

Unlocking value in run-off

*A Survey of Discontinued
Insurance Business in
Europe*

*Sixth edition
January 2013*



Foreword



Throughout 2012, we were expecting to finish the year with just another twelve months to go until the implementation of Solvency II. However, as is widely known, this date is now looking likely to be January 2016. Regardless of this further delay, Solvency II has been and will continue to be much talked about across the legacy sector and has once again featured prominently in the Survey.

All of us who work in the legacy sector understand the benefits arising from tight capital efficiencies on run-off liabilities, whether they are gained by commuting with poor performing reinsurers, getting to grips with static claims or ensuring all premiums have been promptly collected. Some legacy experts believe that there will be an increase in opportunities arising from actively underwriting companies, once they appreciate the capital strain of carrying legacy liabilities. This view is supported by an increased number of respondents in this edition of the Survey.

These respondents believe there will be a healthy amount of disposal activity by insurers and reinsurers, specifically those in Continental Europe. They hold the view that the large global players have got their houses in order with regard to Solvency II preparation and compliance, but many of the mid-size insurers and reinsurers have yet to fully appreciate the potential impact of a reorganisation or a disposal of legacy liabilities on their capital requirements.

Acknowledgement of the need to address legacy portfolios is increasing across Continental European companies and is reflected in the increased membership of the association of which I am Chairman. Previously called the Association of Run-Off Companies, earlier this year we refocused our service offering and relaunched as the Insurance & Reinsurance Legacy Association ('IRLA'). Since then we have also welcomed new members from the live market who are benefitting from the specialist educational and networking opportunities that IRLA provides.

Paul Corver

Chairman, Insurance & Reinsurance Legacy Association

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Introduction



Welcome to the sixth edition of the PwC Survey of Discontinued Insurance Business in Europe which we are delighted to present in conjunction with the IRLA.

The past year or so has seen a number of developments in the discontinued business sector and the results of our 2012 Survey reinforce that there will be no slowing down in activity as owners of legacy business consider some form of exit, undertake restructurings and continue preparations for Solvency II's long awaited implementation.

The Survey results indicate that Solvency II continues to provide challenges for insurance companies. Recent events suggest that Solvency II's implementation will be delayed from January 2014 until January 2016.

Although only one major issue remains unresolved in relation to long term guarantees for life insurance firms, the decision has been made to delay the whole implementation rather than adopt a piecemeal approach.

While it is difficult to predict how insurers will react to the further delay we believe that two opposing approaches are likely, namely to:

- 'Get over the line as soon as possible' – maintaining the momentum of current Solvency II initiatives being undertaken; or
- 'Take the time to get it right' – extending Solvency II programmes over a longer timeframe and involving more resource in the preparation process.

For pure run-off operations and other potentially affected entities such as captives, the delay may provide welcome breathing space to determine their Solvency II approach as feedback to date suggests that many of these entities have not been fully engaged in the process. This may be due in some part to a general lack of clarity in the proposed Directive.

I was fortunate to be asked to chair a Solvency II run-off panel at an IRLA Academy event last year and it was fascinating to hear the views of different stakeholders as to what Solvency II will mean for either stand alone run-off entities or ongoing operations with legacy portfolios.

Our Survey results were consistent in the view that Solvency II when implemented will generate an increase in exit activity. Indeed, we have had more conversations over the past year with providers of new capital looking to acquire run-off business than for some time.

To date the industry has continued to weather the threats posed by the Eurozone crisis. While the rating agencies have downgraded a number of insurance entities, we have yet to see any notable financial casualties in the sector as a result of the turmoil. Regrettably, it seems to me more likely than not that over the next year we will begin to see some failures in the worst hit Euro regions.

On the theme of innovation, I am delighted that the PwC team was again at the forefront when we advised on the first contingent

solvent scheme of arrangement for the Ecclesiastical group's subsidiary, Ansvar New Zealand. Towards the end of 2011, following the devastating Canterbury earthquakes, we were asked to provide advice in relation to solutions that best met the many and varied stakeholder concerns and objectives, whilst also recognising and addressing the difficult circumstances. Our solution was a contingent scheme which ensured the disruption and cost of an insolvency would be avoided if the company's liabilities ever exceeded its assets, whilst also ensuring that all insureds were treated fairly.

Despite the many challenges, creditors voted almost unanimously in favour of the scheme, which was sanctioned by the New Zealand High Court in June 2012.

We are continuing to see healthy interest in solvent schemes both in respect of insurance and noninsurance liabilities. We are also seeing schemes being used in an increasingly innovative way to restructure portfolios of legacy business and there should be some interesting developments on this front over the next year.

It has been a pleasure to bring the Survey to you again this year and, as always, we are very grateful to those who took the time to participate.

Throughout the document we have highlighted some views on what our respondents think will be the most significant developments in run-off over the next 12 months. I think that these make fascinating reading and suggest we are in for an interesting year ahead.

Dan Schwarzmann

Partner, PwC

Major market events

Throughout 2012 we saw some significant events in the run-off market. We briefly take a look at some of these here. Also, whilst Solvency II is clearly a key issue, it is still unclear as to when its full implementation will begin. The latest feedback suggests that implementation will be delayed until January 2016.

December 2011

AM Best downgraded a number of European reinsurers as a result of continued negative developments in the Eurozone sovereign debt crisis.

January 2012

February 2012

On 9 February Darag acquired IngoNord Insurance Company in Finland, adding to the acquisition of the insurance business of Garant Versicherungs in Austria back in September 2011.

