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Unlocking value in run-off

Fifth edition
September 2011

A Survey of Discontinued Insurance Business in Europe

www.arclegacy.eu

Millennium Bridge

London, UK

Foreword

Paul Corver

Chairman, Association of Run-Off Companies Limited ("ARC")

As Chairman of ARC I am delighted to be asked again to write a foreword for this worthy survey of the European market. Now in its fifth year it continues to provide valuable insight into the treatment of legacy liabilities across the continent.

It is inevitable that Solvency II would feature prominently in this survey as the whole industry gets to grip with this forthcoming regime. It is becoming clear that quite a number of insurers and reinsurers will require additional capital to meet the new rules and an assessment of where the capital intensity might lay is of increasing importance.

Responses to the survey plainly identify that there is an expectation of significant restructuring. This has been witnessed over the last few years across the whole industry and will inevitably continue as a means of maximising capital efficiency.

The potential for alleviating some of the capital burden by pruning out dead wood through an exit mechanism is clearly referred to by respondents. This may be achieved by sale, solvent scheme of arrangement, transfer or commutation and may be applied to old years, discontinued lines or redundant territories.

The incoming requirements of Solvency II provide a catalyst to thoroughly examine what may have been pushed to the back of the cupboard. We have seen some significant deals in the last 12 months on both sides of the Atlantic and this will likely continue. The run-off sector has for many years been addressing the exit and resolution of legacy liabilities and these skills are clearly being welcomed and adopted by the live sector.

I am pleased to report an increasing interest in ARC especially from companies and advisors in Continental Europe and beyond. ARC continues to provide a platform for educational and networking events and I am grateful to all the companies and firms, such as PwC, who support our initiatives.

I look forward to witnessing the events of the coming year which I am sure will continue to elevate the value of proactive legacy management across all sectors of the insurance industry.

Royal Palace

Madrid, Spain

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Introduction

Welcome to the fifth edition of the PwC Survey of Discontinued Insurance Business in Europe (the "Survey") which we are delighted to once more present in conjunction with ARC.

Dan Schwarzmann

Partner, PwC

A great deal has happened since we produced our last Survey in early 2010. During the intervening period we have continued to learn more about what Solvency II will mean, both for the industry generally and more recently for run-off specifically. There has been a steady flow of restructuring activity and exit solutions in the live and discontinued sectors and I am proud to be part of the team that has worked on many assignments in this area - such as the solvent scheme of arrangement for Minster Insurance Company which must be the most complex stand alone solvent scheme to date.

We have not experienced any major insolvencies in Europe and have seen the insurance industry stand up well to significant catastrophes in Japan and New Zealand.

We have, however, seen new innovation in respect of existing insolvencies, such as the UK and US solution for Highlands UK's direct policyholders which PwC[1] led.

New run-offs have also emerged, including Glacier Re in Switzerland and Ecclesiastical Insurance Group's withdrawal from the London Market, along with challenges for specific lines of business such as direct motor liability.

Our Survey indicates that across Europe run-off business is now being managed through the use of increasingly sophisticated strategic plans. The spotlight on capital is at the core of these plans, with the majority of Survey respondents commenting that the release of capital from their discontinued business is a key objective.

One of the key themes of our Survey predictably centres around Solvency II, and it was interesting to see just how many respondents believe that in the next 12 months insurers in Europe will begin to exit capital intensive lines of business and divest run-off books. Indeed, in recent times we have witnessed exits from discontinued business from established European players such as Zurich Financial Services and Hannover Re.

1. "PwC" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom), which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity.

The feedback I am getting from the PwC Solvency II team is that it may still be a further year before we see these types of decisions being taken on a widespread basis. The Survey responses also highlight that investors in the run-off market suggest it is only a matter of time before we will see a significant volume of exit and acquisition activity linked to Solvency II.

Much of the focus of the current restructuring activity we are experiencing is centred on consolidating organisational structures, sometimes in preparation for an exit. In particular, Part VII and insurance business transfer activity has been strong and the PwC restructuring team I work with has been appointed to advise on several Part VIIs. These include a multi-billion pound corporate restructuring for Royal Bank of Scotland Insurance as it prepares to consolidate a number of legal entities, including Churchill and Direct Line - involving over 20 million policyholders - in order to achieve a more efficient structure. This is a significant and complex transaction and is similar to others we are involved in within the discontinued non-life business sector, where we recently led the Equitas Part VII, and within the life insurance sector.

In addition to the Minster solvent scheme of arrangement, this year has seen noteworthy solvent schemes for Global General in respect of both its insurance and reinsurance business. Solvent schemes of arrangement remain a viable exit tool in the right circumstances and we are seeing an uptick in enquiries for these in both the insurance and non-insurance sectors.

In our Survey we asked respondents to consider what will be the most significant development in the run-off market in the next 12 months? We received some very interesting views on the shape of things to come and how they may make a difference to our market place. We have included a number of these responses on pages 32 and 33 which we are sure will prove to be excellent debating points with our clients and contacts in the coming months.

I hope that you find the Survey interesting reading. We are very grateful to all those who took part in this Survey and the PwC team looks forward to working with clients in their pursuit of value driven solutions.

Summary

View of Zurich

Switzerland

Key results

Management and structure

Survey respondents continue to converge in their view of defining run-off. ***85%*** now define it as lines of business that are no longer written compared to ***59%*** in 2008.

Run-off is handled in a variety of ways, ***44%*** manage it in a separate business unit but ***15%*** handle run-off alongside ongoing business. Respondents identified appropriately skilled resources as a constraint to being able to deal with run-off effectively within their organisations. This finding echoes the results of PwC's 'Getting set for Solvency II' survey conducted in November 2010.

Over ***90%*** of respondents have a strategic plan for dealing with their run-off business and over ***60%*** of those respondents cite releasing capital as the key objective of their plan.

Summary findings

Run-off is increasingly the subject of strategic plans across Continental Europe, with capital release a key objective. There is greater consistency in the understanding and definition of run-off business although respondents cite availability of run-off skilled resources as an ongoing challenge.

Key challenges, including claims activity

Consistent with previous years, tied up capital remains a major challenge for Survey respondents in respect of their run-off business. However, this year respondents highlighted preparation for Solvency II as the biggest challenge followed by access to exit mechanisms. As a significant proportion of Continental European respondents confirmed that their organisations had considered various exit options for run-off business, it must be that exit mechanisms which meet the needs of the business are still high on the agenda.

It was interesting to note that despite some market perceptions that APH claims are no longer a significant issue, Survey respondents identified long-tail claims as a major concern influencing their ability to gain finality for run-off liabilities. Nearly twice as many UK respondents highlighted this issue compared to their Continental European counterparts.

