

INSURANCE

Run-off survey 2007

Run-off in reinsurance and property/casualty insurance
in Germany, Austria and Switzerland

ADVISORY

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in Germany, Austria and Switzerland

Hamburg/Cologne, February 2007

KPMG, Advisory, Insurance
Run-off Advisor of the Year 2006*

The KPMG's Restructuring Insurance Solutions Team in the UK was presented the award, "Run Off Advisory Services Provider of the Year 2006", by the Association of Run-off Companies Ltd. in October 2006.

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Figures 2–10 summarise the feedback from survey questionnaires. The participants were asked to assess and rate a variety of different subject areas from 1 to 5. In this context, 1 stands for a high rating and 5 a low rating, or 1 for advantageous and 5 for disadvantageous.

“You can run (-off), but you can’t hide!”

Run-off is a phenomenon insurers can no longer afford to ignore. This conclusion is made from the information provided by the participants (primarily reinsurers) in the Run-off Survey of KPMG in Germany. The participants disclosed that approximately 19 percent of their technical provisions relate to discontinued business. Higher demands on capital, Solvency II and the increased attention of rating agencies have caused a change in previous reserved attitudes towards run-off. Indeed, run-off, defined here as the pro-active handling of discontinued business, is expected to become an integral part of the boardroom agenda.

This survey, prepared by KPMG in Germany, analyses feedback from questionnaires sent to 110 reinsurers and property/casualty insurers in three countries: Germany, Austria and Switzerland.

The dedicated run-off team in KPMG’s Advisory practice in Germany, has examined empirical evidence, to produce a detailed market analysis of the German-speaking insurance markets, analysis which has not been performed for over 10 years.

Introduction

The insurance sector in German-speaking countries has generally associated the term “run-off” with management failure. In the U.S. and UK the term “run-off” now stands for a distinct, vibrant sector within the insurance industry. Only in the last few years have German-speaking countries adopted a more outward approach to this subject.

Historically the German-speaking insurance market regarded run-off as an unhelpful management distraction or indeed as a failure of the business. However, in other markets such as the UK, the pro-active management of inactive portfolios has helped to change attitudes in the boardroom.

Background

Late in 2002 the Gerling Group announced the end of active underwriting by its reinsurance subsidiary Gerling Globale Rückversicherung. After a period of phenomenal growth in the years before, the seventh largest reinsurer worldwide¹ entered run-off following substantial losses. In mid-2004, Gothaer Rückversicherung announced the discontinuation of its business. This was due to structural considerations on the part of the parent group. Although similar decisions had been taken years before, such as the run-off of Hamburger Internationale Rückversicherung, Globale and Gothaer Rück have significantly raised the profile of run-off in Germany. Large reinsurers now have separate divisions to manage this area. More and more participants from Continental Europe now attend international discussions on run-off. However, many companies in the market still associate this phenomenon with insurers in difficulty. This apparent conflict, coupled with the fact that a market analysis has not been carried out (or at least published) for more than 10 years, is the reason why KPMG in Germany decided to carry out an empirical survey on run-off in the German-speaking area.

The objective of the survey is to provide an insight into the current situation and an overview of the future significance of run-off as a management tool in the German-speaking region. We examine discontinued business and the potential for active management of run-off; the pro’s and cons of run-off; and we also look to outsourcing run-off activities.

KPMG’s German firm, one of the leading auditing and advisory firms in the insurance industry and one of the few in German with its own run-off team, investigates these issues with this study.

¹ Source: Standard&Poors: “Global Reinsurance Highlights,” Edition 2002, p. 16.

Methodology

In preparation for this study, interviews were conducted with selected market experts. The interviewees comprised managers, lawyers, consultants and service providers who have regular experience in dealing with pro-active run-off management in the German-speaking area. A standardised questionnaire based on the findings was sent to key decision-makers from 110 companies in reinsurance and property/casualty insurance in Germany, Austria and Switzerland. The survey not only encompassed active insurers, but also those which had discontinued all underwriting activity. Technical provisions were taken as a basis for analysis.

Over 25 percent of questionnaires were completed and returned by the companies contacted. The technical reserves of these companies amount to 101.8 billion Euro, corresponding to a market share of approximately 29 percent.