A Tawa led consortium, including Skuld and Paraline, announced the completion of the acquisition of Whittington Insurance. This adds to other acquisitions in the legacy market for Tawa, including the acquisition of Hamburger Ruckversicherung ('HIR'), the holding company of Chilton International. HIR has since acquired certain run-off reinsurance contracts from SV Sparkassen Versicherung Holding AG.

March 2012

The RSA Group announced its proposal to simplify its UK structure (which contains over 20 regulated insurance entities) into five UK based insurance companies.

R&Q acquired the Guernsey based run-off captive Northern Foods Insurance Limited.

The UK Supreme Court handed down judgment in relation to the Employers' Liability 'Trigger Litigation' which provided clarity on an issue which had delayed the settlement of thousands of mesothelioma claims. The ruling means that negligent exposure of an employee to asbestos during a policy period is sufficient to trigger the insurer's obligation to indemnify the employer. Whilst it will not impact the quantum of claims, the amount payable by particular insurers will be affected by the ruling.

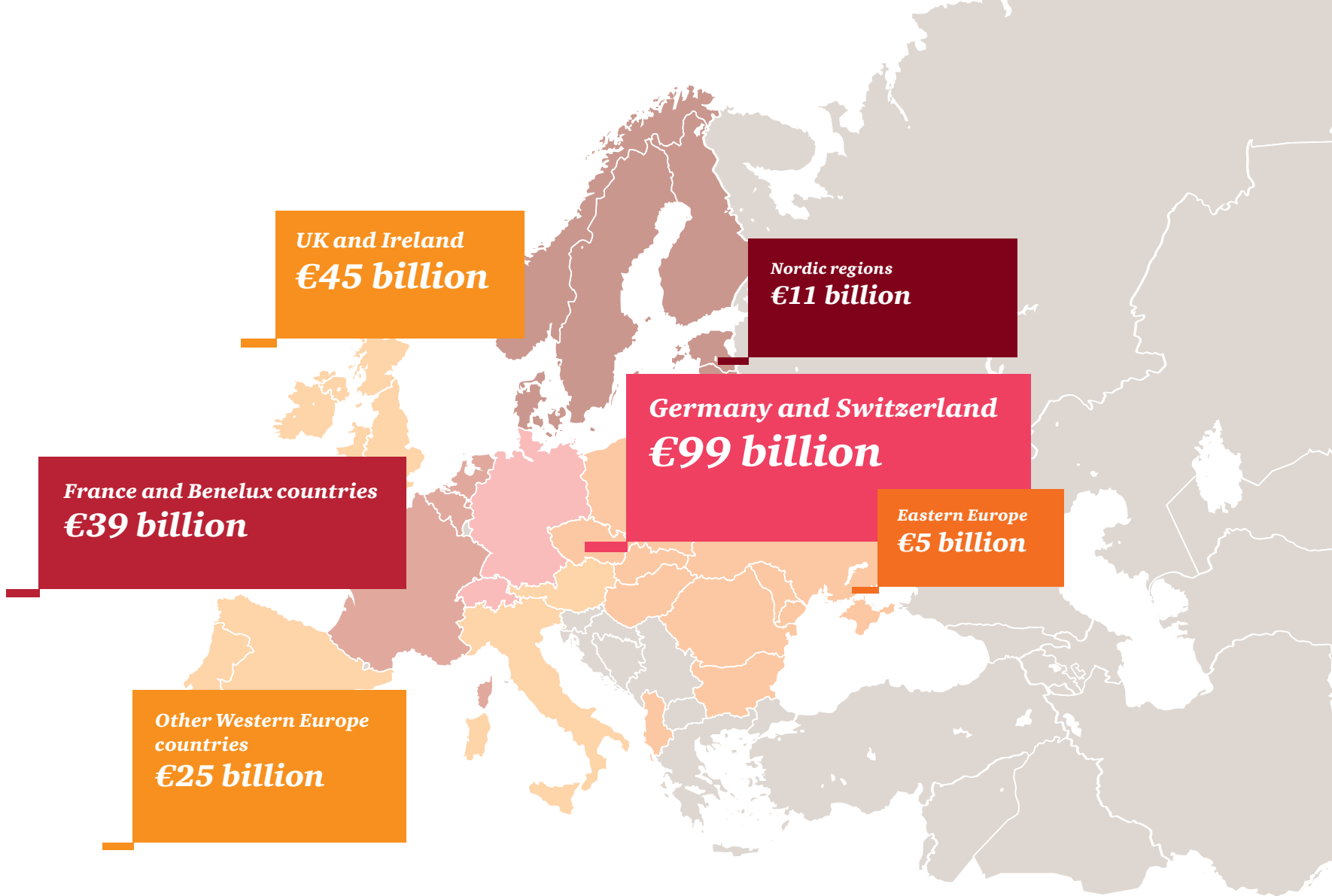
<p>June 2012</p> <p>Subject to regulatory approval, Riverstone Holdings Ltd acquired the majority of Brit Insurance Ltd's in-force policies.</p>	<p>July 2012</p> <p>American Life Insurance Company's UK branch proposed a number of Part VII transfers ahead of closing the branch. Certain policies are being transferred to ReAssure and the remainder to Metlife group entities. The transfers became effective in the second half of 2012.</p>	<p>September 2012</p>	<p>October 2012</p>	<p>November/ December 2012</p>
<p>A significant restructuring took place in New Zealand where the first contingent scheme became effective. PwC advised Ansvar (part of the Ecclesiastical group) on the successful restructuring.</p> <p>Enstar acquired via a portfolio loss transfer, a book of reinsurance and professional disability business from the Danish branch of Zurich Insurance Company Limited.</p>	<p>Following the reorganisation reported in the last Survey whereby ING completed a consolidation of all its non-life portfolios in the Netherlands, ING concluded the next stage of their restructuring plan. This involved the successful transfer of the registration of the consolidated run-off entity from the Netherlands to the UK. PwC advised on this transaction which was the first of its kind in the European discontinued insurance market.</p> <p>Subject to regulatory approval, Catalina acquired two legacy businesses; HSBC Reinsurance Ltd and HSBC Insurance (Ireland) Ltd.</p>	<p>Following a business review Tawa announced a sale process for its business and also disposed of KX Re and OX Re to Catalina. This is in line with its earlier stated intentions to reduce the volatility of the portfolios that it owns.</p>	<p>Armour Group announced, subject to regulatory approvals, its acquisition of the run-off business of One Beacon Insurance Group in the US involving gross reserves of US \$2.2 billion.</p>	<p>R&Q and Compre announced respectively the acquisitions of Alma Insurance Co Ltd in Finland and the insurance and reinsurance run-off businesses of Sparebank 1 Gruppen AS in Norway.</p> <p>Zurich Insurance Group announced its transfer of the Eagle Star run-off to Riverstone Insurance (UK).</p>