More Continental European (re)insurers have concerns over reputational risk in trying to gain finality for run-off than those from the UK.

Summary findings

The Survey indicates that there remains a tension between the challenge of tied up capital and reputational risk in proactively dealing with run-off business for Continental European (re)insurers where the exit market is less mature than in the UK.

Regulation and Solvency II

Increasing numbers of respondents believe that the practical implications of Solvency II will lead to an increased cost of capital and an increased focus on exit options for discontinued business.

63% of respondents believe Solvency II will focus insurers' attention on underperforming lines of business. Nearly half of respondents believe that their organisations may acquire business as a result of Solvency II giving support to the principle of diversification.

Solvency II is expected to increase merger and acquisition activity. Respondents believe that most activity will take place in Germany, the UK and Switzerland.

Summary findings

Solvency II is high on the agenda for Survey respondents. It is strongly expected to be a driver for restructuring activity. We have seen the beginning of this in the last 18 months, but respondents believe any significant increase in volume of activity is likely to be another year away.

Restructuring and exit solutions

91% of Survey respondents believe efficient capital management is the key driver for restructuring activity.

72% of respondents have been involved in some form of restructuring activity to date and half of respondents believe there will be more than 10 run-off disposal transactions in the next two years.

66% of respondents who had contemplated exit had considered a solvent scheme of arrangement, ***41%*** an insurance business transfer, ***55%*** a sale and ***59%*** a loss portfolio transfer or reinsurance. Several respondents commented that they expect to see an opt-out solvent scheme of arrangement in the market in the next 12 months.

Summary findings

Solvent schemes of arrangement have been considered more by Survey respondents than any other exit mechanism. Respondents also believe that there is a strong pipeline for run-off disposals and restructuring activity over the next two years. Those respondents that have considered exit appear to support the conclusion that the solutions need to be bespoke with all of the key tools being considered.

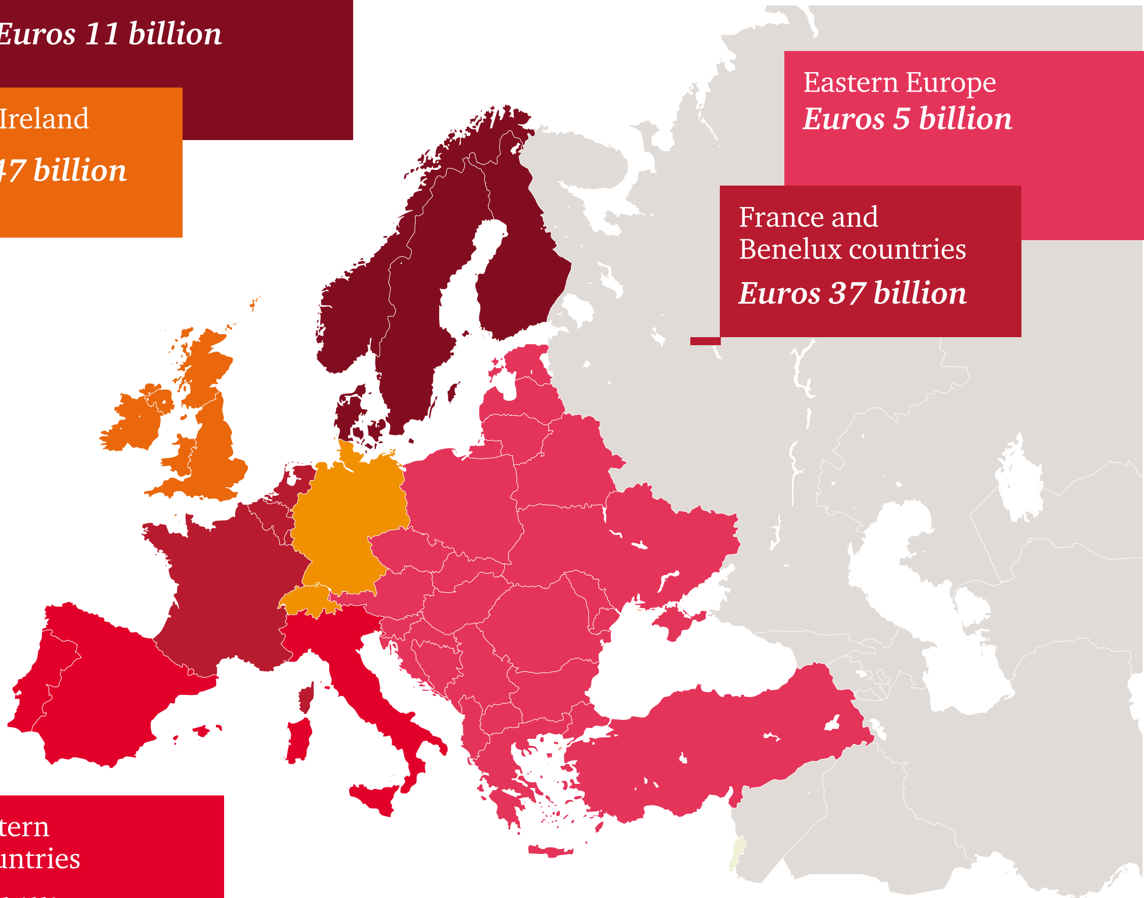
Market size and review of key developments

We estimate that the size of the non-life European run-off market is now in the region of Euros 218 billion. There has been a growth in run-off in some territories, notably in Germany and Switzerland. As our Survey suggests, this may reflect a clearer and more consistent focus in the definition of run-off and a more open approach to dealing proactively with discontinued business lines. In the mature UK market run-off liabilities have continued to shrink. Commutation activity and the finalisation of some solvent schemes of arrangement have contributed to this trend although this has to some degree been offset by underwriting exits in lines such as direct motor liability.

Brandenberg Gate

Berlin, Germany

Figure 1: Estimated run-off liabilities in Continental Europe



Source: PwC

Nordic regions
Euros 11 billion

UK and Ireland
Euros 47 billion

Eastern Europe
Euros 5 billion

France and
Benelux countries
Euros 37 billion

Other Western
Europe countries
Euros 23 billion

Germany and
Switzerland
Euros 95 billion

View of Stockholm

Sweden

We have continued to see some significant developments in the insurance restructuring sector across Europe. In the following two pages we summarise a selection of key transactions and activity from the last 18 months.