The study participants are mainly reinsurers (68 percent), but also captives (23 percent) and direct insurers (9 percent). The majority of survey participants are located in Germany in respect of premium income (63 percent) and Switzerland (34 percent), and in terms of reserves mainly in Germany (89 percent). The majority of them (91 percent) conduct business within the legal form of a public company.

Definitions

The key terms are defined as follows within the scope of this survey:

Discontinued business

Where underwriting for the entity as a whole or a portfolio has ceased.

Reserves

Total of technical provisions.

Run-off

Discontinued business which is being proactively managed.

This terminology is based on the definitions provided by participants in the survey. However, the range of opinions differ widely, from run-off as a synonym for “business whose underwriting activity was discontinued” to an “optimisation tool for return on equity”.

When considering the stigma that has been associated with the term, it is evident that perspectives have broadened considerably. “Run-off” is also becoming an effective management strategy of the insurance industry in the German-speaking region.

Results

Discontinued business

- The information provided by the participants still active in the market shows that approximately 19 percent of their reserves relate to discontinued business.
- Eighty two percent of the survey participants confirm having reserves relating to discontinued business.
- The largest proportion of discontinued business arises in general third party liability insurance and the smallest in legal expenses protection.
- The main reason for discontinuing underwriting activity is unsatisfactory business performance.
- Mergers and acquisitions within the industry are not regarded as a significant driver of discontinued business.

Run-off

- The term is considered synonymous with the cessation of under-writing activity (87 percent). But 80 percent of the participants see it as the pro-active handling of discontinued business.
- Sixty eight percent of the participants have experience of such activity in-house.
- The lines of business where increased run-off activity is conducted correlates positively with levels of discontinued business.
- The main reason for pro-active run-off is adverse claims development. Pressure from rating agencies was not cited as a major driver.
- Finality within a short timeframe is the major advantage expected from pro-active run-off.
- One of the key reasons given for not conducting run-off proactively is to protect existing client relationships.
- Commutation is the best known tool of pro-active run-off.

External service providers

- Fifty percent of the participants contacted have already gained experience using run-off service providers.
- The willingness to engage external contractors is neutral, rated at 2.5 on a scale from 1 to 5 (high to low willingness).
- External service providers are more likely to be considered by the participants for the design of the run-off strategy and less likely for the phase identifying potential run-off portfolios.
- From the participants' point of view, external service providers offer great advantages because they provide access to run-off expertise. But the fact that a third party can access internal data and systems is considered a drawback.
- Due to the knowledge of their own internal portfolios companies prefer in-house management versus external providers.
- The complete outsourcing of run-off management is practically non-existent to date.

Discontinued business

In times of increased demand on capital and corporate resources, and more detailed segmental reporting, the withdrawal from certain risk sectors and simultaneous cessation of business has now become commonplace. On the whole, 82 percent of the participants confirm the existence of discontinued business in their books.

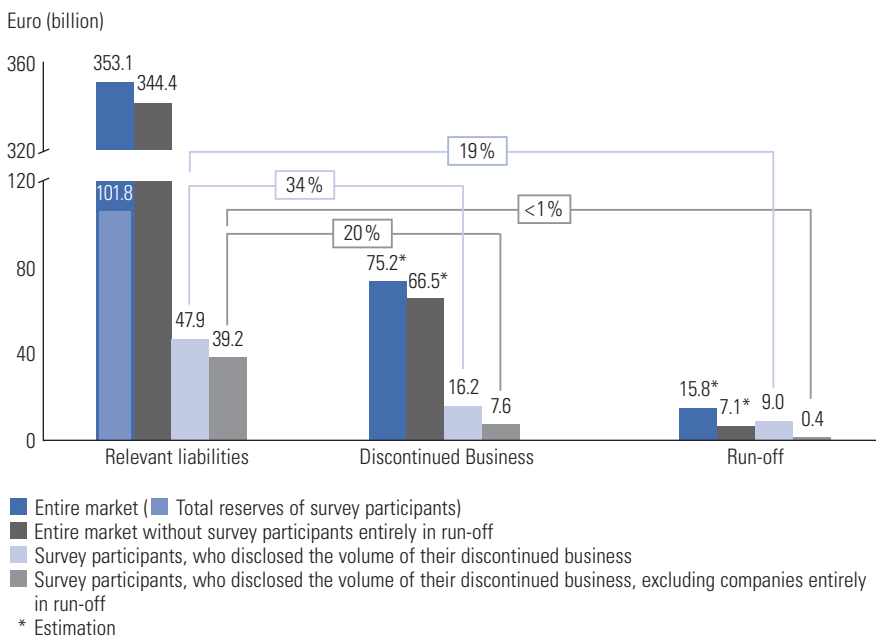
Based on our research the total technical provisions of the companies participating in the survey amount to 101.8 billion Euro. Of this group, study participants, which provided specific financial information