Market size

Our estimates continue to illustrate that the market for discontinued insurance liabilities in Europe exceeds €220 billion and this has grown significantly since our 2008 Survey. The responses to the Survey and feedback from market participants continue to indicate that the market will grow further. This is expected to be driven principally by two factors. Firstly, as a result of the preparations organisations are making for Solvency II, for example through discontinuing lines of business, to improve capital and operational efficiencies. Secondly, and most likely in part also driven by Solvency II, an increasingly transparent approach to the classification of what constitutes run-off or legacy business. Survey respondents anticipate that the greatest amount of restructuring activity will take place in the UK, Germany and France.

The most significant development in the run-off market over the next 12 months will be:

“Starting of a shake out of risk carriers in defaulting European Countries”



Source: PwC

Key findings

Key finding

‘Finality’ replaced ‘capital release’ as the most frequently cited key objective in the strategic plans of European run-off businesses.

Our view

A greater appreciation of the potential impact of Solvency II may explain the increased desire for finality. Respondents perhaps recognise that long term run-off is not an economic option for some books of business. However, whilst finality is high on the radar for run-off businesses, the number of exits may have been limited by businesses postponing major decisions in these times of economic uncertainty.

Respondents predict that midcap insurers and reinsurers, as well as captives, will see the most restructuring activity over 2013-2015, leapfrogging large global insurers and reinsurers.

A number of large UK and Continental European entities have now effected restructurings which consolidate and rationalise their (re)insurance entities. It is anticipated that the next few years will see a spike in the number of restructurings undertaken by midcap (re)insurance entities as they begin to implement their strategic plans. These restructurings will take a number of forms, and it is likely that a significant proportion will involve the transfer of portfolios of business rather than the disposal of entire entities.

Disposal was the most commonly identified exit option considered by respondents, with 62% of Continental European (re)insurers having assessed that option.

Disposal has overtaken solvent schemes as the most frequently considered option. There is clearly still a substantial appetite for transactions from both a seller and an acquirer perspective, with a number of consolidators being active in this market and new investors looking carefully at the returns available. It is possible that over the short to medium term we will see a change in dynamics in this space, with a secondary market emerging in the re-sale of run-off portfolios.

Key finding

In the third edition of the Survey in 2009, 34% of respondents predicted that Solvency II would increase their cost of capital. In 2012, 71% of respondents anticipated such an impact.

There is recognition that Continental European (re)insurers are increasingly facing challenges associated with operational costs.

Our view

Solvency II remains a clear area of sensitivity for the insurance industry as a whole. There is continued uncertainty as to the precise impact of the new regulations on run-off as well as ambiguity in respect of the timing of its implementation. What is clear is that in anticipation of Solvency II organisations have started to focus on the business they want to retain and/or exit. We expect that there will be an increase in the volume of exits of under-performing or capital intensive lines of business.

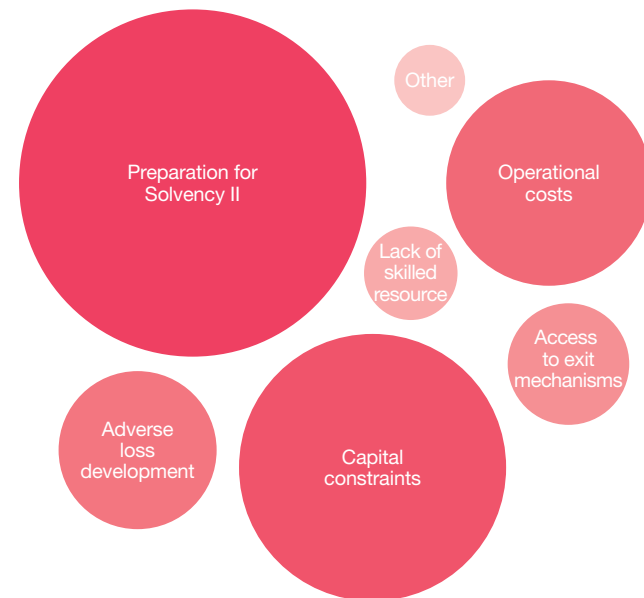
Whilst the (re)insurance industry appears to have so far coped well with the demands that the Eurozone crisis has placed upon it, strains are beginning to show. There are clear signs that in times of lower investment returns, (re)insurance organisations are having to focus more closely on managing costs, and ensuring that operations are as lean and effective as possible.

