



RESTRUCTURING

# The KPMG/ARC Run-Off Survey – Non-Life Insurance

October 2007

ADVISORY

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# Foreword

These are interesting times for the legacy business sector and this, the fifth Run-Off Survey of non-life insurance commissioned by the Association of Run-off Companies Limited (ARC)<sup>1</sup> and produced by KPMG LLP (UK), reveals some surprising trends. We are fortunate indeed to have such detailed data on our market and ARC is, as always, grateful to KPMG for its painstaking research and analysis. We are also grateful to the leading players from the run-off arena who gave up their time to share some of their views and insights on the state of the market.



It should not in theory be surprising that a run-off sector runs off, but the significant decline in the volume of non-life run-off liabilities in the UK will, I suspect, come as a surprise to many. Two numbers stand out: the £2.3 billion reduction in the Lloyd's open year provisions and the £2.7 billion reduction in other solvent run-off.

The welcome Lloyd's reduction represents the closing of 12 open years, which has doubtless been facilitated by the resolution of some significant market issues, such as the World Trade Centre disputes. For the companies market, the reduction seems to stem from the increasingly active use of finality tools such as commutations and solvent schemes, but will also, as pointed out in the Survey, owe something to the dearth of major new run-offs in the market.

Whilst it is obviously a good advertisement for the run-off management sector that it can manage down liabilities so effectively, the lack of replacement business will be a cause of concern to those who make their living in the sector, especially the outsourced service providers. As the Survey reveals, the numbers employed in major run-off service providers declined last year and this trend may continue across the sector unless there is an injection of new discontinued business to manage.

Happily, relief may be at hand, from two different quarters. The first is overseas, as service providers increasingly look to ply their trade in less competitive marketplaces. The second is a function of the mounting pressure on capital, which is forcing risk carriers to seek an exit from unprofitable or redundant lines of business. The credit squeeze that is gripping financial markets as I write will inevitably promote this activity.

A word of caution, however: these new lines of legacy business will not be the same as the toxic portfolios of old. They will need a different, less aggressive approach to management, to preserve the brand and reputation of their original carriers. They will also run off more quickly, so service providers will have to rethink both their pricing structures and their resourcing.

The business of managing run-off, it would seem, is the same as any other business in its need to 'adapt or die'. Given the nature of the work we do, however, we have less excuse than most for failing to recognise it.

**Philip Grant**  
Chairman, Association of Run-Off  
Companies Limited

October 2007

# 1 Executive Summary

This Survey analyses the state of the UK non-life insurance market as at the end of 2006, unless specifically described otherwise. As in our previous Surveys, UK non-life business of companies from other EU countries has not been included in the Survey.

For the first time in this Survey, KPMG has conducted a series of interviews with leading figures in the UK run-off market, who comment on the recent developments in the sector as well as the challenges ahead<sup>2</sup>.

There are approximately 550 firms and Lloyd's agents currently authorised by the Financial Services Authority (FSA) to carry on general insurance business in the UK, including composite insurers who write both life and non-life insurance. Of this number, there are approximately 480 companies for which publicly held information is available<sup>3</sup>.

- Total liabilities of the UK non-life run-off market, including business written at Lloyd's<sup>4</sup>, are estimated at £32.7 billion, a decrease of £5.5 billion since the end of 2005.
- Liabilities of the non-life run-off market in the UK represent approximately 18 percent of the non-life market as a whole, compared to 19 percent in 2005 and 23 percent in 2004.
- Total liabilities of open year syndicates at Lloyd's are approximately £5.2 billion, a decrease of £2.3 billion since the end of 2005.
- Total capital tied up in solvent UK non-life companies in run-off is approximately £4.9 billion, an increase of approximately two percent since the end of 2005.
- By the end of 2006, total liabilities of UK companies whose entire non-life insurance business was subject to a solvent scheme of arrangement were £418 million representing more than a threefold increase since 2005. These companies collectively increased reported net assets by approximately £38 million.
- There were 20 Part VII transfers<sup>5</sup> of non-life portfolios in 2006, of which 13 involved predominantly discontinued business. This compares to 2005 in which there were 16 Part VII transfers of non-life business, of which four related to run-off.
- Since 1990 the UK insurance compensation scheme has paid out over £979 million in compensation to policyholders of failed UK insurers.

2) The views and opinions expressed herein are those of the Survey respondents and do not necessarily represent the views and opinions of their organisations or KPMG LLP (UK).

3) This Survey is based on an analysis of publicly available financial information, including regulatory returns submitted to the FSA, utilising A.M. Best - Best's Statement File - UK, S&P Thesys - SynThesys Non-Life product and from audited statutory accounts filed at Companies House. This information has not, however, been verified or validated in any way by KPMG LLP (UK).

4) Lloyd's is not an insurance company but a Society of members, both corporate and individual, who underwrite in syndicates, on an annual joint venture basis.

5) Part VII of the Financial Services and Markets Act 2000.

# 2 Current size

This section provides a snapshot of the current size of the UK non-life run-off market.

## 2.1 Run-off market

As shown in Table 1, at £32.7 billion, the liabilities of the UK non-life run-off<sup>6</sup> market represent approximately 18 percent of the non-life market as a whole.

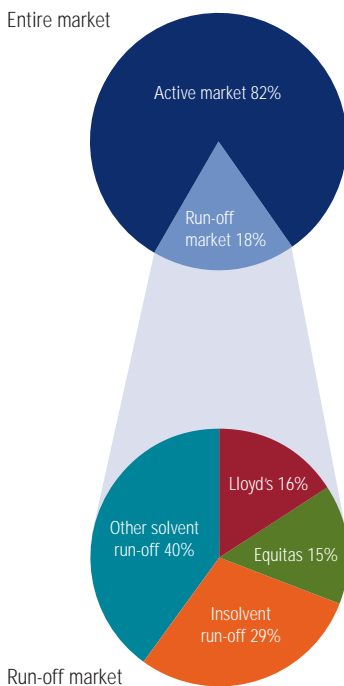
**Table 1**  
Size of the UK non-life market

As at end of 2006	Total liabilities (£ billion)	Percentage share of market (%)	Technical provisions (£ billion)	Percentage share of market (%)
Active market	153.0	82%	126.7	82%
Run-off market	32.7	18%	27.4	18%
<b>Total UK non-life market</b>	<b>185.7</b>	<b>100%</b>	<b>154.1</b>	<b>100%</b>

Source: A.M. Best - Best's Statement File - UK, S & P Thesys Non-Life, KPMG LLP (UK) 2007, Lloyd's

The UK non-life run-off market can be divided into four distinct components as shown in Table 2.

**Figure 1**  
Total liabilities of the UK non-life market



Source: A.M. Best - Best's Statement File - UK, S & P Thesys Non-Life, KPMG LLP (UK) 2007, Lloyd's

**Table 2**  
Main components of the UK non-life run-off market

As at end of 2006	Total liabilities (£ billion)	Percentage share of market (%)	Technical provisions (£ billion)	Percentage share of market (%)
Lloyd's (1993 onwards)	5.2	16%	4.7	17%
Equitas (Lloyd's 1992 and prior)	4.8	15%	4.8	17%
Other solvent run-off	13.2	40%	10.9	40%
Insolvent run-off	9.5	29%	7.0	26%
<b>Total UK non-life run-off market</b>	<b>32.7</b>	<b>100%</b>	<b>27.4</b>	<b>100%</b>

Source: A.M. Best - Best's Statement File - UK, S & P Thesys Non-Life, KPMG LLP (UK) 2007, Lloyd's

6) In this Survey insurance companies classified as "in run-off" comprise those companies that have ceased to actively underwrite new business. Whether a company has ceased underwriting has been determined by reference to public announcements by the applicable companies or in the absence of such information, by application of a premium volume test. Due to the inherent delays in the reporting and accounting of financial transactions in non-life insurance business, and in particular reinsurance, premiums (including adjustment and reinstatement premiums) may continue to be received long after a company ceased underwriting. Nevertheless, premium income will, in general, reduce substantially shortly after a company ceases underwriting.