hold 47.9 billion Euro. of total reserves of which 16.2 billion Euro (34 percent) relates to discontinued business. Excluding companies entirely in run-off from this sample, this figure reduces to 39.2 billion Euro, of which 7.6 billion Euro (nine percent) relates to discontinued business (see Fig. 1).

Although reinsurance companies are overrepresented in the survey, the information still allows us to make a qualified estimate of the proportion of discontinued business and run-off contained in the total reinsurance and property/casualty market in German-speaking countries.

This proportion, extrapolated on the entire German-speaking market (353.1 billion² Euro) estimates total reserves relating to discontinued business at 75.2 billion Euro³. This compares to the size of the UK non-life run-off market, currently estimated at 38.2 billion £⁴ (56.7 billion Euro).

Fig. 1: Technical reserves in German-speaking insurance market (reinsurance and property/casualty direct insurance)



Source: KPMG in Germany, 2006

2 Sources: Assessment based on "Statistiken der Versicherungsaufsicht" by the German Federal Office for the Supervision of Financial Services (BaFin)
 "Österreichische Versicherungsstatistik" by the Austrian Office for the Supervision of Financial Markets (FMA) as well as "Statistiken der privaten Versicherungseinrichtungen in der Schweiz" by the Swiss Federal Office for Private Insurances (BPV).
 3 Excluding survey participants entirely in run-off, the estimate of total reserves for discontinued business is 66.5 billion Euro, out of a total market size of 344.4 billion Euro.
 4 ARC/KPMG Non-Life Run-off Survey 2006

The study participants were asked about the number of contracts in their discontinued portfolios. Of those that were able to respond (58 percent), in each case at least 500 policies are involved.

Discontinued business is not a phenomenon exclusive to individual lines of business. As far as the participants are concerned, the absolute size of general business in third party liability insurance and in motor insurance

tends to be higher than in other sectors (see Fig. 2), the decisive factor being the nature and risk of losses (i.e. bodily injury) which are associated with lifelong annuity payments.

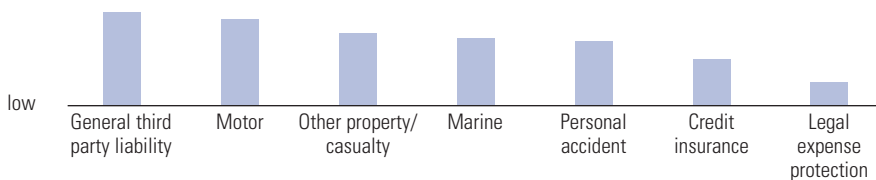
There are a variety of motives for discontinuing underwriting activities. A distinction can be made between three levels of importance (see Fig. 3).

Unsatisfactory business results are named as the key factor. The second

group includes motives of high or higher significance: extraordinary claims development, concentration on core business and the optimisation of capital were given as important reasons. All other motives mentioned in interviews are of medium-level significance. Unusual is the limited importance of discontinued business as a result of market consolidations.