Survey results

Challenges and strategy

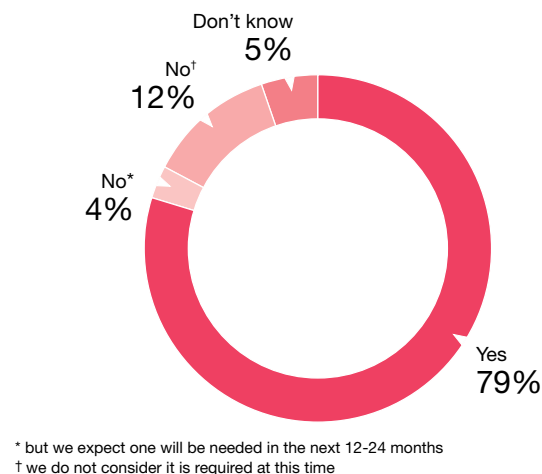
The results of the Survey in 2012 indicated that Solvency II and capital constraints remained high on the agenda for Continental European (re)insurers, echoing the results from 2011's Survey, where these options were the first and third most popular responses respectively. A distinct change in 2012 however was the increased focus on operational costs as being a significant challenge; this was identified as the third greatest issue facing run-off businesses overall. This is supported by the results of the PwC 2012 Global CEO Survey which indicates that cost control is an imperative issue for the insurance industry generally, with 64% of respondents confirming that they intend to commence a cost reduction initiative over the next 12 months.

Figure 1 What are the major challenges facing Continental European (re)insurers with run-off business?



Source: PwC

Figure 2 Does your organisation or client have a strategic plan for dealing with its run-off business?



Source: PwC

The Survey responses demonstrated a slightly surprising movement from previous years, where there had been a growing trend towards a consensus view that organisations have strategic plans in place for dealing with run-off (92% in the fifth edition). In 2012, however, only 79% of participants indicated that this was the case, with a further 16% highlighting that their organisation did not have any such plans. This may indicate that organisations are starting to classify more business as being in run-off than before, rather than less focus in the area of strategic planning. Anecdotal feedback supports this, with some taking the perspective that organisations are starting to look at liabilities as legacy business

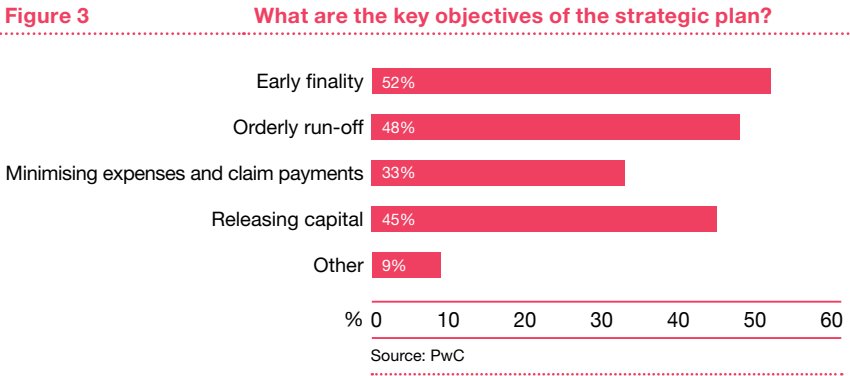
almost from the point that business is written. We are also aware of initiatives to align underwriters more closely with specialist in-house run-off units, so as to generate value from legacy business that may otherwise be lost. Whilst some of the older run-off issues such as asbestos remain and are the subject of well formulated strategic plans, developing plans for more recent run-off business is an area we would expect organisations to become more focused on.

The most significant development in the run-off market over the next 12 months will be:

“The large European companies have adopted strategies for run-off but there are very many smaller companies that have not”

The 2011 Survey indicated that the most common objective within strategic plans was releasing capital, with 63% of respondents identifying this as their key strategic objective. Perhaps surprisingly this objective was significantly less popular in 2012, with 45% of respondents taking this view. The leading key objective in the 2012 Survey, as identified by 52% of respondents, was early finality. This suggests that there may have been a subtle change in the strategic direction of organisations, with a greater emphasis on the end goal of exit. The second most frequently identified key objective was that of conducting an orderly run-off, with 48% of all respondents citing this response. This was of particular importance to Continental European respondents, with 58% taking this view, and this represents an upward trend from 2011's Survey where only 43% of such respondents were of this view.

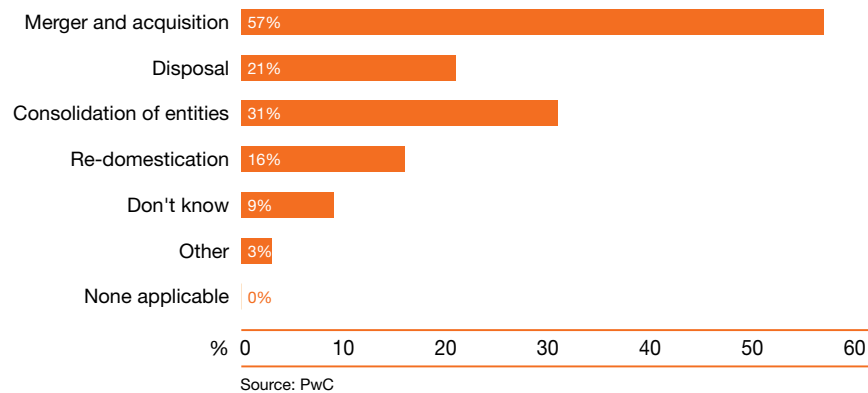
This suggests that whilst the (re)insurance industry as a whole appears so far to have weathered the economic storm created by the Eurozone crisis, managers of run-off are concentrating on minimising risk through sound operational processes. The pressures of the crisis could also be impacting decisions as to when and how to exit. Whilst this appears to be accelerating the evaluation process, as supported in the Survey by the number of respondents considering various exit options, entities appear to be postponing the implementation of their determined strategies while general market uncertainties continue.