Conversely, "run-off" at Lloyd's comprises liabilities of open syndicate years in respect of underwriting years 1993 to 2004. A syndicate year remains open until its business is fully concluded or is transferred to another syndicate or insurer. Underwriting years 2005 and 2006 are not included as open syndicate years: under Lloyd's Byelaws, a syndicate's results are not finally determined until at least two years after the end of each underwriting year.

## 2.2 Lloyd's and Equitas

At the end of 2006, the total liabilities of Lloyd's non-life insurance syndicates in run-off in respect of 1993 and subsequent years of account were £5.2 billion (2005: £7.5 billion) across 85 open syndicate years (2005: 97 open years for non-life insurance business). This is a decrease of £2.3 billion on 2005, and is now similar to the level of Equitas' total liabilities of £4.8 billion. The gross technical provisions at Lloyd's have also decreased by £2.3 billion to £4.7 billion during the period.

Just under 40 percent of run-off liabilities at Lloyd's relate to the 2001 year of account, in which there remains a significant level of US casualty losses and World Trade Centre related losses and older syndicate years' liabilities reinsured into the 2001 year of account. According to Steve McCann, Head of Open Years at Lloyd's, "The tail of the liabilities [at Lloyd's] in recent years has been shorter than for historic business due to the fact that 'claims made' forms rather than 'occurrence' forms are used these days". This contrasts with Equitas where approximately 75 percent of its technical provisions comprise asbestos, pollution and health hazard liabilities.

In October 2006 Equitas announced that it had agreed to enter into a transaction with Berkshire Hathaway, under which Equitas' liabilities were to be reinsured by National Indemnity Company, a member of the Berkshire Hathaway Group. It is envisaged that once certain legislative issues have been resolved, the liabilities will subsequently transfer to another UK Berkshire Hathaway vehicle<sup>7</sup>.

During 2006/2007 the value of Equitas' liabilities discount of £2.0 billion was fully unwound. After taking this into account, Equitas' total undiscounted liabilities reduced by £1.6 billion to £4.8 billion (2005: undiscounted £6.4 billion; discounted £4.4 billion).

**"The tail of the liabilities [at Lloyd's] in recent years has been shorter than for historic business due to the fact that 'claims made' forms rather than 'occurrence' forms are used these days."**

**Steve McCann, Lloyd's**

<sup>7</sup>) With effect from 30 March 2007, National Indemnity reinsured all of Equitas' obligations and provided an additional US\$5.7 billion of cover over and above existing reserves. The premium for this reinsurance consisted of all of Equitas' existing assets less £172 million, plus a contribution of £72 million from the Corporation of Lloyd's. Berkshire Hathaway has taken on Equitas' existing staff and operations and assumed responsibility for the management of the run-off. (Source: Lloyd's 2007) The transfer of Equitas' liabilities is planned to be effected by the end of 2009, by means of an insurance business transfer under Part VII of the Financial Services and Markets Act 2000.



## 2.3 Insolvent market

Approximately one third of the total liabilities of the insolvent run-off market are represented by the UK asbestos exposures of Chester Street Insurance Holdings Limited (formerly Iron Trades Holdings Limited), which remains the largest UK non-life insurance insolvency.

Of the other insolvencies, the reduction of approximately £1 billion in total liabilities during 2006 reflects the general progress made in winding up insolvent estates, coupled with the absence of new insolvencies.

For example, Anglo American Insurance Company Limited (Anglo) made its final scheme payments to creditors in 2006. Total scheme payments to Anglo's creditors were USD \$270 million; each creditor received payment in full plus interest.

“We have been able to pay all creditors in full, which was an unlikely situation given the much lower initial projected outcome at the outset of the insolvency.”

John Wardrop, partner at KPMG and Joint Scheme Administrator of Anglo

# 3 Change in size

In this section, we look at the change in the size of the UK non-life run-off market and in its components including Lloyd's, Equitas, insolvent and solvent run-off.

## 3.1 Run-off market

The change in the size of the UK non-life run-off market since 2001 is shown in Table 3 and Figure 2.

There has been a reduction in the total size of the run-off market of £5.5 billion since 2005. This represents the largest change in the size of the UK non-life run-off market since this Survey has been produced. The principal drivers behind the decrease in the size of the run-off market are:

- the significant acceleration of run-offs through commutations and settlement activity as companies proactively manage down books of discontinued business;
- the absence of significant new run-offs<sup>8</sup>;
- the £1 billion reduction from the general progress made winding up insolvent estates, including Anglo; and
- the weakening of the US Dollar against UK Sterling by 14 percent between 31 December 2005 and 31 December 2006; a significant proportion of technical reserves in the UK non-life run-off market is denominated in US Dollars.

Apart from Lloyd's and Equitas, the total liabilities of the UK solvent non-life run-off market have reduced to approximately £13.2 billion, a reduction of approximately £2.7 billion on the level for the previous three years. This appears to be due to the successful implementation of accelerated run-off strategies by the run-off market in general.

**Table 3**

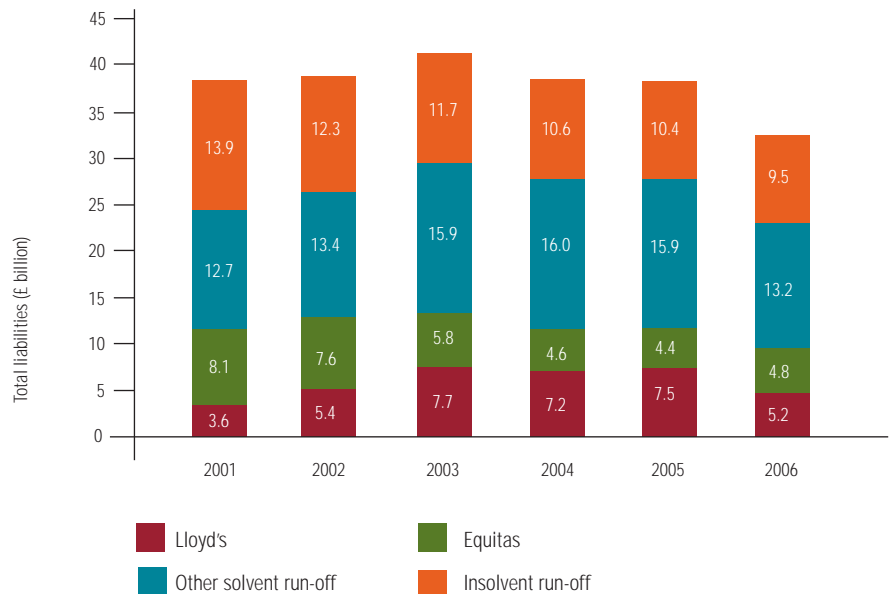
Change in the size of the UK non-life run-off market<sup>9</sup>

Total liabilities	2001 (£ billion)	2002 (£ billion)	2003 (£ billion)	2004 (£ billion)	2005 (£ billion)	2006 (£ billion)
Lloyd's	3.6	5.4	7.7	7.2	7.5	5.2
Equitas	8.1	7.6	5.8	4.6	4.4	4.8
Other solvent run-off	12.7	13.4	15.9	16.0	15.9	13.2
Insolvent run-off	13.9	12.3	11.7	10.6	10.4	9.5
<b>Total</b>	<b>38.3</b>	<b>38.7</b>	<b>41.1</b>	<b>38.4</b>	<b>38.2</b>	<b>32.7</b>

Source: A.M. Best - Best's Statement File - UK, S & P Thesys Non-Life, KPMG LLP (UK) 2007, Lloyd's

**Figure 2**

Change in the size of the UK non-life run-off market<sup>9</sup>



Source: A.M. Best - Best's Statement File - UK, S & P Thesys Non-Life, KPMG LLP (UK) 2007, Lloyd's

<sup>8</sup>) With the exception of Zurich Specialties London Limited, which has total liabilities of £1.3 billion now entirely in run-off.