Fig. 2: Significance of discontinued business according to lines of business

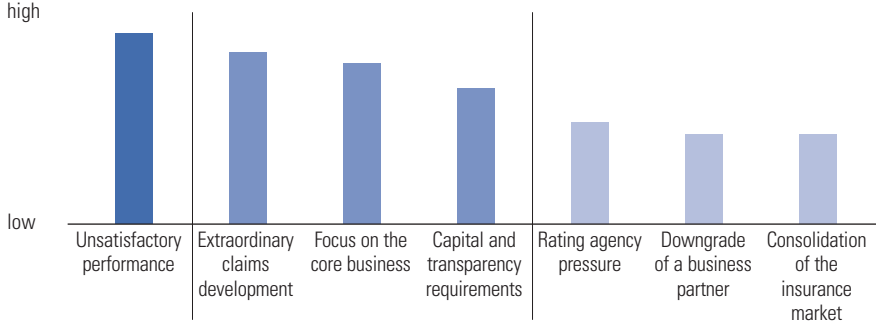
Size
High
Low



Source: KPMG in Germany, 2006

Fig. 3: Motives for ceasing underwriting

Relevance
high
low



Source: KPMG in Germany, 2006

Run-off

Eighty six percent of participating companies consider that run-off is an important topic for them. Only 14 percent of the participants have no direct experience of pro-active run-off management. Sixty eight percent are conducting run-off activities within parts of their discontinued business.

According to the participants, who disclosed their volume of discontinued business, the sum of their reserves in active run-off amounts to 9.0 billion Euro.

For these respondents 34 percent of their total provisions relate to inactive portfolios, while 19 percent of their total reserves are proactively managed (see Fig. 1).

Excluding companies entirely in run-off, the reserves relating to run-off portfolios total 0.4 billion Euro. This represents less than one percent of the total technical provisions held by companies, who disclosed the information on their discontinued business. It should be noticed, that the same group of participants identified 19 percent of their reserves as inactive (see Fig. 1).

Fig. 4: Comparison of insurance lines of business which contain discontinued business and run-off portfolios

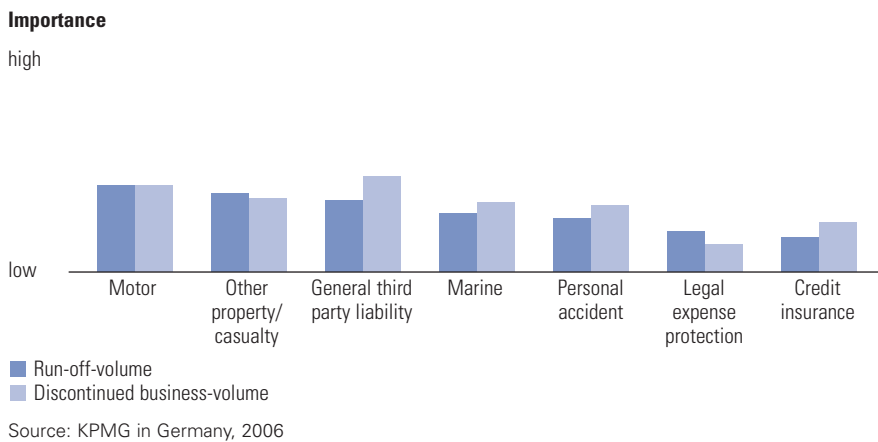
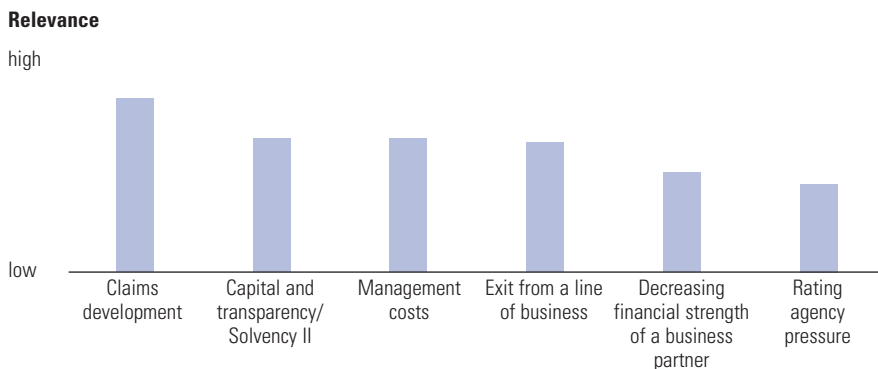


Fig. 5: Motives for pro-active run-off



Pro-active management of discontinued business is more prevalent in companies which have ceased all underwriting activity. The next group conducting run-off activities are larger reinsurers whose proportion of reserves in run-off is still relatively low, but who have already recognised the benefits of run-off to the organisation. Smaller and medium-sized companies, especially direct insurance companies, have made little progress in run-off of discontinued business.

