



Feature Article

The Deal of the Decade

Speaking in public for the first time since the deal was announced, Equitas Chief Executive Officer Scott Moser addressed the Association of Run-Off Companies (ARC) yearly congress at the Merchant Taylors Hall on 27th February 2007.

Mike Palmer reviews the deal and looks at what it means for policyholders, cedents, and the wider market. Mike also looks at what precedent if any, the Equitas scenario sets for tackling Lloyd's open years or post-Equitas run-off issue.



By Mike Palmer

Creation of Equitas and Setting the Scene

Mike Palmer

Before Scott outlined the “deal of the decade”, he went through some key milestones in the creation of Equitas and the build-up of what lead Equitas to becoming the cornerstone of the massive losses suffered by Lloyd's in the 1980s and the 1990s. Following the comprehensive reconstruction and renewal exercise, Equitas reinsured 1992 year and prior liabilities of Lloyd's names. Equitas was funded with almost \$12 billion premium and reinsured risks written by 390 syndicates over more than 750 separate reinsurance programmes spanning 220,000 different reinsurance policies with 3,000 reinsurers. So with all of that in the past Scott went on to define the deal that had been struck with Berkshire Hathaway, the Omaha based organisation that will take on the full liabilities of Equitas in a two-stage process.

Four Guiding Principles

Scott Moser outlined the major principles under which Equitas sought to find finality:

- Reinsurance needed to be massive – practical finality achieved.

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- Equitas needed the right to seek novation – within a structure that maximised the chances of approval.
- Equitas required a “gold-plated” solution of high quality financial security.
- Governance was required to protect the Lloyd's syndicate names.

The Deal at High Level

Scott Moser outlined the eight key stages of the Berkshire Hathaway deal:

1. Equitas transfers all of its assets to National Indemnity.
2. Equitas keeps £172 million.
3. Lloyd's contributes £72 million.
4. National Indemnity conducts run-off and pays liabilities up to Equitas reserves \$8.7 billion plus an additional \$5.7 billion.
5. Parties seek transfer of liabilities and Equitas can buy up to \$1.3 billion more cover.
6. Lloyd's contributes another £18 million.
7. National Indemnity either retains an AA- rating or puts money in trust or posts a letter of credit.
8. If a situation deteriorates markedly Equitas can play an active role in conducting a run-off.

The Deal Structure

Under phase one National Indemnity:

- Reinsures ALL of the reinsurance obligations of Equitas.
- Agrees to pay liabilities up to Equitas claims reserves plus a further \$5.7 billion – total cover of around \$13.8 billion.

This is set out in the table below:

Total Cover	\$ Billion
Net claims reserves as of 31.03.2006	8.7
Additional reinsurance	5.7
Net payments	(0.6)
Total	13.8

- National Indemnity takes on the staff and operations of Equitas and conducts the run-off at its own expense.

Phase One – The Reinsurance Premium

The premium payable is:

- All Equitas assets less £172 million and
- The contribution from Lloyd's of £72 million.
- Effective cost to Equitas is £286 million.
- Equitas surplus at 31 March 2006 £458 less retained by Equitas (£172) giving a total of £286 plus Lloyd's contribution £72 million – total phase one premium £358 million.

Phase One – Return Premium Potential

- Small return premium expected to be paid.
- FSA advise that maximum they will consider during phase one is £50 million.
- Equitas believe they will be able to secure FSA's approval for making the payment this spring or summer 2007.

Phase One – Deal Contingencies

The following are required:

- Approvals and waivers from the FSA.
- Approval of New York insurance authorities for the release of EATF assets.
- Approval of Equitas trustees.
- If steps do not occur by 31 March 2007, deal collapses unless parties agree to extension.
- Lloyd's must gain approval at an EGM to pay its contribution (this approval has subsequently been given).

Phase One - Summary

- Procures a massive amount of reinsurance.
- Protects the financial integrity of reinsurance.
- Establishes rights of names to assure run-off conducted properly.

- All economic benefits of the deal are crystallised.
- Total cover of £13.8 billion is assured.
- Cover is not linked to National Indemnity's future investment profits or losses on assets transferred.