<sup>9</sup>) The total liabilities for Equitas for 2001 – 2005 (year end 31 March 2002 – 2006) are discounted values taken from its audited financial statements. For 2006 (31 March 2007 year end), Equitas presented its results on an undiscounted basis. The undiscounted liabilities for prior years are: 2001 - £12.3 billion, 2002 - £10.2 billion, 2003 - £7.7 billion, 2004 - £6.4 billion, 2005 - £6.4 billion.

## 3.2 Lloyd's and Equitas

The decrease in total run-off liabilities at Lloyd's from £7.5 billion at 31 December 2005 to £5.2 billion at 31 December 2006 reflects the impact of closures of open syndicate years, natural payment of claims, commutations and exchange gains due to the weakening dollar.

Since 1998, Equitas' total undiscounted liabilities reduced from £16.7 billion to £4.8 billion in 2007. In the last three years, Equitas' total undiscounted liabilities reduced by £2.9 billion, compared to the reduction of Lloyd's undiscounted run-off liabilities of £2.5 billion over the same period.

“The immediate impact of the Equitas/Berkshire Hathaway deal will be the stark contrast in strategies. Berkshire Hathaway is expected to play a longer game compared to Equitas. Under Berkshire Hathaway, the actions and results for Equitas will be more predictable.”

Ken Randall, Randall & Quilter Group

During the early years at Lloyd's from 1993, the number of open syndicate years grew quickly, which was compounded by the absence of a significant Reinsurance To Close (RITC) market. The large number of closures of open syndicate years in 2006 was welcome and amendments to RITC rules introduced in 2007 make the process more attractive, as Steve McCann notes, “50 percent of the risk premium will now count as capital, whereas none would be considered before.”

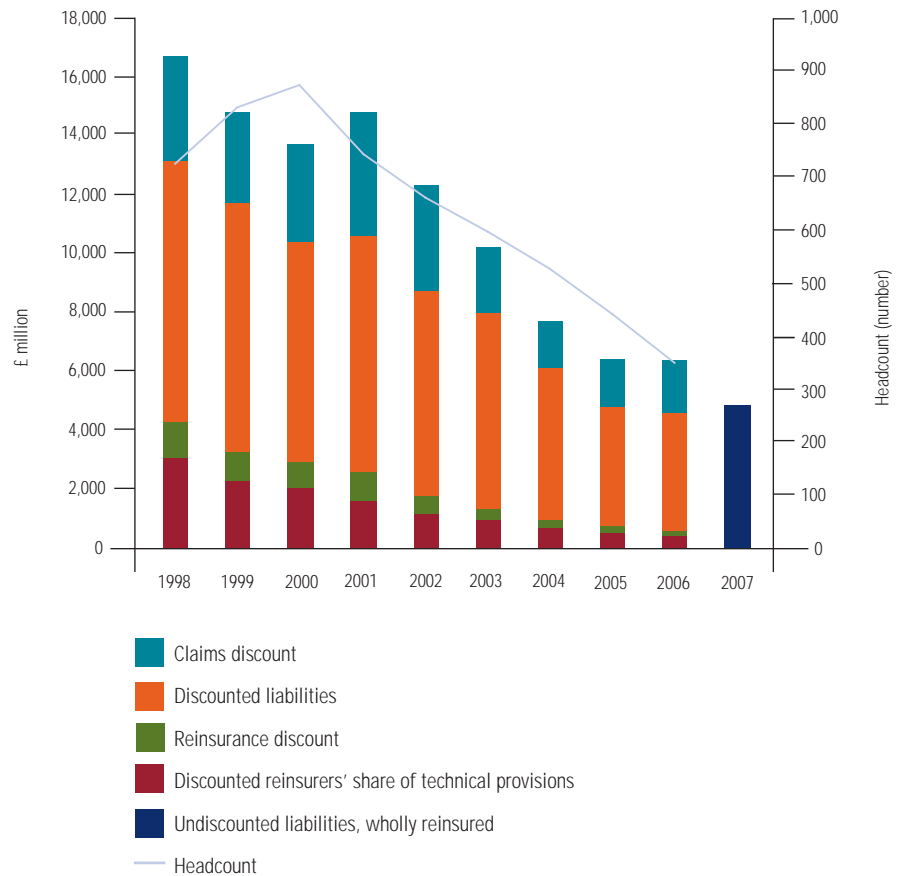
Figure 3 reveals the development of Equitas' run-off since its inception, and demonstrates the resulting change in its reinsurance arrangements in 2006, which now match 100 percent of technical liabilities.

The Equitas/Berkshire Hathaway transaction was probably the most significant event for the UK non-life run-off market in 2006. Based on total liabilities, Equitas is the single largest non-life run-off vehicle in the UK, and is a large part of the balance sheets of many London market insurers. The impact of the deal on the market is likely to be felt over a number of years. Ken Randall, Group Chairman of the Randall & Quilter Group, suggests that, “The immediate impact of the Equitas/Berkshire Hathaway deal will be the stark contrast in strategies. Berkshire Hathaway is expected to play a longer game compared to Equitas. Under Berkshire Hathaway, the actions and results for Equitas will be more predictable.”

“The trend of shrinking run-off [at Lloyd's] has continued in 2007, with 11 open years closed to date. The drastic decrease in the size of run-off seen in 2006 is not likely to carry on at the same rate but we expect about 20 percent of claims to be paid off each year.”

Steve McCann, Lloyd's

**Figure 3**  
Development of run-off at Equitas



Source: Equitas Limited accounts (1998-2007) and Equitas Management Services Limited accounts (1998-2006)

### 3.3 Insolvent market

The insolvent run-off market has reduced in size consistently since 2001 from £13.9 billion to £9.5 billion, reflecting the lack of any new UK company insolvencies of any material size<sup>10</sup> in that period coupled with the substantial closure of a number of estates, including Anglo and KWELM<sup>11</sup>.

Insolvent insurers which are exposed to asbestos claims through protected UK employers' liability policies, in particular Chester Street, are unlikely to close for many years.

<sup>10</sup> For the purpose of this Survey, a material insolvency has total liabilities in excess of £100 million.

<sup>11</sup> The KWELM companies are Kingscroft Insurance Company Limited, Walbrook Insurance Company Limited, El Paso Insurance Company Limited, Lime Street Insurance Company Limited and Mutual Reinsurance Company Limited.

# 4 Other features

This section provides an update on Part VII transfers and solvent schemes within the UK non-life run-off market.

## 4.1 Costs of run-off

During 2006, companies in the London market continued to outsource run-off operations to specialised service providers. Excluding Equitas, total fees charged by the largest run-off providers were approximately £220 million in 2006 (2005: £227 million) and the number of staff employed was 2,350 employees in 2006 (2005: 2,600).