If the size of discontinued business in specific lines of business is compared with run-off, the results are positively correlated (see Fig. 4).

The main motive for placing discontinued business into active run-off is claims development within the portfolio or within the company (see Fig. 5).

Optimisation of capital, the costs of managing discontinued business or the final exit from a line of business were indicated as other motives, however, with medium-level significance only.

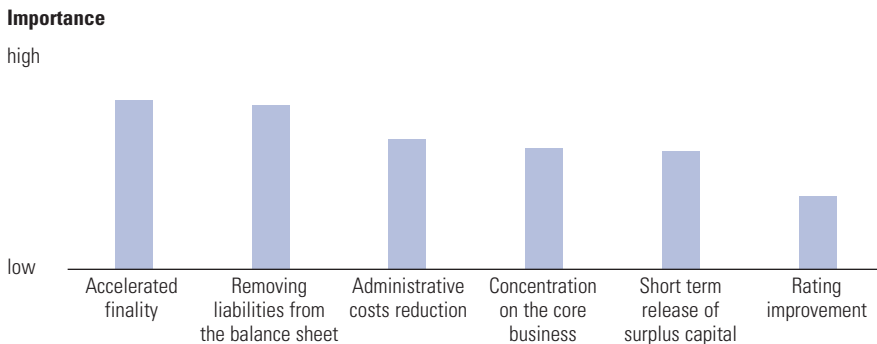
The declining financial strength of reinsurers or the pressure from rating agencies, which was mentioned in nearly all the interviews with experts at the beginning of the study, was only

emphasised by a small number of participants. Therefore the importance of these factors was considered to be low.

When asked about run-off activity already experienced or anticipated study participants indicated that its main advantages are exit in the short term and the importance of removing “inactive” reserves from the balance sheet (see Fig. 6). The reduction of administration costs, the removal of distractions from core business and the release of capital were also considered to be beneficial. Any improvement in rating is considered of secondary importance.

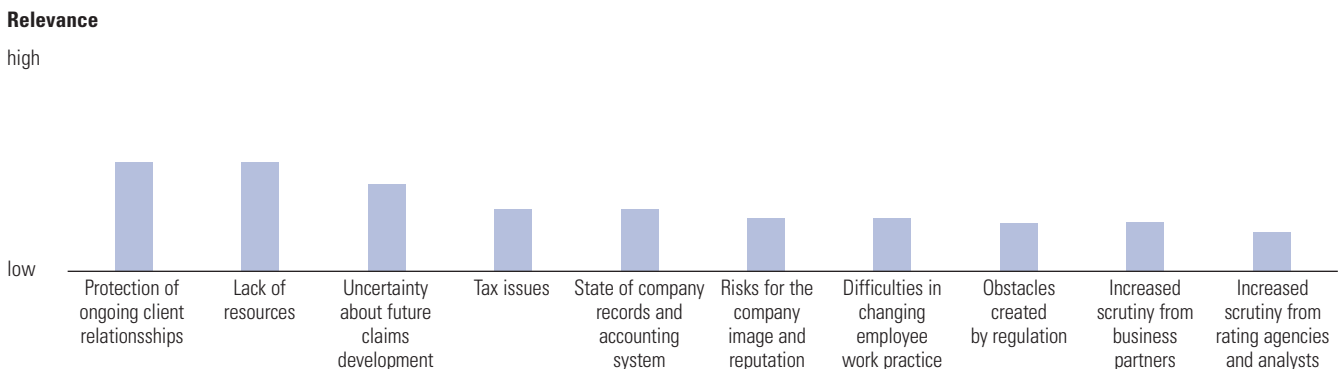
When compared with the advantages noted here, the amount of reserves proactively managed are (still) modest. Hence, the reasons for current low levels of active run-off were also investigated. The main reasons for a lack of appetite for pro-active run-off are protecting existing customer relationships and the lack of free or suitable resources (staff, time, expertise etc.) (see Fig. 7). However these and a number of other “barriers” fail to undermine the relative importance of the benefits specified above.