Survey results

Restructuring

Figure 4 Has, or do you anticipate, your organisation or client being involved in any of the following activities in the Continental European run-off market?



The most significant development in the run-off market over the next 12 months will be:

“More sale and purchase transactions in Europe”

We asked Survey respondents about whether their own business had considered restructuring options. The responses suggest that UK based businesses have been or anticipate being more heavily involved in acquisitions (Continental Europe: 52%, UK: 63%), whereas Continental European respondents appear to be more focused on disposals (Continental Europe: 23% UK:19%). It will be interesting to see if this leads to a growth in Continental European based disposals to UK controlled entities and we have seen some signs of this over the past 12 months from UK consolidators. The results of the PwC 2012 Global CEO Survey suggest that, compared to other industries, insurance is less likely to initiate cross-border merger and acquisition activity, with 15% of insurance sector respondents taking this view compared to 28% across all industries. It appears from our Survey that the niche run-off market is

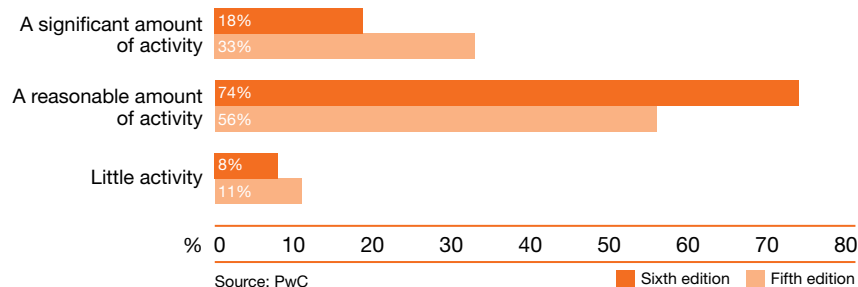
perhaps more active in the mergers and acquisition space than the insurance market as a whole, and this could be a result of the clear innovation and release of value seen in this sector over the last decade.

A further area of difference was in respect of re-domestication, with 19% of Continental European compared to 11% of UK based respondents considering this activity. However, it is not clear whether this re-domestication will remain within Europe or go beyond its borders. This may be driven by organisations perceiving that being headquartered in alternative territories with different tax, legal or regulatory environments has significant benefits. The current general sensitivity to tax compliance and payment may also be an influencer.

Areas where restructuring activity is expected to be greatest over the next three years:

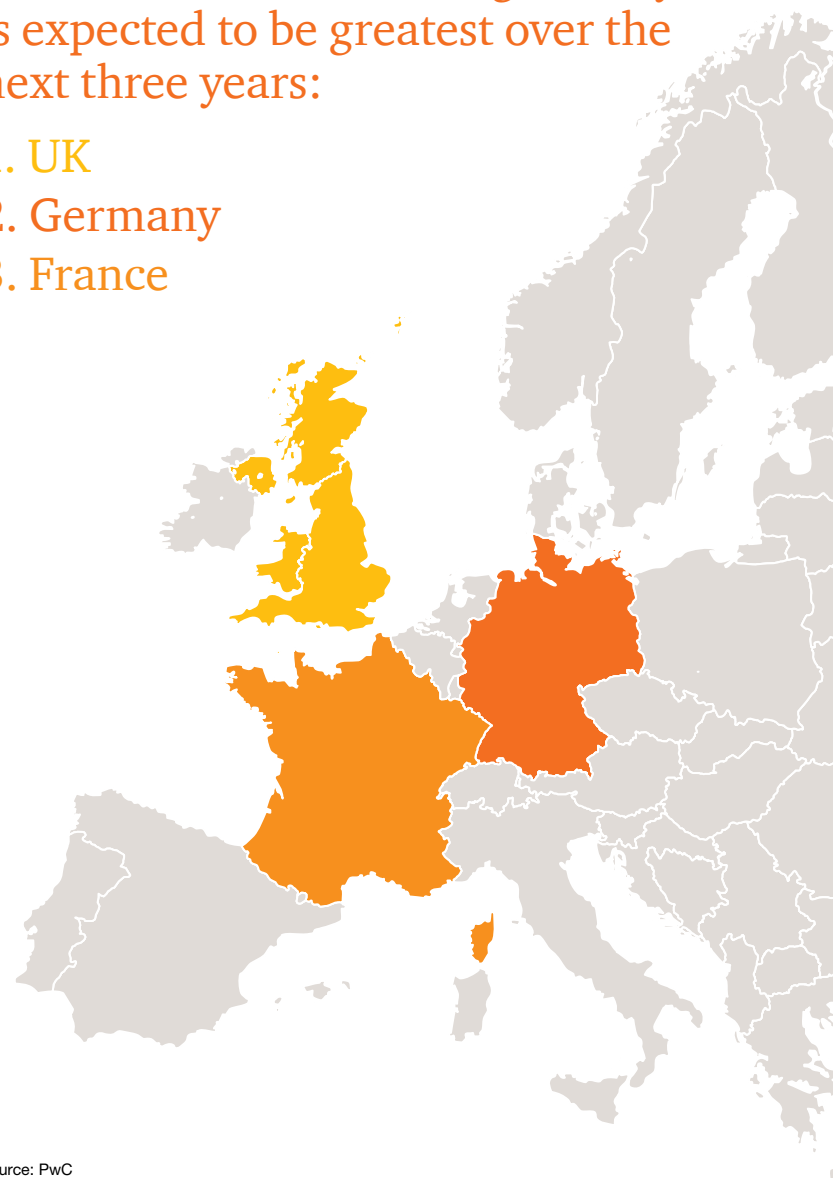
1. UK
2. Germany
3. France

Figure 5 How much insurance restructuring activity do you expect to take place in Continental Europe over the next three years?