Consolidation in the UK non-life run-off service provider market has continued, most recently with The Capita Group plc acquisition of CMGL Group Limited in March 2007. Such consolidation is likely to continue according to Nick Bentley, Managing Director of RiverStone Holdings Limited, “There are too many players chasing too little run-off business. The market is too crowded. I expect there will be more consolidation as there is only a limited supply of run-off contracts and the margins are thin. To survive service providers will need to have scale.”

“There are too many players chasing too little run-off business. The market is too crowded.”

Nick Bentley, RiverStone Holdings Limited

The reduction in headcount in 2006 is consistent with the decrease in size of the UK non-life run-off market. At the time of printing this Survey, accounts for Resolute Management Services Limited (formerly Equitas Management Services Limited) for the year ended 31 March 2007 were not available, although it is expected that Equitas’ strategy of reducing administration costs by approximately 15 percent per year<sup>12</sup> will have been continued. During the year ended 31 March 2006, Equitas employed 347 people to manage its operation, and total run-off costs were £72 million.

Ken Randall suggests that the run-off outsourcing sector is also developing in other ways, “The outsourcing market is dividing into those who can add real value and those who focus on processing.”

John Byrne, CEO of AXA Liabilities Managers UK, provides a perspective from the buyer; whilst AXA employs the services of agents on discrete projects, “AXA manages its worldwide run-off in house. We have sufficient scale, greater experience and knowledge of each portfolio, we can control the run-off better and our in-house team is cost efficient.”

“The outsourcing market is dividing into those who can add real value and those who focus on processing.”

Ken Randall, Randall & Quilter Group

The risk remains that outsourced run-off costs in the UK non-life run-off market may yet be subject to a steep increase if the UK tax authorities implement the 2005 ruling of the European Court of Justice<sup>13</sup>, which held that VAT should be charged on certain supplies made to the financial services industry.

<sup>12</sup> Based on Equitas’ strategy set out in Equitas Limited annual accounts for the year ended 31 March 2000.

<sup>13</sup> Re Arthur Andersen & Co (C-472/03). For further information, please visit [www.arcrunoff.com](http://www.arcrunoff.com)

## 4.2 Solvent Schemes

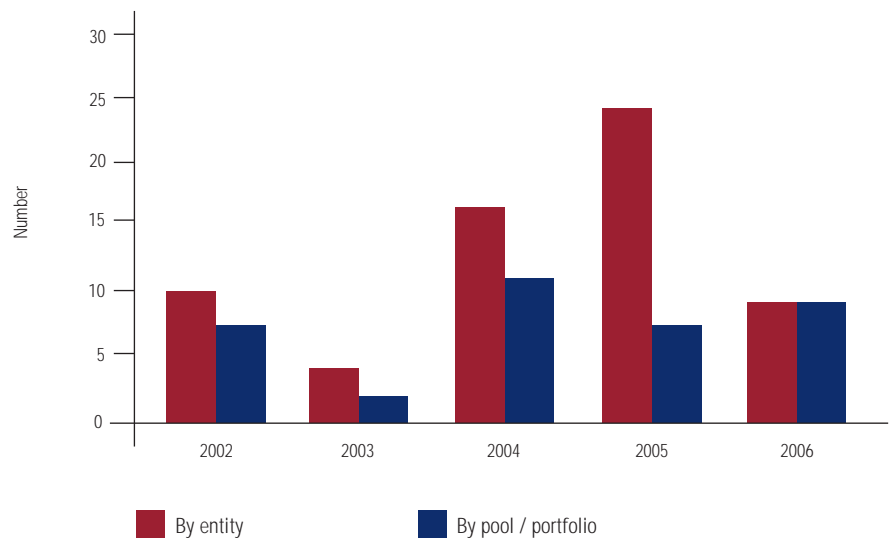
The use of solvent schemes to achieve finality has continued in 2006. Table 4 and Figure 4 plot the number of solvent schemes of UK businesses over time both by entity and by pool or business portfolio, represented by the calendar year in which the schemes became effective. There have been a total of 63 solvent schemes for individual entities by the end of 2006, and a total of 36 when considered on a pool or portfolio basis.

**Table 4**  
Solvent schemes of UK non-life business

Number of solvent schemes	2002 and prior	2003	2004	2005	2006	Total
By entity	10	4	16	24	9	<b>63</b>
By pool / portfolio	7	2	11	7	9	<b>36</b>

Source: KPMG LLP (UK) 2007

**Figure 4**  
Solvent schemes of UK non-life business



Source: KPMG LLP (UK) 2007



“ Solvent schemes are a fantastic finality mechanism, as long as they are used at the right time in the company’s life cycle.”

Nick Bentley, RiverStone Holdings Limited

Table 5 highlights the change in assets and liabilities of UK companies subject to solvent schemes by comparing year end results before and after the respective scheme bar dates<sup>14</sup>.

**Table 5**

Change in total assets and total liabilities following bar dates for UK companies subject to solvent schemes

As at the end of 2006	Total assets (£ million)	Total liabilities (£ million)	Net assets (£ million)
Year end immediately preceding bar date	1,182	418	764
Latest audited balances following bar date	857	55	802
Increase / (reduction)	(325)	(363)	38
Increase / (reduction)	(27%)	(87%)	5%

Source: KPMG LLP (UK) 2007

Liabilities subject to solvent schemes have increased 243 percent in 2006 to £418 million from £122 million.

Companies subject to solvent schemes with a 2006 or prior bar date collectively increased reported net assets by approximately £38 million after the elimination of £363 million or 87 percent of their liabilities. On a relative basis, the improvement in the net assets (or net worth) of businesses averages approximately five percent.

The number of entities obtaining sanction increased in 2006, demonstrating continued support for the scheme process. Nick Bentley is such a supporter, “Solvent schemes are a fantastic finality mechanism, as long as they are used at the right time in the company’s life cycle.”

<sup>14</sup> For the purpose of verification, the analysis of solvent schemes is restricted to accounts filed for solvent schemes of UK companies with bar dates falling on or before 31 December 2006 and excludes companies where only certain parts of the business have been schemed. Non-UK companies have been excluded from the analysis. As a result of the limitation in the scope of this analysis a number of solvent schemes have been excluded. However, the impact of all solvent schemes on the liabilities of UK companies is reflected in the overall size of run-off as at the end of 2006.

“ Schemes have been one of the key drivers that have enabled an accelerated, orderly run-off in the London market.”

John Byrne, AXA Liabilities Managers UK

There were no pool schemes which became effective in 2006. The schemes for the Willis Faber Underwriting Management (WFUM) pool members, comprising 16 solvent entities and Sovereign Marine & General Insurance Company Limited, which is insolvent, were sanctioned by the English Court for all pool members on 17 September 2007, except for two companies whose scheme meetings have been adjourned: Sphere Drake Insurance Limited and Hibernian General Insurance Limited. This is one of the largest and most complex pool schemes to date. It has been subject to scrutiny at every stage by those interested in schemes. The WFUM pools scheme was published in July 2006, creditors meetings were held in October 2006, and the sanction hearing was held on 17 September 2007. During this period, a number of planned solvent schemes have been deferred pending the outcome of, and lessons from, the WFUM pools scheme.

Since the beginning of 2007 to the time of printing, eight solvent schemes have been sanctioned and there is currently a number of schemes in development.