Fig. 6: Assessment of the benefits of run-off



Source: KPMG in Germany, 2006

Fig. 7: Participants' arguments against active run-off



Source: KPMG in Germany, 2006

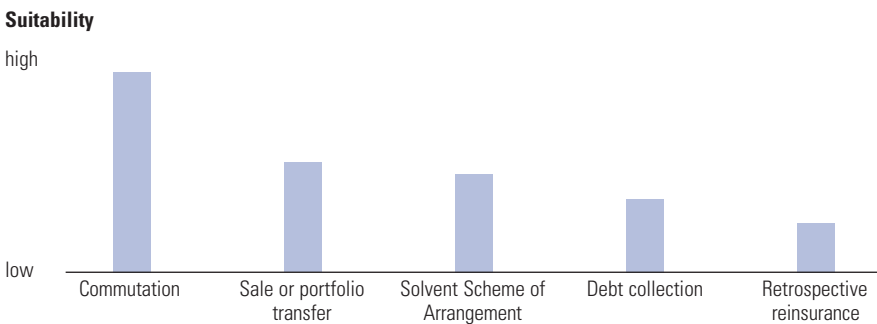
When interviewed about their knowledge of run-off methods, 32 percent of the participants stated that their knowledge was good or very good. Commutation of assumed liabilities seems to be the best-known tool used in run-off activity. Eighty seven percent of the participants claim to have good knowledge of commutation, whereas 35 percent stated to have good knowledge of portfolio transfers and solvent schemes

of arrangement. Knowledge of retrospective reinsurance and debt collection is low. Only 14 percent of the participants state they have good knowledge of the subject (see Fig. 8).

A scheme of arrangement (SoA) is a statutory agreement between a company and its creditors pursuant to English law. In the insurance industry, it is a procedure enabling mass commutation between an insurer (direct insurance/reinsurance or a retrocessionaire) and its policyholders under Section 425 of the Companies Act 1985. There has only been passive reaction in Germany to Solvent Schemes of Arrangement initiated by business partners from English law based countries. There has been no similar legal mechanism in existence in German-speaking countries to date.

Source: KPMG in Germany, 2006

Fig. 8: Suitability of run-off methods



Source: KPMG in Germany, 2006

External service providers

The participants consider the involvement of external service providers in respect of run-off activities to have potential. But interest is neutral as shown in a rating of 2.5 on a scale ranging from 1 to 5 (high to low willingness). High willingness to outsource was indicated by 23 percent of survey participants.

Companies are more interested in engaging external advisors in the initial phase of the run-off, especially in preparation of run-off strategy or when creating a first implementation plan. The identification of potential run-off portfolios or specific business lines is regarded as the primary task of the insurer.

On initial consideration, it seems surprising that use of external advisers

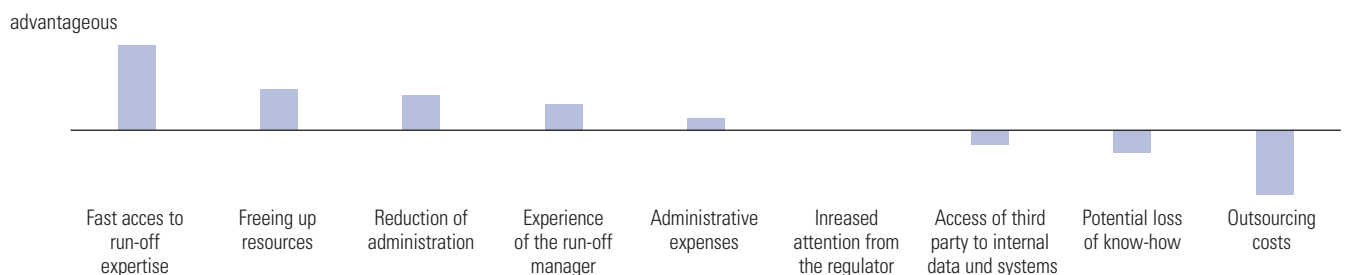
is not as commonplace as in the UK. Run-off management is rarely outsourced. In October 2006, a German-based active insurer outsourced the run-off management of a whole business segment for the first time for many years. In the light of intensive marketing efforts by UK-based service providers, one can assume the companies are aware of outsourcing opportunities. The participants were therefore asked to evaluate different arguments in favour of contracting with external providers compared to in-house management (see Fig. 9, 10).