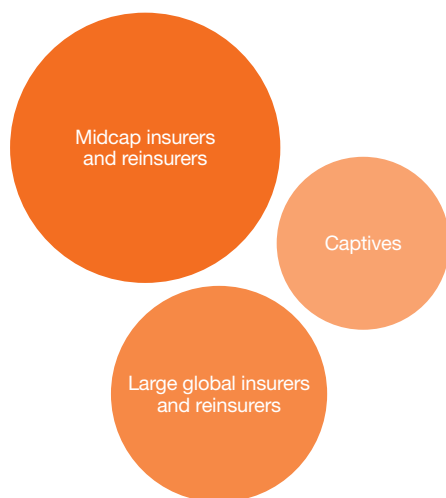
92% of respondents consider that 2013-2015 will see either a significant or reasonable amount of restructuring activity, consistent with previous results of this Survey. Innovations in restructuring, such as the ING central run-off vehicle which was re-registered from the Netherlands to the UK, suggest that this could be an area of continued growth.

The results of the Survey in 2011 indicated that the UK, Germany and Switzerland were the three territories where there would be the greatest amount of restructuring. In 2012, France replaced Switzerland as the third country where respondents consider most restructuring will take place.



Source: PwC

Figure 6 Which types of organisation are most likely to experience the most restructuring activity?

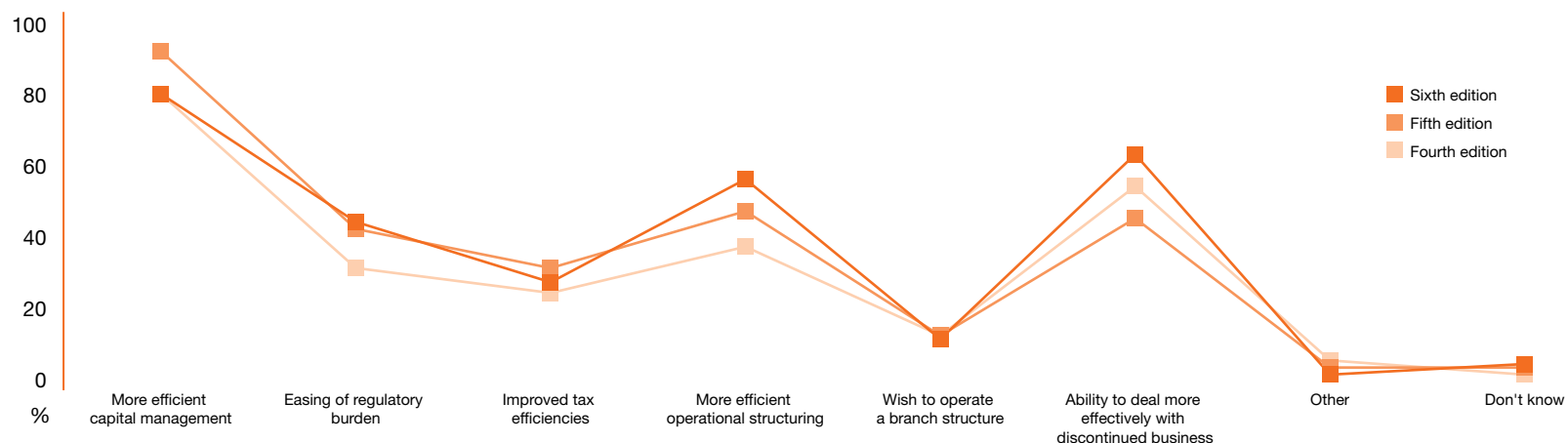


Source: PwC

The Survey in 2011 indicated that large global insurers and reinsurers would be those where restructuring activity was most likely to take place, followed by midcap insurers and reinsurers. Interestingly, this trend has been reversed in 2012's Survey. The Survey results suggest that many of the very large European groups have either completed or are well advanced with restructuring initiatives, especially driven by Solvency II, and the restructurings undertaken by Swiss Re and Aviva are good examples of this. Our own experience also highlights more activity amongst our midcap clients who are focussing to a greater extent on the benefits of restructuring, whether for capital or operational reasons.

Captives polled as the third most likely type of business to experience restructuring activity. We have seen a number of disposals of captives by corporates to specialist acquirers since 2011's Survey, while others have looked to derive greater benefits from existing captive structures. Corporates have also investigated the opportunities presented by proposed tax changes to enhance existing captive operations, or set up new captives. As with the run-off market, Solvency II still represents something of a great unknown to European Economic Area based captives and we believe there will be continued captive restructuring activity for some time to come.

Figure 7 Which drivers will influence the restructuring activities of Continental European (re)insurance groups over the next 5 years?



Source: PwC

Whilst Survey respondents consider that more efficient capital management will remain the most important factor influencing restructuring activity over the next five years for Continental European (re)insurance groups, the percentage of respondents taking that view has dropped from 91% in 2011 to 79% in 2012.

As previously mentioned, this could be as a result of the belief that many of the larger groups have already embarked on some restructuring activity. Following efficient capital management is the ability to deal more effectively with discontinued business, with 62% citing this response, whilst 55% selected the objective of achieving more efficient operational structuring.