As a result of creditor and Court scrutiny and comment, solvent schemes continue to evolve and there remains a strong appetite for them. The market for solvent schemes in the future seems to be assured, and improvements to the design of schemes are to be expected. According to John Byrne, “ Schemes have been one of the key drivers that have enabled an accelerated, orderly run-off in the London market. Previously policyholders and cedants may not have been organised to deal with schemes but this has certainly changed. Pricing the arrangement for each stakeholder is becoming more difficult and schemes need to develop further to address these difficulties.” All of the executives interviewed for this Survey welcomed the FSA’s recent policy statement on solvent schemes<sup>15</sup>. However, due to their unique circumstances, Lloyd’s is still reluctant to embrace them. “ The answer to solvent schemes is [still] No”, says Steve McCann.



## 4.3 Part VII transfers

From December 2001, when the Financial Services and Markets Act 2000 took effect to the end of 2006, there have been 54 transfers of non-life portfolios, of which almost half involved predominantly or entirely business in run-off. The use of Part VII transfers is increasing each year, dramatically so in relation to run-off business, as demonstrated in Table 6.

**Table 6**

Number of Part VII transfers in the UK non-life insurance market

Dominant portfolio	2001	2002	2003	2004	2005	2006
Active	---	1	5	5	12	7
Run-off	---	2	2	3	4	13
<b>Total</b>	<b>---</b>	<b>3</b>	<b>7</b>	<b>8</b>	<b>16</b>	<b>20</b>
Cumulative	---	3	10	18	34	54

Source: Kendall Freeman; KPMG LLP (UK) 2007

Of the 13 Part VII transfers in 2006 relating to run-off portfolios, nine involved the internal reorganisation of run-off portfolios within large insurance groups, including Swiss Re Group and Zurich Group. The other four Part VII transfers involved transactions between third parties. The attractiveness of the Part VII transfer procedure reflects, in part, the ability to include the transfer of the reinsurance asset of the business as well as underlying policies, without the need for individual assignments or novations. It is also a mechanism that can be readily combined with other related transactions requiring Court approval, such as a capital reduction.

After the first ever Part VII transfer of a life portfolio from Lloyd's to the company market in 2006, the first ever transfer under Part VII of a non-life portfolio from Lloyd's took place in July 2007<sup>16</sup>. The popularity of Part VII transfers seems to be increasing, and there are understood to be many Part VII transfers in the pipeline for 2007 and 2008. Nick Bentley observes from RiverStone's experience, "A Part VII transfer is a very useful tool. It is a good consolidation mechanism."

The number of Part VII transfers may be boosted still further when the EU Reinsurance Directive is implemented by Member States. Alan Quilter, Group Finance and Commercial Director at the Randall & Quilter Group, expects that, "the liberalisation of the European market will lead to business coming to London".

The enforceability of Part VII transfers outside Europe, however, cannot be assumed. In particular, the willingness of US Courts to provide relief is likely to be further tested.

<sup>16</sup> Certain policies written by the members of Syndicates 37 and 2037 at Lloyd's (the Highway Syndicates) were transferred to Highway Insurance Company Limited. (High Court of Justice Chancery Division Number 4069 of 2007).

# 5 Compensation paid to protected policyholders

The Financial Services Compensation Scheme (FSCS) is the statutory fund of last resort for customers of failed financial services firms. It deals with claims against defaulting insurers.

The FSCS insurance compensation sub-scheme and its predecessor under the Policyholders' Protection Board (PPB) is funded (on a cash flow basis) by levies raised against active UK insurers. Levies raised and compensation payments made since 1990 in respect of non-life insurance are summarised in Table 7.

The total amount of compensation paid to protected policyholders of failed UK insurers in the year to 31 March 2007 was £65.9 million (2006: £93.2 million). In this same year, 83 percent of total compensation was in respect of payments to protected policyholders of Independent Insurance Company Limited and Chester Street (2006: 87 percent).

There was no levy in the year to 31 March 2007 (2006: £10.3 million).

In March 2007, the FSA published a consultation paper on proposals to change the funding arrangements for the FSCS<sup>17</sup>. With respect to UK non-life insurance companies in run-off, the FSA proposes to amend the tariff for calculating the FSCS levy to include, for the first time, a contribution based on the proportion of gross technical liabilities that relate to protected business. The reasoning behind this proposal is that many insurers in run-off contribute very little and yet may still present ongoing risk to the FSCS, a situation which it considered inequitable.

ARC, acting on behalf of the market, has responded to the FSA's consultation rejecting these proposals on the basis that, "Insurers in run-off are unable to recoup the cost of FSCS contributions through pricing of future business and moreover stand to receive no benefit to their business from the maintenance of confidence in the markets that the FSA regulates." ARC considers that the proposals are also inappropriate because, "To require insurers in run-off to contribute significant amounts to the FSCS would increase the financial uncertainty of their situation against a background of finite resources." The outcome of the FSA's consultation is still awaited.

**Table 7**  
Payments and levies by the FSCS and PPB

Payments and levies	Industry levy (non-life) (£ million)	Compensation payments (non-life) (£ million)
PPB 1990-2001	341.5	418.7
FSCS 2001-2007	295.9	560.6
<b>Total</b>	<b>637.4</b>	<b>979.3</b>

Source: FSCS Annual Reports (2002-2007), PPB Annual Reports (1990-2001)

# 6 Capital tied up

This section provides an overview of capital tied up in the UK non-life run-off market.

At the end of 2006, total capital tied up of solvent UK non-life companies in run-off was approximately £4.9 billion (2005: £4.8 billion), excluding Lloyd's vehicles and companies with run-off portfolios that are mixed with other live business.

The net assets figure as calculated for regulatory solvency purposes is £3.7 billion (2005: £3.2 billion).

The level of capital tied up has increased by two percent compared to 2005, whilst the overall size of the solvent company run-off market has reduced by 17 percent. Therefore, in 2006 companies appear to have successfully advanced their run-offs and at the same time maintained net asset value. However, few companies have been able to tap into these surplus funds and the next few years may witness an increase in the use of solvent schemes, Part VII transfers and other mechanisms as companies seek to access this trapped capital.

The EU Solvency II Directive is driving companies to look hard at their capital structures and undertake appropriate reorganisation to avoid future capital penalties. The result of this may impact the run-off market. According to John Byrne, "Companies will look more carefully at their allocation of capital and question whether it should be applied to business which is generating insufficient returns. We may see a more critical look being taken of marginally profitable lines of business. Groups are merging entities to improve allocation of and returns on capital and this may result in more divestment activity of discontinued lines."



**"Companies will look more carefully at their allocation of capital and question whether it should be applied to business which is generating insufficient returns."**

**John Byrne, AXA Liabilities Managers UK**

# 7 Future challenges

In this year's Survey, a number of senior executives were asked to comment on what they consider to be the key future challenges for the UK non-life run-off market. Representatives of the traditional company market as well as those involved in buying and managing run-off were interviewed and some of their observations and insights are set out here.

The environment in which these comments have been given by our Survey commentators is one of change; as this year's Survey shows aggressive management and commutation activity together with a growing appetite for finality is shrinking the market; the number of employees in the run-off market is declining.

In this context, the key themes which have emerged from interviewing these senior members of the market reflect the need to address the changes occurring in the marketplace.

On the whole, our Survey commentators agreed that the principal challenges for the industry to address in the near future include:

- Developing bespoke run-off strategies.
- Addressing the reinsurance assets.
- Retaining key employees.
- Dealing with changes in the regulatory environment.
- Pricing run-off investment.
- Positioning for new opportunities.

Each of these issues is dealt with in more detail here.