As far as carrying out run-off in-house is concerned, the companies stress their own expertise of the business area. Building own run-off expertise resulting in greater independence from

outside firms is often put forward as an argument in favour of in-house run-off management. However, redeployment or loss of key employees is a source of some concern.

Since building in-house know-how in run-off takes time, outsourcing is seen as a quick way of accessing and gathering run-off experience. The involvement of own resources and management time is also assessed as being a disadvantage for the in-house management of run-off. The cost factor is seen as the major drawback in outsourcing portfolios to external service providers.

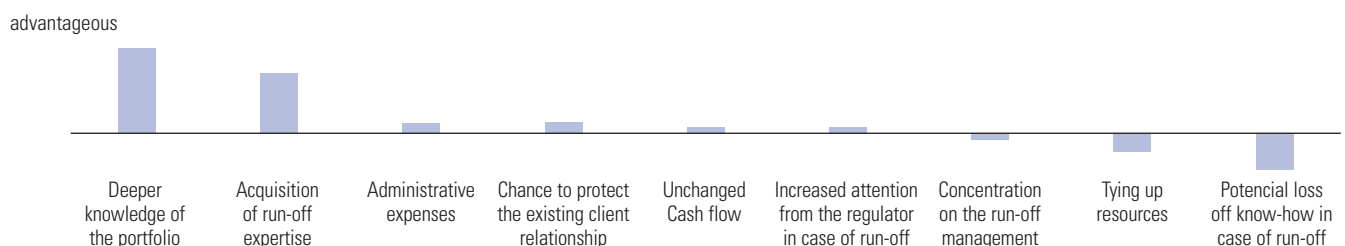
Fig. 9: Advantages and disadvantages of outsourcing to external run-off advisors/managers



disadvantageous

Source: KPMG in Germany, 2006

Fig. 10: Advantages and disadvantages of in-house run-off management



disadvantageous

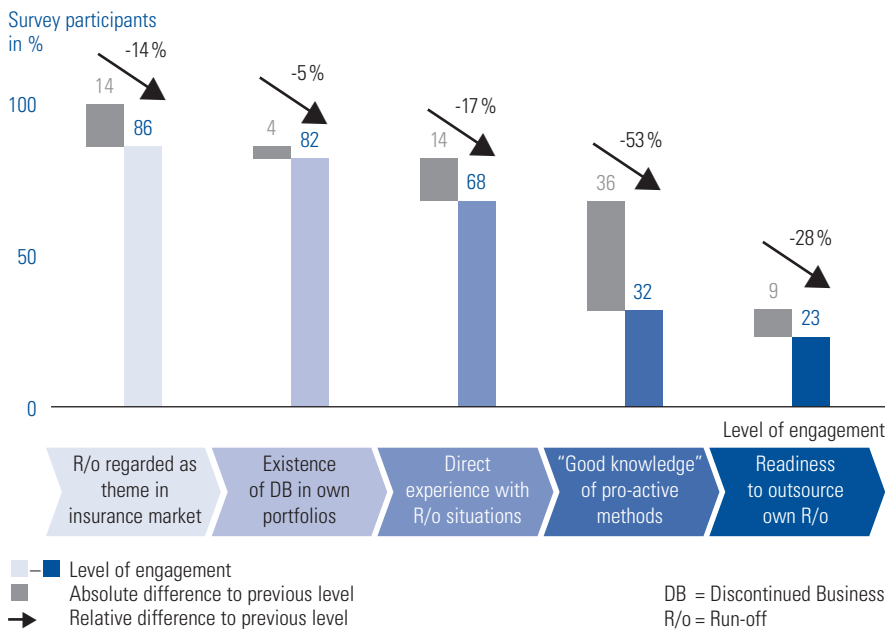
Source: KPMG in Germany, 2006

Conclusion

The run-off phenomenon is still in its early phases in the German-speaking insurance industry, especially when compared with the UK or U.S. markets. Many insurance companies have begun to take a more outward attitude and we expect that run-off will steadily gain impetus in Germany, Austria and Switzerland. According to estimations by KPMG in Germany the lag in these markets compared to the UK run-off market is estimated at 10 to 12 years. But a clear convergence can be expected within the next few years.