01 *Solvency II developments: Europe*

In 2011 new transitional measures were proposed for Solvency II's implementation, although these are still to be agreed. Run-off insurers with three year exit plans from the date of implementation of Solvency II will not be subject to its requirements. However, those with run-offs that continue beyond three years will then become subject to Solvency II's requirements, in some cases earlier where the supervisor is not satisfied with the progress being made towards terminating activities. These provisions do not extend to run-off business within groups that also contain live business. This creates clearer guidance in respect of the impact of Solvency II for run-off companies where there has been inertia for some time. It will be interesting to see how stand alone run-off entities, particularly those with long-tail liabilities, react to these proposals.

02 *New exits: Switzerland and UK*

New run-offs have emerged since our last Survey. Examples include Glacier Re in Switzerland, which closed to new business in 2010 and placed its portfolio into run-off. In the latter half of 2010 Ecclesiastical Insurance Group in the UK ceased underwriting London market business and placed its subsidiary into run-off. More recently, in July 2011 the Co-operative in the UK ceased writing life insurance business with a view to selling its life insurance fund and utilising Axa to provide insurance products in the future.

03 *Non-life Part VII transfers: UK*

Royal Bank of Scotland Insurance is in the process of using Part VII transfers to consolidate Direct Line, Churchill, UK Insurance and The National Insurance and Guarantee Corporation into a single legal entity.

This is a significant and complex transaction and we are aware of numerous other Part VII transfer applications submitted to the FSA in recent times as groups seek to consolidate and create more efficient capital, regulatory and operational structures.

04 Solvent schemes of arrangement: UK

Following the successful appeal of Scottish Lion in 2010, the UK court sanctioned the Global General solvent scheme of arrangement in early 2011 in respect of both its insurance and reinsurance business. The bar date for Minster Insurance Company's solvent scheme of arrangement passed in September 2010 and this, the largest stand alone solvent scheme of arrangement to date, has since terminated successfully.

05 Focus on core business: Netherlands, Switzerland and Germany

A number of companies have divested their run-off operations in order to focus on core activities. Examples include Ageas Group, the successor company to Fortis Holding, which in mid 2011 announced the transfer of all of the run-off business of Intreinco NV, the former reinsurance captive of the Fortis Group, to Swiss Re. In the same month, Zurich Financial Services Group sold its UK run-off business, Zurich Specialties London, to Swiss Re in order to unlock capital and boost its position in its key markets.

Similarly, Hannover Re announced the sale of its US insurer in run-off, Clarendon Insurance Group, to the Bermuda-based legacy specialist Enstar Group. Late last year, DARAG embarked on plans to split its live business from its run-off business to allow the ongoing company to concentrate on its core activities.

06 Run-off acquisitions: Switzerland, Germany, France and UK

The European run-off market is now the focus of a number of specialist acquirers who have a continuing appetite for run-off acquisitions. Recent transactions include Catalina Holdings' acquisition of Glacier Re in early 2011. DARAG continued to expand its run-off book through its acquisition of a majority shareholding in Hamburger Versicherungs-Aktiengesellschaft followed by its acquisition of Quantum Insurance in Belgium, part of Liechtenstein-based Quantum Holdings. In early 2010, Randall and Quilter acquired La Licorne Compagnie de Reassurances, a French reinsurer in run-off, from Maaf Assurances.

Milestone Capital Partners' acquisition of a majority stake in the Scandanavian run-off specialist Compre Holdings was announced in 2010.

More recently, in July 2011 HSBC sold its UK motor insurance division, which ceased underwriting more than a year ago, to Syndicate Holding Corp, a business specialising in managing books of discontinued insurance business.

07 New initiatives: Malta

In October 2010, Grafton (Europe) Insurance Company, an insurance company based in Malta, accepted the transfer of liabilities in respect of legacy years from the Morrison Supermarkets captive, allowing the parent to release reserves and collateral obligations.

08 Restructuring: Netherlands

In the latter half of 2010, ING combined its remaining non-life run-off portfolios in the Netherlands into one already existing entity.

09 Consolidation of service providers: UK

The service provider market continued to consolidate with the acquisition by Randall & Quilter of Reinsurance Solutions.

10 Life run-off acquisitions: Switzerland and Guernsey

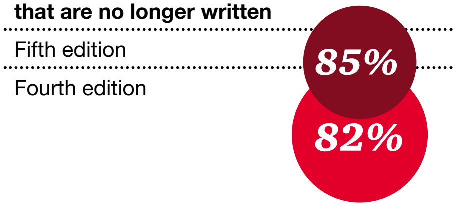
In June 2011, Swiss Re acquired UK life insurance policies from American Life Insurance. The policies will be managed by Admin Re, a Swiss Re subsidiary that specialises in buying life and health insurance businesses in run-off. In June 2010, Charles Taylor Consulting completed the acquisition of Guernsey registered Finistere Life Assurance from Carey Group.

Survey results

San Marco Square

Venice, Italy

Run-off is defined as lines of business that are no longer written



Management and structure

In comparison to last year's Survey, this year's results indicate small movements in the way in which respondents define run-off business.

How does your organisation define run-off business?

Some respondents identified more than one of the suggested definitions as being in use at their organisation. The responses reflect a continued concentration of the view that run-off business is most widely defined as lines of business that are no longer written. Some 85% of respondents took this view, a 3% increase from last year. 31% took the view that run-off business was defined as business which is with a party where there is no ongoing business relationship, a 4% increase on last year. 9% of respondents found that the definition of run-off used within their organisation did not fall into any of the suggested categories. They provided their own suggestions, with definitions that included non-core business. It is encouraging that no organisation responded with the answer 'don't know', indicating that a more consistent approach to defining run-off business has developed since the introduction of the Survey questionnaire in 2008.