## Developing bespoke strategies

Our Survey confirms that one of the major challenges for CEO's and CFO's of businesses with discontinued operations will be designing a strategy specific to the needs of each individual book of business.

According to John Byrne, "Other than for UK asbestos liabilities, I think we are seeing the beginning of the end of the run-off of legacy business written in the early 90s and prior in the London market, as this market has got to grips with it and discontinued business is now well managed."

As a result of this change, the view is that many run-offs of the future will be fundamentally different from those typical London market books around which the run-off industry has grown.

As John Byrne says, "Some challenges ahead will depend on the nature of the portfolio in run-off: the profile of liabilities; personal versus commercial lines; insurance versus reinsurance; extent of reinsurance protections. The biggest challenge is to find a strategy that accommodates the specifics of the portfolio and the expectations of stakeholders."

## Addressing the reinsurance asset

All executives emphasised the need to develop a strategy to deal with the reinsurance programme protecting legacy business. In a run-off situation, with no other new sources of cash, the realisation of reinsurance is critical to the success of the run-off.

Ken Randall says that, "A big challenge [for the run-off market] is the monetisation of the reinsurance asset. In cases where legal action is needed to enforce recovery, some jurisdictions have a much slower process. The US is much slower than the UK."

Run-off portfolios which are contained within larger insurance groups may have an advantage over isolated run-offs. Ken Randall notes, "Groups containing a number of risk carriers have the ability to look across group relationships to maximise recoveries from reinsurers."

John Byrne at AXA agrees and adds, "At AXA, commutations with reinsurers are overseen centrally, which provides for consistency of approach across the group."

## Retaining key employees

Historically, one of the critical issues for any run-off is retaining those key individuals who have the skills and knowledge necessary to ensure run-off is conducted effectively. Our Survey commentators confirm that this issue is still very much at the forefront of executive thought in dealing with run-off.

This year, for the first time since this Survey has been published, the size of the UK non-life run-off market has shrunk significantly compared to previous years. This year's reduction in service providers' headcount, many of whom manage significant run-off portfolios, is consistent with the decrease in size of the market.

For those companies which manage their shrinking discontinued businesses in-house, retention of key staff is also a major issue. "Keeping high ability people is a problem, especially when an estate is closing", observes Nick Bentley.

John Byrne comments that, "Staff retention and staff management are key as the run-off progresses."

In order to maintain profitability, headcount may need to reduce in line with the contracting run-off and management will need to design people strategies to address this, such as thinking more laterally about reward structures and retraining and redeploying staff. The need for a flexible workforce is becoming increasingly important.

## Dealing with changes in the regulatory environment

A particular focus for executives is the challenge and opportunity arising from the regulatory changes of the recent past and the impending implementation of future rules and regulations.

Since the early 1990's there has been significant change in the regulatory environment which the industry has had to digest, from the Third Non-Life Directive through the birth of the FSA to the EU Reinsurance Directive. On top of that, the industry is preparing itself for the implementation of the Solvency II regime.

Nick Bentley considers that, “The burden of regulation seems to be disproportionate compared to the risks faced by these businesses. The corporate structure and compliance standards and rules now required are very expensive for companies in run-off.”

Nick does, however, acknowledge that the area of the FSA charged with dealing with the run-off sector is trying to address this, “[The regulator] is a hard but pragmatic regulator.”

On the other hand, the EU Reinsurance Directive and Solvency II are noted as presenting valuable opportunities for the run-off sector, as Ken Randall observes, “The imperative for companies to focus on the efficient use of capital may create business opportunities for run-off practitioners.”

## Pricing run-off

There has been widespread recent commentary in the industry press regarding the significant amount of capital seeking investment opportunities in the run-off market. Indeed some significant deals have been effected during 2006 including transactions involving Equitas, Winterthur Swiss Insurance Company, Minster Insurance Company Limited and Sompo Japan Insurance Inc.

Whether the current “credit crunch” being experienced at the time of writing will affect the continuing availability of these funds remains to be seen.

Ken Randall, however, considers that the demand for investment in legacy businesses has had some adverse effects, “There is too much money chasing too little value, and pricing decisions are going wrong. If there are insufficient returns on investment, with the mobility of capital, the sharper investors will move on.”

Nick Bentley shares these concerns, “The proper pricing for run-off may not happen for another three years.”

## Positioning for new opportunities

Looking further into the future, the Survey commentators anticipate major developments overseas. Nick Bentley observes that, “Continental Europe has a fantastic run-off inventory, however, culturally it is a very different environment.”

John Byrne expects that, “Run-off globally will become a bigger business. There will probably be growth in Continental Europe and Bermuda, and a constant flow of business from the US.”

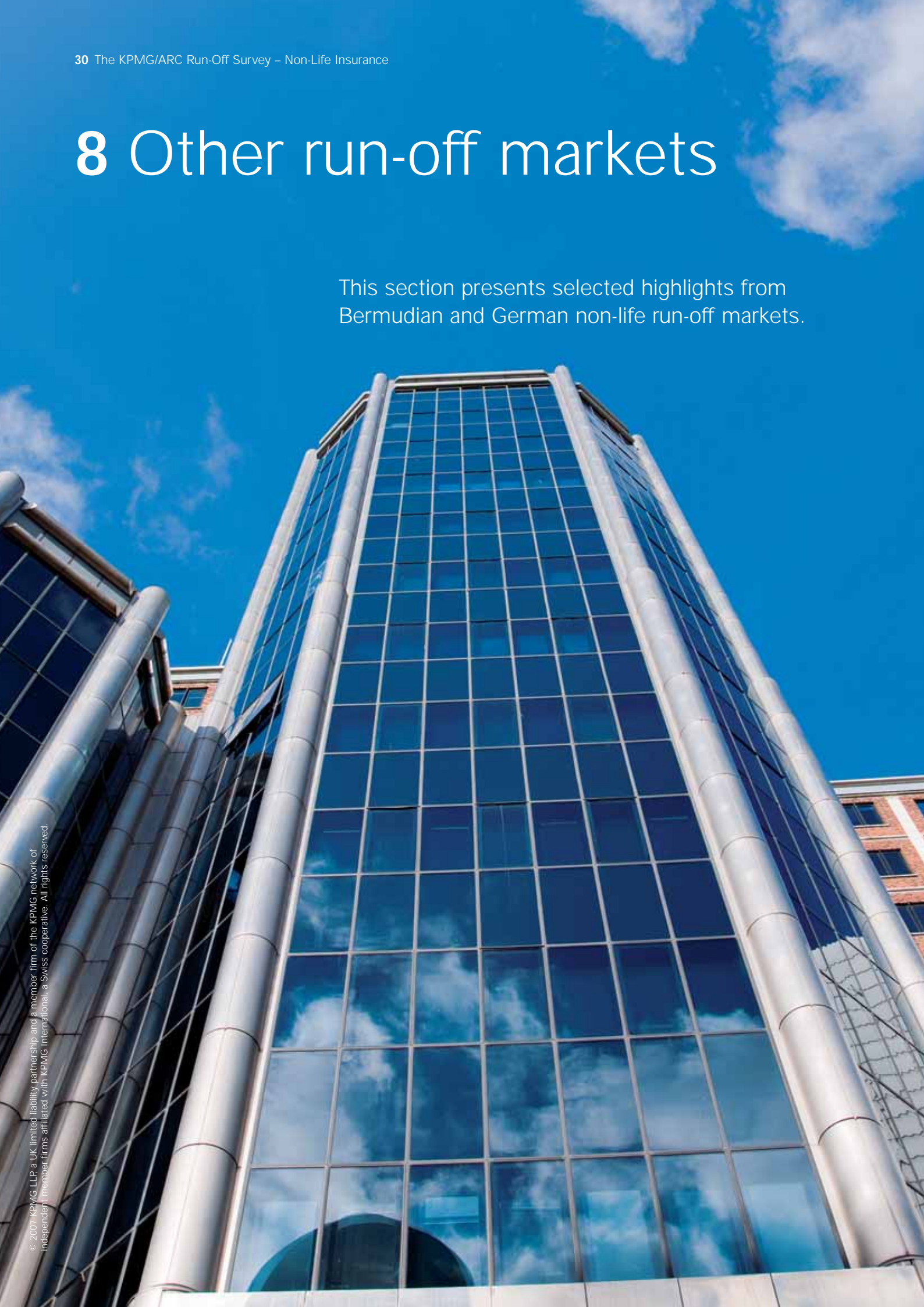
The challenge for executives looking for opportunity in the future is to position their organisation to take advantage of the opening of potential new markets looking for skills specific to the run-off environment.