Progress in run-off practice in German-speaking markets is being made. The existence of inactive portfolios among own books of business is recognised by the majority of insurance companies. The awareness that pro-active management of discontinued business helps companies optimise their financial situation, is already widespread in the sector. However, only some insurers have begun tackling run-off seriously, even if they have already gained initial experience. Extensive consideration of the methods and tools for run-off has been performed by around half of them. Companies entirely in run-off and the largest reinsurers may be considered the pioneers.

Fig. 11: Level of engagement in run-off market in German-speaking area



Source: KPMG in Germany, 2006

In the light of this picture, it is not surprising that although many companies are aware of the option of outsourcing, they are hesitant to take the first step. Interest in high level strategic advice in the initial phase is quite high, even by companies with a lot of experience in run-off.

The findings, condensed in a "engagement model", produce the picture opposite (see Fig. 11).

Support by KPMG

KPMG member firms can provide services through the relevant phases of run-off.

Transition to run-off

Advice on run-off strategy and implementation; including:

- Assessment and benchmarking of business segments
- Identification of suitable portfolios
- Development and evaluation of alternative run-off strategies
- Consideration of relevant conditions (loss development, capital situation, tax effects, regulatory, personnel and IT-related matters)
- Assistance in actuarial matters
- Roll-out plan

Run-off management

Advice on the implementation of run-off strategies including:

- Data preparation and assessment of portfolios
- Data preparation and consolidation in a run-off model
- Implementation of a run-off business model or business process
- Project management
- Preparation and monitoring of commutations activity
- Interaction with schemes of arrangement
- Outsourcing opportunities and arrangements
- Finality mechanisms

Run-off transactions

Advice on the evaluation and monitoring of transactions, including:

- Analysis of marketing potential for portfolios, branches or legally independent entities
- Identification of purchasers
- Vendor due diligence and assessment
- Transactions services (carve-out, portfolio transfer, novation, Part VII transfer etc.)

Contacts

KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft

Michaelis Quartier
Ludwig-Erhard-Straße 11–17
20459 Hamburg
T +49 40 32015-5397

Barbarossaplatz 1a
50674 Cologne
T +49 221 2073-1666

E-Mail:

DE-Run-Off-2007@kpmg.com

Tammo Andersch

Partner, Advisory
tandersch@kpmg.com

Arndt Gossmann

Director, Advisory, Insurance
agossmann@kpmg.com

Staff:

Sebastian Blankenstein
Kamila Kaukiel
Philipp C. Kleyser
Zsolt Szalkai

Further international contact

KPMG LLP (UK)

8 Salisbury Square
London EC4Y 8BB
T +44 20 7311-1000

Mike S. Walker
mike.s.walker@kpmg.co.uk

Tom Riddell
tom.riddell@kpmg.co.uk

John Wardrop
john.wardrop@kpmg.co.uk

John Milsom
john.milsom@kpmg.co.uk

KPMG LLP (Canada)

Suite 3300
Commerce Court West
199 Bay Street
Toronto ON M5L 1B2
T +1 416 777-8500

Bob O. Sanderson
bsanderson@kpmg.ca

Bob M. Rusko
brusko@kpmg.ca

Elisabeth J. Murphy
elisabethmurphy@kpmg.ca

KPMG (Bermuda)

Crown House
4 Par La Ville Road
Hamilton HM 08
T +1 441 295-5063

Malcolm Butterfield
malcolmbutterfield@kpmg.bm

Mike Morrison
mmorrison@kpmg.bm

Charles Thresh
cthresh@kpmg.bm

KPMG S.A. (France)

66, Rue de Villiers
92300 Levallois-Perret, Paris
T +33 1 4748-8150

Noël Bugnet
nbugnet@kpmg.fr

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