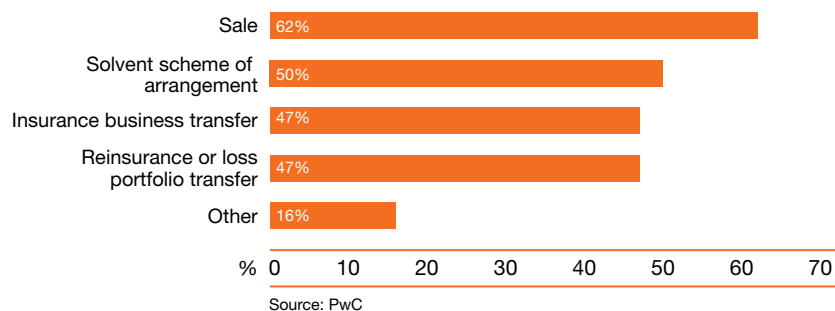
The most significant development in the run-off market over the next 12 months will be:

“Continued opening up of the German Market”

Survey results

Exit

Figure 8 If your organisation or client has considered exit, which options have been considered?



The most significant development in the run-off market over the next 12 months will be:

“Buy to kill. Legacy acquirers buy an entity, sell renewal rights and run off the legacy”

Over the last five years of this Survey we have seen that consideration of the most appropriate exit option is a critical area for owners of discontinued insurance business. Factors such as reputation, speed of exit and maximising value are all influencers when run-off owners consider the exit routes most suited to their strategic plans. Figure 8 highlights those exit options that our Survey respondents have considered for their run-off business and illustrates that sale has overtaken solvent scheme of arrangement as the most frequently considered option. In part, this probably reflects the focus by the investor community in this area and the good market press currently being achieved. However, a number of respondents expected developments in schemes, and in particular opt-out schemes, to provoke further interest in this route to an exit.

Significant numbers of respondents also considered insurance business transfers as an exit route. In particular, this option had been evaluated by two thirds of Continental European respondents this year compared to only 17% in the previous Survey. This may well reflect the fact that a significant proportion of run-off liabilities in Continental Europe are discrete portfolios housed within live ongoing operations rather than being stand alone run-off entities that are more suited to a share sale transaction.

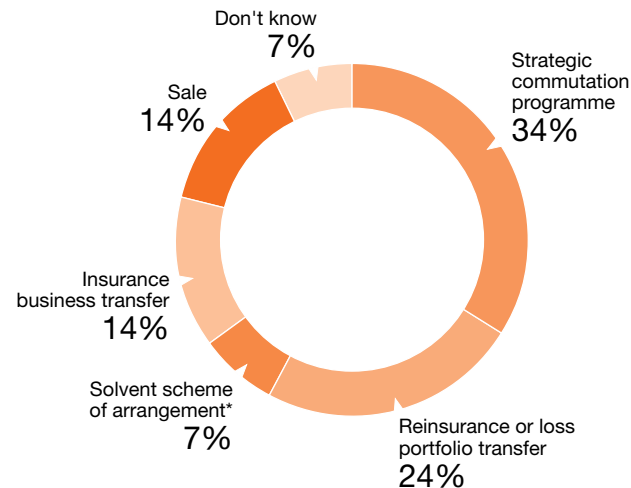
We asked respondents which exit mechanism they believe will be utilised most frequently by Continental European run-off business over the next three years. Consistent with previous editions of this Survey a strategic commutation programme is expected to be most widely used. As we have seen, whilst respondents are clearly giving careful consideration to more wholesale managed exits such as sales, solvent schemes and insurance business transfers, it is apparent that the piecemeal approach of commuting

discontinued liabilities is expected to remain prevalent for some time to come. A number of respondents, when considering the future for run-off, noted that commutations would eventually lead to a more structured solution for bringing finality to a whole book of business. As figure 9 shows, the overall expectations on the most frequently used exit mechanisms has remained broadly consistent with the results of last year. The popularity of solvent schemes as an exit mechanism has increased overall, with more

Continental Europeans selecting this mechanism. This suggests a growing recognition of the potential application of solvent schemes to business domiciled outside of the UK. A number of respondents also expect opt-out schemes to make a long expected appearance in the run-off market in 2013. The introduction of an opt-out provision in the traditional solvent scheme of arrangement provides creditors with the opportunity to retain their insurance coverage that would otherwise be crystallised under the scheme. Creditors wishing

to opt-out would likely do so after the scheme has become effective and prior to the bar date, thereby retaining their rights and benefits under the original policy. Opt-out provisions provide further evidence of the flexibility and evolution of the solvent scheme of arrangement technique.

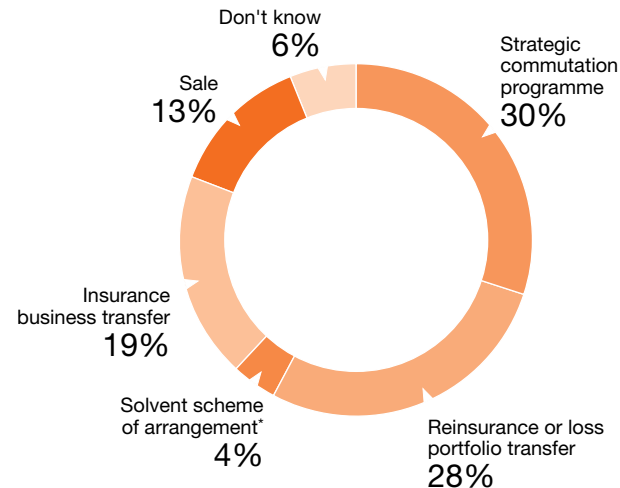
Figure 9 Which exit mechanism will be the most frequently used in relation to run-off business in Continental Europe over the next three years?
a) Sixth edition



*(Either through 'sufficient connection' or following an insurance business transfer)

Source: PwC

b) Fifth edition



*(Either through 'sufficient connection' or following an insurance business transfer)