In the next section, the Survey considers the run-off markets in the potential growth areas of Bermuda and German-speaking countries.



# 8 Other run-off markets

This section presents selected highlights from Bermudian and German non-life run-off markets.



## 8.1 Run-off in Bermuda

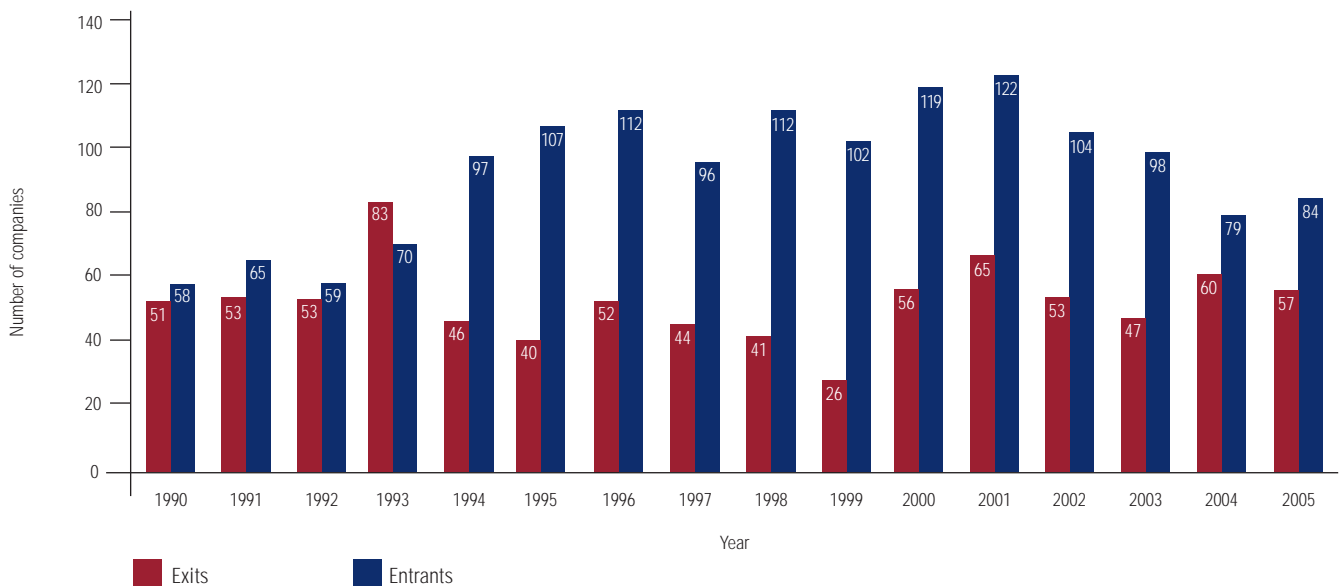
Bermuda is a key player in the global insurance and reinsurance market and is home to over 1,300 registered insurance companies ranging from captives to large commercial reinsurance companies. Following the hurricane losses of 2005 approximately USD\$20 billion of capital was raised and deployed either through new or existing Bermudian reinsurers.

Figure 5 illustrates the number of newly incorporated insurance entities by year as well as the number of cancelled insurance licenses per year. The number of entities entering and exiting the Bermuda market would indicate the existence of a significant number of insurance companies that are currently in run-off.

Although Bermuda is home to a significant number of run-offs, it is not possible to estimate their overall level of liabilities or trapped shareholder surplus because the data is unavailable to the public.

Bermuda is principally a reinsurance centre, therefore its run-offs have comparatively little involvement with private policyholders. Bermudian reinsurers have less exposure to legacy issues (particularly asbestos, pollution and health hazard risks) and a significant proportion of Bermuda's run-off liabilities relate to short tail, property catastrophe business.

**Figure 5**  
Number of companies entering and exiting the Bermuda market



Source: Bermuda Registrar of Companies 2006<sup>18</sup>

<sup>18</sup> Although every licensed reinsurer is required to submit an annual financial return to the Bermuda Monetary Authority, these returns are not publicly available and it is therefore difficult to identify individual entities in run-off and gauge the overall size of the run-off market. Using information derived from the Registrar of Companies in Bermuda it is possible to assess the overall turnover of insurance entities based on the number of new company formations and company liquidations.



### Development of the Bermuda run-off market

The Bermuda run-off market has developed in a number of distinct phases since its emergence as a domicile for captive insurance companies in the 1960s.

- The 1970s and 1980s saw a number of insolvent liquidations (such as Mentor Insurance Limited (Bermuda) and Cambridge Reinsurance Limited) and the market was characterised by many captives commencing underwriting of third party business (particularly London Market business).
- The 1990s saw a number of high profile insolvencies such as Bermuda Fire & Marine Insurance Company Limited, Electric Mutual Liability Insurance Company (which was redomesticated from the US), New Cap Reinsurance Corporation (Bermuda) Limited and Belvedere Insurance Company Limited. The 1990s also saw the sale of a number of insurance companies in run-off such as Walton Insurance Limited, Paumanock Insurance Company Limited and Brittany Insurance Company Limited. The use of the first solvent scheme for a non-life insurance company (Hopewell International Insurance Limited) also occurred in the 1990s.
- The 2000s saw a considerable increase in the scale of run-offs such as LaSalle Re Limited, Centre Solutions (Bermuda) Limited, Overseas Partners Limited and Stockton Reinsurance Limited as well as a greater use of solvent schemes to close books of discontinued business.
- More recently, the most significant impact has been the 2005 hurricane season which saw a number of property catastrophe reinsurers enter run-off or significantly curtail underwriting, including Rosemont Reinsurance Limited, Alea Group Holdings (Bermuda) Limited and Quanta Capital Holdings Limited.

### Schemes of Arrangement

Since 1995 there have been 11 solvent schemes for non-life companies (see Table 8). The schemes that have been promoted in Bermuda more recently have been larger and more complex.

Bermudian insurance legislation does not contain statutory novation provisions for non-life business. As a result, Bermudian reinsurers have to rely on other available mechanisms to effect a transfer of business (which may include the scheme of arrangement). One such example of the use of a scheme to transfer a portfolio of business was the transfer of a portfolio of non-life risks from Sphere Drake Insurance (Bermuda) Limited in Bermuda to RiverStone in the UK in 2002.