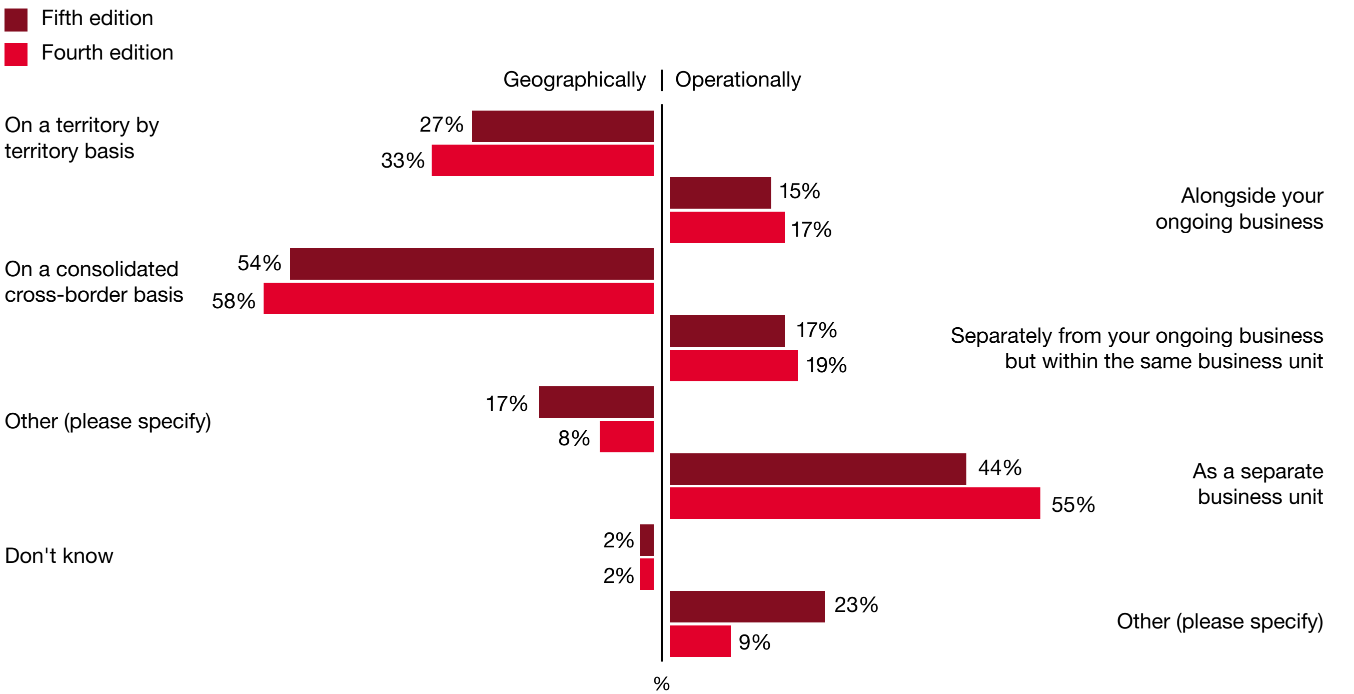
At what point in time does your organisation classify business as being in run-off?

The concentration of responses as to the question of the definition of run-off business contrasts with the spread of responses to the question on the point in time at which an organisation classifies business as being in run-off. 27% of respondents consider business as being in run-off at the date of expiry of the policy, and a further 27% from at least three years from when policies expire. However, 13% of respondents were unable to answer this question, with a further 33% of respondents suggesting alternative timings or criteria. A number of respondents took the view that the decision to classify business as being in run-off needs to be applied on a case by case basis. The responses to this question indicate that the definition of run-off business is not consistently applied in the context of both different businesses in the sector as well as within organisations.

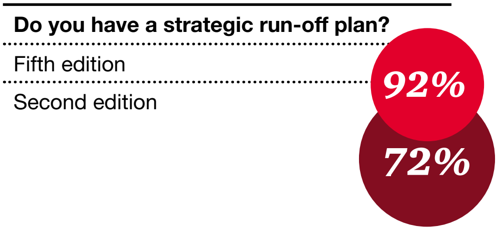
How is your organisation's run-off business managed?

The results of the Survey indicate that managing run-off as a separate business unit remains the most frequent response, with 44% of respondents selecting this answer. The proportion of respondents managing their run-off business alongside ongoing business or separately from ongoing business, remained relatively stable compared to last year. However, there was a significant increase in the percentage of respondents that suggested alternative ways of managing their run-off from an operational perspective. Of these, the majority represented businesses that are entirely in run-off.

Figure 2: Management of run-off business in Continental Europe



Source: PwC



Does your organisation have a strategic plan for dealing with its run-off business?

The results of the Survey clearly demonstrate a continuing trend towards a strategic plan being developed for run-off business, with the proportion of respondents having such a plan now at 92%. This suggests that even businesses where run-off is not a core part of their operations are recognising the importance of having such a plan.

There are also indications that the sophistication of these plans is increasing in line with the pressures on businesses to consider how run-off business fits in with their overall strategy. Companies are also aware of the need for flexibility towards changing circumstances that test even the best laid plans. As part of the PwC 14th Annual CEO Survey, 46% of respondents from the insurance sector reported that they had fundamentally changed their strategy over the last two years, with a further 44% making at least some modifications. This approach to strategic planning is significant when considered in the context of the sweeping changes arising from Solvency II, in particular Pillar II, as well as potentially Omnibus II which if adopted will result in modifications to how Solvency II will impact run-off businesses.

> ***"Exit strategy and run-off business management are new challenges"***
>
> Continental European risk carrier

Royal Route, Church of St Anne

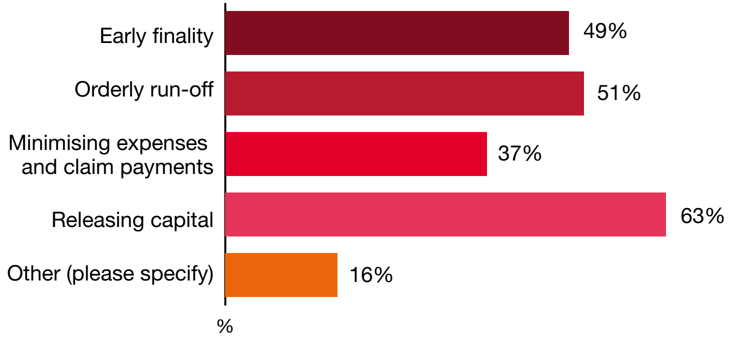
Warsaw, Poland

What are the objectives of your strategic run-off plan?

The Survey results confirm that capital is at the top of the agenda for managers of run-off business, with 63% confirming that releasing capital is a key objective within their strategic plans. 51% of respondents cite the achievement of an orderly run-off as a key objective of their strategic plans, lending weight to the argument that run-off managers are taking a structured approach to run-off business.

This may reflect a conservative approach by some towards the acceleration of finality. However, 49% have indicated that early finality is a key objective of their strategic plan, and 37% are focused on minimising expenses and claims payments. As one would expect, a high proportion of those that identified early finality as a key objective also indicated that releasing capital was an important part of their plan.

Figure 3: Key objectives of strategic run-off plans



Source: PwC

Key challenges, including claims activity

Top ranked challenges
1. Preparation for Solvency II
2. Access to exit mechanisms
3. Capital constraints

What are the major challenges facing Continental European (re)insurers with run-off business?

