to achieve benefits via more proactive claims management, debt collection or commutation increasing the value of those service providers who can deliver good quality service provision. This may indeed be a key factor in recent activity with a trend to create a wider and more experienced servicing offering, the KMS acquisition by R&Q perhaps being a notable example of this.

As such, whilst the principal run-off options may remain the same, the constantly developing aspects of run-off market solutions ensure the legacy market remains an important area for capital and solution providers alike. ●

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