### Future trends for the Bermuda run-off market

In terms of future trends, the growth of the run-off market in Bermuda is likely to be driven by a number of factors, including:

- 1) Loss events – Events such as hurricanes Katrina, Rita and Wilma in 2005 resulted in a number of companies entering run-off. Another loss of the same magnitude may result in a number of new run-offs.
- 2) Rating agencies' influence – The inability to maintain an 'A' rating may drive some Bermuda players to sell or discontinue less profitable lines of business. The rating agencies have also placed importance on diversification of portfolios.

3) Captives – The formation, run-off and dissolution of captives is a continuous cycle and it is the captive market that may be the next focus of run-off investment.

4) Market conditions – Softening market conditions may lead to certain reinsurers (and their investors) concluding that the business environment is unable to generate returns that are commensurate with the investment risk and that the entity should be sold or placed into run-off.

In light of the above, and as the Bermuda run-off market continues to grow, more interest is being shown in the purchase of Bermudian run-offs by international capital providers (in addition to the more traditional run-off buyers) and therefore there is likely to be further merger and acquisition activity over the coming year.

**Table 8**

Solvent schemes in Bermuda since 1995

Company	Liabilities (USD \$ million) <sup>19</sup>	Scheme effective date
Hopewell International Insurance	8.9	1995
Scottish and Commonwealth Insurance Company	0.5	1998
Trent Insurance Company	7.2	1999
Ramus Insurance	1.5	2001
Transcon Insurance	9.7	2001
The Seven Continents Insurance Company	14.1	2004
NRC Reinsurance Company	3.3	2006
SRO Run-Off	2.5	2006
Arion Insurance Company	6.0	2007
LaSalle Re	58.5	2007
Walton Insurance	21.9	2007

Source: KPMG Advisory Limited, Bermuda (2007)

<sup>19</sup> Insurance liabilities that have been included in the scheme according to scheme documentation.

## 8.2 Run-off in the German-speaking market

Unlike the UK market, the insurance sector in German-speaking countries has generally associated the term run-off with a failure of the business, or at least an unhelpful management distraction. This attitude is symptomatic of many Continental European insurance markets, and explains to some degree the historic cultural resistance to promoting run-off issues and run-off solutions.

During 2006 and 2007, KPMG's Advisory practice in Germany examined run-off in reinsurance and property/casualty insurance in the German-speaking countries of Austria, Switzerland and Germany. Analysis was performed on financial results; feedback was received from questionnaires distributed to 110 insurers and reinsurers; and face to face interviews were conducted with survey participants and market experts, all of which led to the first detailed Run-off Survey (2007) being produced.

### Survey findings

The size of the German-speaking non-life run-off market measured by technical reserves is estimated at EUR €66.5 billion (£45 billion) which is approximately 19 percent of the total non-life market<sup>20</sup>.

With a few notable exceptions such as the Gerling Group and Gothaer Rückversicherung, run-off is managed very privately by insurers and reinsurers in German-speaking countries. Over 80 percent of survey participants considered that run-off was an important topic for them, a substantial change from enduring attitudes held until just a few years ago. Proactive management of discontinued business is viewed as providing many benefits to organisations: accelerated finality, the removal of liabilities from the balance sheet and the reduction of administration costs. However, proactive management of run-off business is not undertaken very widely. Reasons provided for this are that such action may harm ongoing client relationships and that there is a lack of available, suitable resources. The most commonly used method of run-off acceleration is commutation, which is privately negotiated between the parties.

Companies in the German market indicated that they are interested in outsourcing solutions and are willing to employ external specialists to assist with discrete areas of their discontinued business. Run-off advisers are viewed as beneficial to organisations as they have suitable experience and expertise, and using external suppliers frees up internal resources. However, significant outsourcing projects are uncommon: in-house teams are considered to have a greater knowledge of the portfolio; companies seek to build their own run-off skills; and outsourcing costs are viewed as a major drawback.

The run-off phenomenon is still in its early phases in the German-speaking insurance industry, especially when compared with the UK or US markets. Many insurance companies have begun to take a more open approach and it is likely that run-off will steadily gain impetus in Germany, Austria and Switzerland, especially as Continental European insurance groups reorganise their businesses ahead of Solvency II. According to estimates by KPMG in Germany the lag in these markets compared to the UK run-off market is estimated at 10 to 12 years. However, a clear convergence can be expected within the next few years.

<sup>20</sup> If companies entirely in run-off are included, the estimated size of the German-speaking non-life run-off market increases to EUR€75 billion (£50 billion).



# 9 Conclusion

2006 was a year of change for the UK non-life run-off market. Whereas older run-offs comprise persistent and problematic US (and increasingly) UK asbestos and environmental liabilities, the tail of the liabilities in recent years has been much shorter than for historic business. Lloyd's liabilities in run-off have shrunk by some 31 percent and now only marginally exceed those at Equitas. Since 2003, Equitas has reduced its undiscounted liabilities by £2.9 billion to £4.8 billion. In the same period run-off at Lloyd's has decreased by £2.5 billion to £5.2 billion. Lloyd's has continued to innovate in its approach to run-off liabilities, encouraging active commutation programmes, amending its RITC rules and, for the first time, adopting Part VII transfers as an instrument. However, due to the unique circumstances of the Lloyd's franchise, there appears to be no prospect of Lloyd's approving a solvent scheme.



There has been a reduction in the total size of the UK non-life run-off market of £5.5 billion since 2005. It is now estimated at £32.7 billion at the end of 2006. This is the largest change in the size of the UK non-life run-off market since this Survey has been produced. The principal drivers behind the decrease are proactive management of existing run-off portfolios, absence of new run-offs and the weakening of the US Dollar. Capital tied up in run-off has, however, increased from £4.8 billion to £4.9 billion. The UK run-off market is clearly benefiting from the successful implementation of proactive management strategies, although it has not yet fully reaped its rewards.

The willingness to outsource the management of London market run-off portfolios continues. As these discontinued lines are successfully wound down greater competition between service providers is leading to consolidation in the outsourcing market. Run-off managers may have to adapt their services or win business from new markets if they are to survive as independent concerns.

Almost half of all non-life insurance Part VII transfers since 2001 were primarily in respect of discontinued business and there has been an increase in the number of solvent schemes since 2005. By the end of 2006, there have been a total of 24 Part VII transfers and 36 solvent schemes of run-off portfolios. These statistics and the comments from Survey participants reveal companies' continued demand for run-off finality mechanisms and rationalisation of portfolios.

An important development in the run-off market during 2006 was the Equitas/Berkshire Hathaway deal, which is testament to the level of interest now shown by investors in run-off opportunities. The Equitas deal alone may impact the run-off strategies of other companies as Equitas run-off liabilities are still an important part of the balance sheets of many insurers.

According to leading run-off executives consulted in this Survey, the challenges facing the sector will test management's ability to design appropriate run-off strategies, to secure reinsurance assets, to retain and manage experienced staff and to deal with regulatory change. To succeed in the current cycle of the run-off market, run-off practitioners may need to continue their focus on identifying, winning and managing new business effectively. Some of this business may be located in the run-off markets overseas, such as Bermuda and the German-speaking countries. The size of these markets remains significant, although the features and characteristics of each market differ in many ways to the UK, necessitating alternative strategies for their legacy business.

The UK non-life run-off market is beginning to transform, and managers of legacy portfolios face challenges ahead, some familiar and some new. Competition is increasing for those seeking to invest in run-off, and for those who service it. These challenges to the run-off market in the UK and across Continental Europe could bring many opportunities. The next Survey may reveal how well the market has responded and how much trapped capital will have been accessed.

2006 was a year of change for the UK non-life run-off market.

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