As in previous years, tied up capital continues to be a key theme for respondents to this latest edition of the Survey. However, this challenge is being brought into clearer focus through the demands of Solvency II. Survey respondents rated Solvency II, and its impact on capital, as the greatest challenge facing Continental European (re)insurers with run-off business. The second greatest challenge from respondents was access to exit mechanisms. We have explored this in more detail through additional questions on this area, and report on this on pages 30 and 31. In keeping with our previous Surveys, capital constraints were highly ranked, being the third greatest challenge according to our respondents.

What are the most important concerns influencing your ability to gain finality for run-off liabilities?

Given that finality is a key part of the strategic plans of a significant proportion of respondents, it is important to understand the issues impacting exit decisions. The findings of the Survey this year were consistent with previous years, in that long-tail claims are an important factor in influencing the ability of organisations to gain finality for run-off liabilities. This was considered a significantly more important issue in the UK than in Continental Europe, with 42% and 22% of responses respectively. These results reinforce the Insurance Banana Skins 2011 survey produced by PwC in conjunction with the Centre for the Study of Financial Innovation. This publication considers the risks facing the insurance industry and is completed by a wide variety of stakeholders. Respondents indicated that long-tail liabilities represented the seventh greatest risk to the industry. Reinsurer and Regulator respondents ranked this risk at number four and number five respectively.

Counterparty interest remains a concern impacting the ability to gain finality for Continental European run-off businesses. 23% of respondents viewed this as an issue for Continental European (re)insurers, whilst 14% believed this was an issue for UK (re)insurers.

The most likely exit route where counterparty interest might have been an issue relates to commutations. Indeed, over the last two years run-off commutation events have experienced declining attendances and some Survey respondents commented on the importance of the continuation of these market gatherings to facilitate counterparty engagement.

Reputational risk was a further area of concern with respect to gaining finality and highlighted material differences between Continental Europe and the UK. Only 2% of respondents considered this was an issue in the UK, compared to 21% who perceived this to be the case in Continental Europe. This suggests that there is still an issue in Continental Europe with respect to gaining finality, despite the fact that exit mechanisms, such as sufficient connection solvent schemes of arrangement, have been successfully implemented for numerous Continental European domiciled run-off books.

What is your organisation doing to overcome these concerns influencing your ability to gain finality for run-off liabilities?

There were a wide variety of responses to this question, reflecting the range of experience of Survey participants and the run-off management strategies being adopted. A number of participants suggested that their approach was to maintain a strategy of orderly run-off and proactive policyholder management, although it was not clear if this was aimed at attaining early finality. Others were more exit focused, and are employing strategies such as wholesale exits or the transfer of portfolios into one entity before embarking on a sale of business or solvent scheme of arrangement.

What do you think the major claims exposures from Continental European and UK (re)insurers will be over the next five years?

The Survey results suggest that there will be significant differences in the claims exposure experience over the next five years for Continental European (re)insurers compared to UK (re)insurers. Respondents consider that asbestos will be a more substantive issue for UK (re)insurers than those in Continental Europe, with 29% and 15% respectively. This result is perhaps not surprising given the long established prevalence of asbestos claims from the US impacting the London Market together with the more recent and continued emergence of asbestos claims from within the UK. It seems very likely that both US and UK asbestos claims will continue to impact run-off portfolios over the next five years and beyond. The situation for asbestos claims in most other Continental European countries is less well established. In particular, it is currently unclear in many jurisdictions whether any asbestos related claims that do emerge would be dealt with internally through that country's Government (possibly working with the major domestic insurers) or whether these claims would be of sufficient nature and size to become an issue for international (re)insurers.

29% of the UK and 16% of Continental European respondents highlighted claims exposures relating to pharmaceuticals to be a significant issue. An area where it is perceived that Continental European (re)insurers will be harder hit is in respect of climate related exposures, with some 34% of Continental European respondents compared to 23% of UK respondents quoting this phenomena. There is a clear difference between climate related claims relative to latent claim types in that a loss from say a hurricane is identified relatively quickly and losses incurred in one underwriting year can often be mitigated through the cyclical nature of the markets and the premium levels written in subsequent years. The impact of climate related claims on capital is therefore likely to be (i) known with more certainty and (ii) mitigated more quickly when considered relative to latent claims. The need for (re)insurers to demonstrate agility in reacting to future claims exposures is thrown into sharper focus when considered in the light of responses elsewhere in the Survey which indicate the ever increasing focus on efficient use of capital. What is clear from the range of responses to this question is that Continental European (re)insurers will continue to face claims from a range of different sources and that the ability to deal with these claims in a capital efficient manner will be key.

Where will these claims exposures emanate from?

The results of the Survey this year suggest that there is a changing perception as to where claims exposures will emanate from over the next five years. Whilst the proportion estimated to occur in the United States has remained stable at 45%, the percentage from Continental Europe is estimated to shrink from 33% to 21%. Conversely, the proportion emanating from the UK is now considered to be 17% compared to 8% last year. This revises the trend that was observed in the Survey last year.

This could reflect a reaction to the continued development of asbestos losses in the UK, compared to the relatively benign claims experience in Continental Europe.

> *"Most Continental European insurance companies continue to be reticent in overtly dealing with their legacy portfolios and those that do, tend not be very aggressive in trying to achieve finality"*
>
> UK risk carrier

Regulation and Solvency II

Unsurprisingly, the responses to this year's Survey underlined the insurance industry's preoccupation with the regulatory changes to be delivered through Solvency II's implementation. This is currently planned for 2013 although alternative proposals for a deferred start are being promoted by both the European Council and European Parliament and a 2014 implementation date now appears increasingly likely. As we have seen earlier, preparing for Solvency II is considered to be one of the major challenges facing Continental European (re)insurers with run-off business.

What are the practical implications of Solvency II for Continental European (re)insurers with regards to their run-off business?

PwC's European network is increasingly busy with a wide range of Solvency II projects from Gap Analyses to full Solvency II implementation assignments. We are still helping clients come to terms with the results of the QIS5 exercise run by CEIOPS and its impact on their businesses.