Phase Two - Novation

- Propose to seek novation under UK law.
- Option to purchase up to additional \$1.3 billion reinsurance.
- Novation not possible today due to technical defect within FSMA.
- HM treasury consulting now on a proposed amendment to fix defect.
- Parties seeking novation must get approval of FSA and court.
- Court must be satisfied policyholders no worse off.
- Deal structured to provide an attractive setting for court approval.

Phase Two – Additional Cover

- Equitas has an option to buy up to \$1.3 billion of cover in event of court approval.
- Additional reinsurance should be recognised by courts and policyholders as an improvement in situation.
- Option to purchase additional cover:
 - Only open until 31 December 2009.
 - Expires if reserves deteriorate by \$2 billion or more.

Phase Two - Lloyds

- Lloyd's will contribute £18 million on 31 December 2009 regardless of the novation.
- After novation, Equitas hopes to pay a further return premium.

Phase Two – If no Novation by 2009

- If phase two does not occur by 31 December 2009, Equitas may:
 - Continue to seek court approval of novation with new arrangements for additional reinsurance.
 - Abandon novation and purchase reinsurance.
 - Buy no further reinsurance and seek FSA approval to pay a further return premium.
 - Decide on some combination of these choices.

Phase Two – Legal Finality

- We realise names want *legal* finality.
- Transaction designed to provide greatest opportunity to achieve it.
- Names are well protected if this is not possible.

Conclusion

- Agreement is validation of our strategy.
- Affirmation of claims dealing methodologies.
- Names want to sleep easy.
- They have the world's best mattress.

But What Does All of this Mean for the Rest of Us?

It would seem there is no doubt that the Equitas deal will become a defining event or moment in terms of the management of prior year's business – a kind of coming of age maybe for the likes of Lloyd's discontinued business and for a legacy business sector that had previously been largely ignored outside a fairly narrow circle of insurance practitioners and professional advisers. It would also seem clear that senior executives of many major insurance groups all over the world are now coming to a similar conclusion about the use of strategic run-off techniques on live and discontinued business. It could be said that almost every reinsurer that has ever existed "since the dawn of time" must effectively have run-off and legacy issues. But the sheer scale of the Equitas deal will make it a defining moment.

The world's largest run-off vehicle since day one of its creation, the 2006 ARC/KPMG run-off survey put Equitas total liabilities at £4.4 billion. More importantly the deal also shows recognition by Lloyd's that the exposure to prior year's liabilities is indeed a brake on future development.

So, does the deal of the decade mean that Equitas and Lloyd's have severed its links on the past and will never have to look at run-off again? Certainly the figures would indicate not, in 2002 the ARC/KPMG run-off

survey put Equitas total liabilities at £7.6 billion.

At the same point the run-off liabilities of 1993 and following years of non-life Lloyd's syndicates came to £5.4 billion.

By the 2006 survey which was based on 2005 results Equitas liabilities had gone down to **£4.4 billion** but Lloyd's 1993 and post-open years liabilities had increased to **£7.5 billion**. So is the past about to repeat itself?

In another presentation at the same ARC congress Peter Taylor of Lovells spoke at length about asbestos toxicity, comparing it to the "perfect storm" and sought comments from the audience on what might be the next perfect storm. Using this analogy it is probably fair to say that the post-Equitas Lloyd's run-off is not as toxic as the APH ridden content of the older years however, it would probably be complacent of Lloyd's to consider the current open years syndicates as free from the perfect storm.

So, two questions spring to mind as by-products of the "deal of the decade":

- 1) Clearly the Berkshire model for run-off of long tail liabilities is not one of proactive or overt commutation policy. I have heard Ajit Jain (who heads Berkshire's catastrophe insurance operation) say on one occasion that he sees run-off as a game of inches! For my money, many of those inches and more importantly yards will not be measured by commutation. What scale of impact will this have on future London market commutation deals and strategies?
- 2) What is a true finality solution for its pre 1992 open years, leaves Lloyd's with a quandary; what will they now do with the post 1992 open years, or £7.5 billion worth of run-off liabilities? To-date only one Part 7 transfer (small life syndicate) has been approved by Lloyd's. This leaves RITC as the only open solution for the corporation or will they decide to dig a little deeper into the tool box of run-off solutions? ■

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