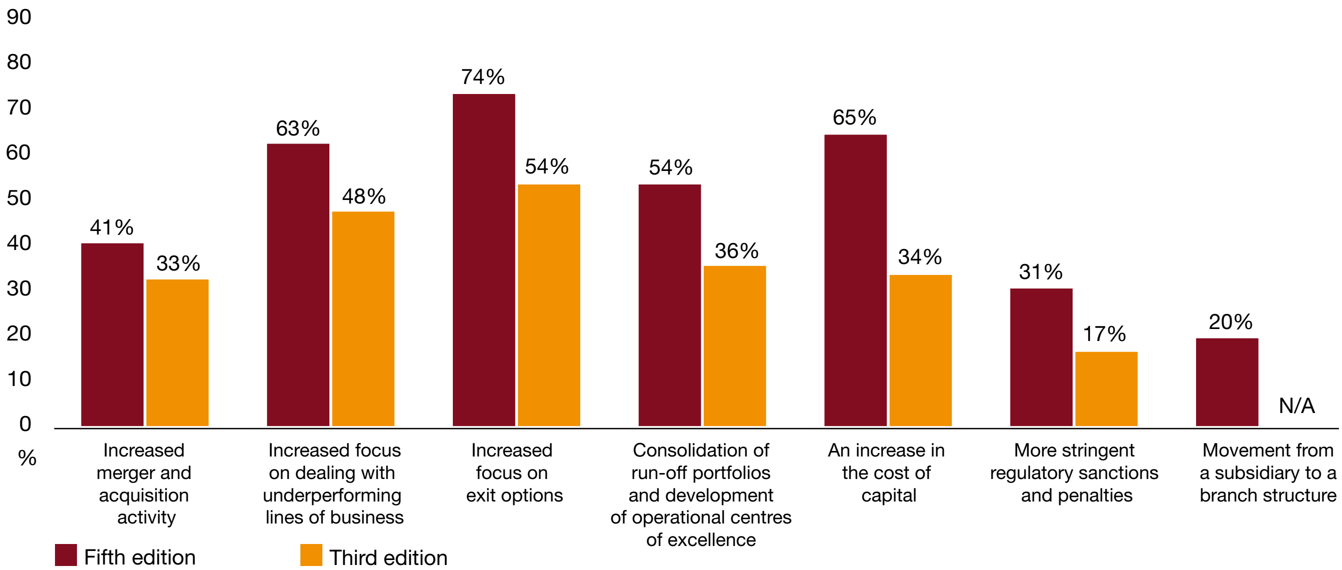
Compared to previous Surveys, there is an increasing feeling amongst Survey respondents that Solvency II will result in an increased focus on exit options for discontinued business. Indeed, 20% more respondents believe this will be the case than when the question was first posed in the third edition of this Survey. Perhaps unsurprisingly, similarly increasing numbers of respondents believe that there will be additional consolidation of run-off portfolios with groups developing centres of excellence for their run-off administration, as has already occurred in organisations such as Allianz and QBE. Respondents also appear to have a greater sense that Solvency II will drive an increase in the cost of capital – 65% of respondents compared to 34% in the third edition of this Survey took this view. This supports the finding of QIS5 which revealed an average reduction in insurers' capital surplus of 12% compared to the existing Solvency I framework.

Most capital intensive products under Solvency II
1. Pre 1990 APH
2. 2000 onward recent run-off classes
3. 1990s casualty business

Which insurance products do you think are likely to be considered the most capital intensive under Solvency II?

As we have seen in the section of this Survey considering challenges presented by run-off, many respondents still have issues with the traditional long-tail APH liabilities that are for some a hallmark of run-off. Respondents expect these types of liabilities to continue to be a capital strain going forward. Perhaps it is only once organisations have determined the size of the capital requirement that we will see live underwriting groups beginning to dispose of these types of liabilities or look to gain closure themselves. Certainly, significant direct and ceded APH business has previously been commuted and exited through solvent schemes of arrangement and so tried and tested exit options do exist. It is also clear from the Survey responses that (re)insurers are beginning to look critically at their more recent run-off liabilities. This is corroborated by what we have seen in the last 18 months in the UK, where solvent schemes of arrangement have been approved for Global General and Minster which featured liabilities from business written in the early 2000s and late 1990s.

Figure 4: Practical implications of Solvency II



Source: PwC

Will Solvency II result in your organisation exiting or acquiring lines of business?

Our Survey was consistent with the previous edition in that nearly two thirds of participants expect Solvency II to increase focus on underperforming lines of business. However, almost 70% of our respondents did not believe that their own organisations would exit lines of live or run-off business. Of the 15% of respondents who believed that their organisation would exit certain lines, specific mention was made of medical malpractice, credit and surety and employers' liability ("EL"). The latter has often been seen as a thorn in the side of companies looking to wind down operations, for example, in the UK EL is compulsory insurance and cannot be exited through a solvent scheme of arrangement. There are therefore many examples of run-off entities that have carved out EL business from solvent schemes of arrangement.

Some of our respondents cited EL business as an area of opportunity and predicted the emergence of niche players focused on assuming EL liabilities to provide a true exit for original risk carriers.

There is a clear expectation amongst Survey respondents that as Solvency II draws closer there will be a significant increase in merger and acquisition activity in the live market. PwC's own client and market experience supports this sentiment, but we remain of the opinion that the current focus amongst most businesses is on consolidation as part of in-house clean-up exercises of existing discontinued business. Anecdotal evidence suggests that management are postponing decisions around what will be the run-off business of tomorrow, and we believe that these decisions may still be 12 months away.

Some 43% of respondents believe that the introduction of Solvency II will result in their organisation acquiring certain lines of business. This appears to support both the principle of diversification in counterbalancing a potentially increased capital charge and also that run-off acquirers consider that Solvency II will present them with a significant opportunity to acquire portfolios. Respondents indicated a wide range of business lines that may become available for acquisition as businesses focus on separating non-core from core business. There was a general consensus that long-tail liability lines were the likeliest target areas.

Proportion of respondents who believe their organisation will exit or acquire lines of business as a result of Solvency II

Exit	15%
Acquire	43%

Update on Omnibus II

One potential welcome point of clarification on Solvency II for run-off entities came in June 2011 with an update to the draft Omnibus II Directive (subject to its adoption by the European Parliament and European Council – likely to be 1Q 2012). The update proposes the insertion of a new article in the Solvency II Directive so that an insurer wholly in run-off by 1 January 2014 will gain an exemption from Solvency II for three years. This is subject to the specific insurer's regulator being satisfied that the run-off will be completed within three years of Solvency II's implementation date and the insurer submitting annual progress reports to its regulator.

Trafalgar Square

London, UK

> *"Solvency II will provide transparency over true capital costs related to in-force business, run-off or not. Exits can thus be evaluated on a risk-adjusted basis"*
>
> A Continental European risk carrier

However, if a run-off entity is subject to reorganisation and winding up measures, the exemption for compliance extends to five years. It is important to note that the exemption may be revoked and Solvency II provisions applied if the regulator is not satisfied with the progress towards termination of the run-off. Furthermore, this potential exemption applies only to stand alone run-off entities and will not apply to groups that may have individual subsidiaries or portfolios in run-off. It will be interesting to see how these transitional measures will be applied and monitored by regulators.

How much longer on average do you expect your run-off business to take to reach natural expiry?

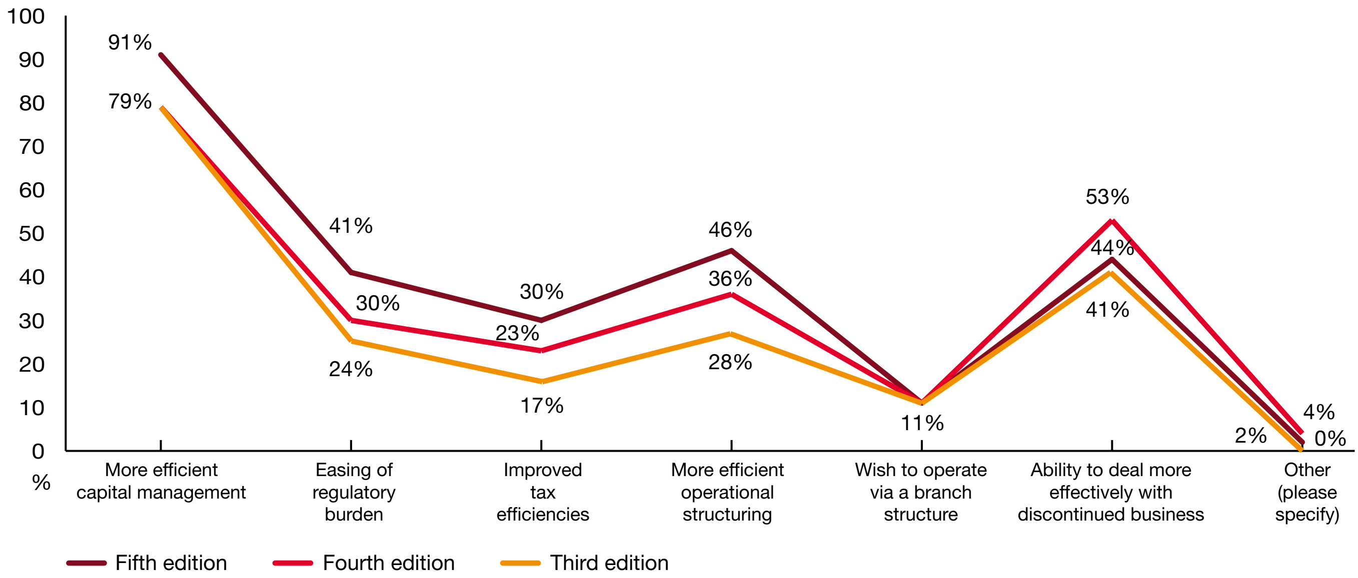
Over 75% of our Survey respondents believe that their run-off will take longer than six years to reach natural expiry. The proposed Omnibus II transitional measures might therefore result in the implementation of finality options that are key objectives of many of our respondents' strategic run-off plans. Certainly, the proposed measures appear to pose a threat to a long term passive approach to run-off, although the practical sanctions regulators may impose for non-compliance with these transitional measures remain unclear.

Restructuring and exit solutions

Which drivers do you believe will influence the restructuring activities of Continental European (re)insurance groups over the next five years?

In keeping with previous editions of the Survey we asked respondents to identify those drivers that they believe will influence restructuring activity over the next five years. As already highlighted, there was a very clear sign that efficient capital management is at the forefront of people's thinking with 91% of respondents selecting this driver compared to 79% in both of the last two Surveys. The ability to deal with discontinued business more effectively was a less popular choice than in the previous Survey with a shift towards more efficient operational structuring and a desire to ease the regulatory burden. While appreciating the focus on efficient capital management, the corresponding low response rate for wishing to operate a branch structure was perhaps surprising as branches are expected to be one of the most efficient capital structures, likely to yield capital benefits compared to operating a subsidiary structure.

Figure 5: Key drivers influencing restructuring activities



Source: PwC

How much insurance restructuring activity do you expect to take place in Continental Europe over the next three years, where will that activity take place and what types of organisation will be involved?

33% of the respondents to this Survey consider that the next three years will see a significant level of restructuring activity while a further 56% believe that the same period will see a reasonable level of restructuring activity. Germany and the UK were identified as the two territories that are expected to experience the greatest level of restructuring activity, followed by Switzerland.

Our respondents were also asked to identify which types of organisation were likely to experience the greatest level of restructuring and it was not surprising to see large global and midcap insurers and reinsurers being the most popular responses. It was interesting to note, however, that mutuals, captives and brokers all polled a significant number of responses. Clarity around the impact of Solvency II is a particular concern for owners of captive insurance companies and also mutual members, especially in France, where considerable consolidation of such organisations is predicted.

Our own experience also identifies regulatory issues for brokers in relation to client monies and living wills as potential drivers of restructuring activity.

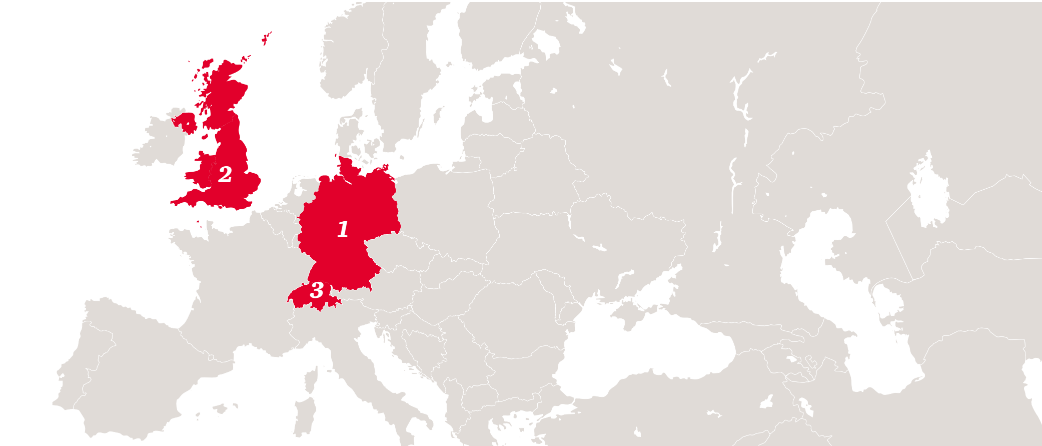
Has your organisation been involved in any restructuring activities in the Continental European run-off market?

Just over a quarter of respondents advised that they had not been involved in any restructuring activity. However, of the 72% that had been, mergers and acquisitions, entity consolidations and disposals were the three most popular activities identified. Some 45% of these activities involved a cross-border transfer.

"Not every market is ready with an organised strategy to deal with discontinued business"

Continental European consultant

Figure 6: Predicted areas of restructuring activities



Ranking

1. Germany
2. UK
3. Switzerland

Exit option activity

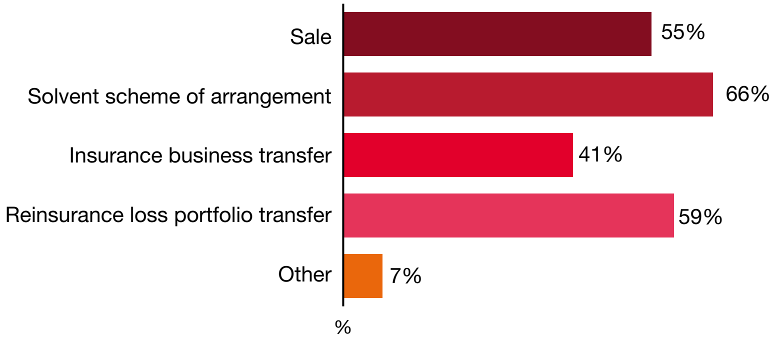
We asked Survey respondents to provide their views on a number of specific questions surrounding exit. 84% had considered using exit options. 66% had considered utilising a solvent scheme of arrangement, 59% a reinsurance or loss portfolio transfer, 55% a sale and 41% an insurance business transfer. This appears to highlight that (re)insurers consider an insurance business transfer to be more of a restructuring activity that facilitates organisational clean up than an exit option in its own right. Some 73% of Continental European respondents stated that they had considered a reinsurance or loss portfolio transfer compared with only 45% of their UK counterparts. This may suggest that Continental European (re)insurers do not believe that the full exit tool kit – including schemes of arrangement – is available. However, of those that had considered utilising a solvent scheme of arrangement, 43% indicated that this would be on the basis of sufficient connection to the UK. This is an increase on previous Surveys and it therefore appears that more non-UK territories are looking to utilise this exit mechanism.

Furthermore, where respondents had considered using a cross-border transfer only 12% indicated that it was a means to facilitate a solvent scheme of arrangement.

Our summary of events in run-off over the last 18 months on pages 14 and 15 indicates that there has been a steady flow of disposals. 50% of our respondents expect this to continue and predict that the next two years will see more than 10 run-off disposals, representing an increase of 17% on our last Survey.

> ***"It will be important to replace the commutation rendez-vous events in Norwich and Cologne if they are discontinued"***
>
> Continental European risk carrier

Figure 7: Exit options considered

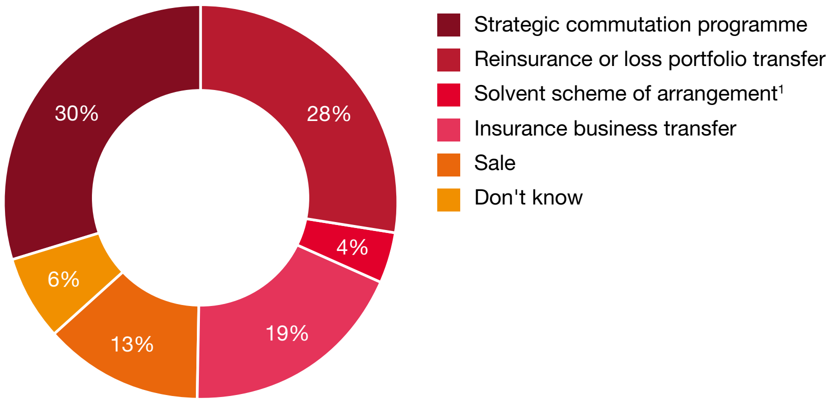


Source: PwC

Commutation remains the most commonly utilised tool for gaining exit. In line with our previous findings we noted that some 56% of respondents had completed up to 30 inwards commutations during the past year, and a further 33% had completed over 30 settlements. Commutation activity was also strong in respect of outwards business with some 74% of respondents having completed up to 30 ceded commutations, a slight decrease from the last Survey.

Respondents expect this trend to continue, with 30% of those surveyed predicting that a strategic commutation programme will be the most frequently utilised exit mechanism for run-off business in Continental Europe over the next three years. This represented a small decline from our previous Survey. Moving in the other direction, 28% favoured a reinsurance or loss portfolio transfer compared to 15% in the last edition of the Survey. We were surprised that responses in respect of solvent schemes of arrangement remained at a relatively low level, particularly after recent developments in the UK with the Global General and Minster solvent schemes of arrangement gaining sanction and proceeding smoothly towards closure. However, a number of respondents commented that they expect to see the emergence of opt-out solvent schemes of arrangement where policyholders are provided with the option not to participate in a proposed scheme.

Figure 8: Exit mechanisms used most frequently



Source: PwC

[1] Either through “sufficient connection” or following an insurance business transfer

Making a difference

We asked respondents to comment on what they consider will be the single most significant development in the run-off market over the next 12 months. A sample of the range of responses we received is shown here:

Solutions for UK EL exposures

An increase in activity in Continental Europe

Consolidation via Part VII

Broker run-off consolidation

Lloyd's syndicates identify their legacy issues

Failure of a major reinsurer

Opt-out facility within schemes

Major European insurers selling discontinued portfolios

Exit of non-core lines of business due to higher capital requirements under Solvency II

More new run-off coming up for sale

Emergence of asbestos issues on the Continent

Growth of motor liability claims

The PwC team

The Solutions for Discontinued Insurance Business team has access to more than 200 specialists focusing on providing restructuring and operational consulting services to companies in the insurance industry with run-off business. Issues being faced by operations around the world where the team is able to provide advice, support and assistance include:

- the requirement to release capital from run-off
- the need to bring finality to run-off and extinguish liabilities
- consideration of options such as sale or transfer of liabilities
- project managing complex insurance business transfers and securing key stakeholder buy-in
- the need to rationalise operations to achieve efficiency
- the need to proactively manage outsourced run-off, including the development of a robust outsourcing contract
- the need to benchmark the claims and reinsurance functions to assess their effectiveness

To find out more, please contact any of the team or visit our website:

www.pwc.co.uk/discontinuedinsurance

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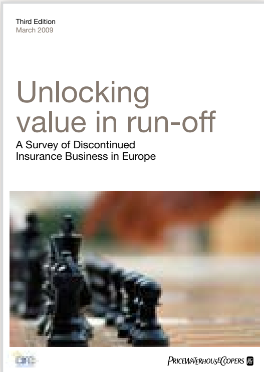

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