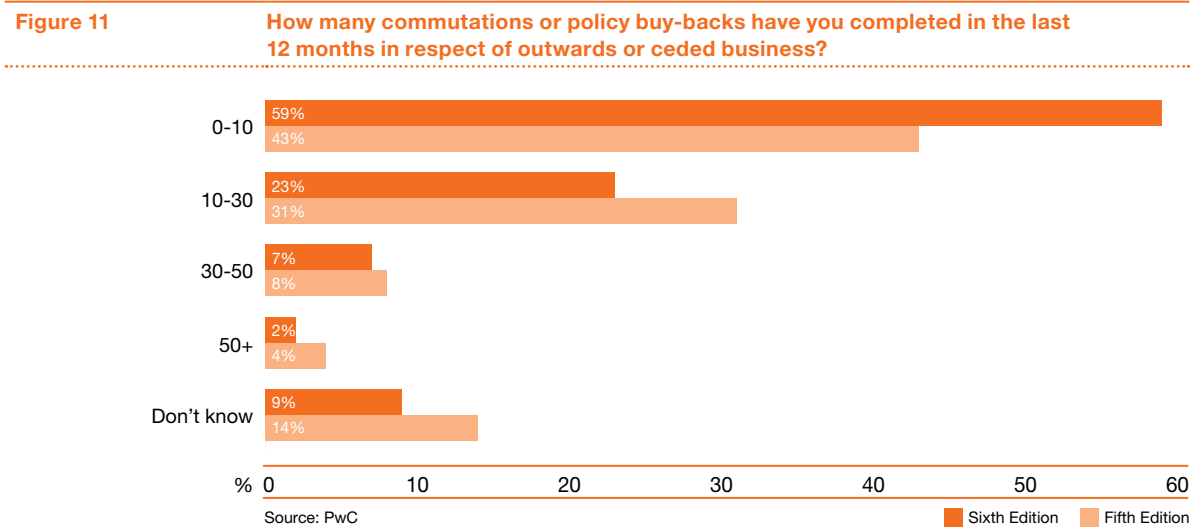
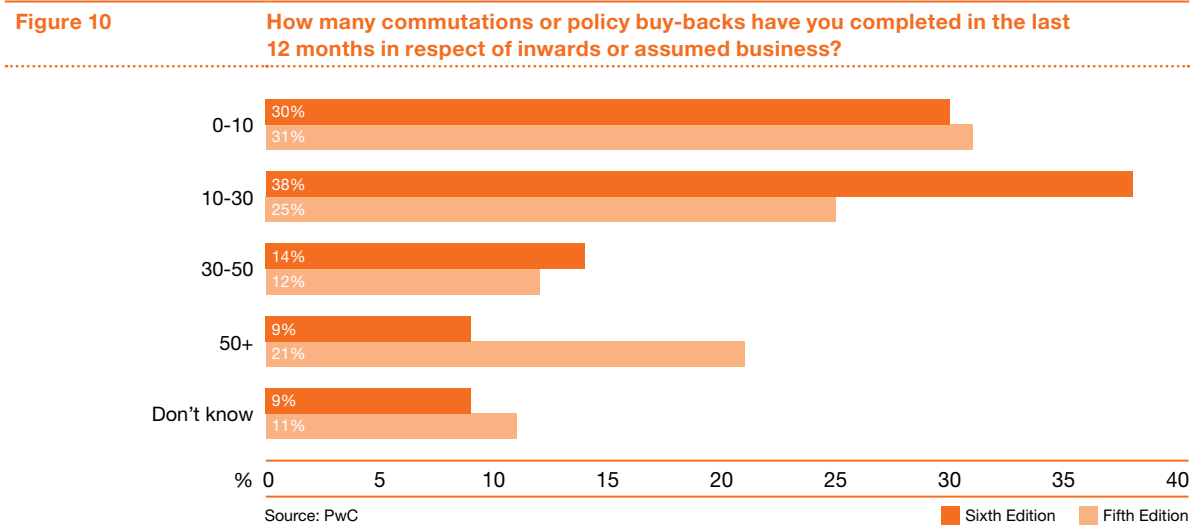
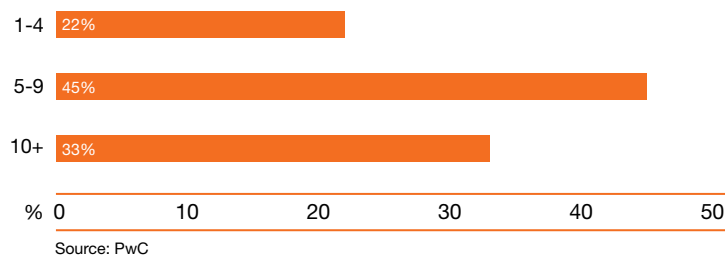


Figure 10 indicates that commutation activity amongst respondents was relatively stable over the course of the past year. However, it is noticeable that there was an increase of 13% in those that had completed 10 to 30 commutations. In previous years some respondents had identified a wish to retain commutation rendez-vous events and 2012 saw the inaugural Munich Rendez-Vous that attracted some 150 delegates and the IRLA Congress held in Brighton.

Figure 11 illustrates that the number of respondents conducting 0 to 10 outwards commutations in the past 12 months has increased from 43% in the 2011 Survey to 59% in 2012. In other words, fewer outward commutations were being conducted by respondents. This may reflect the identification in Continental Europe of more recent lines of run-off business where reinsurance protection is being preserved while strategic options for the assumed run-off liabilities are formulated.

In Continental Europe, insurance business transfers do not allow attaching reinsurance to be automatically transferred. This is in contrast to the UK's Part VII mechanism. Consequently if Continental European owners of run-off opt to utilise a transfer mechanism to exit, it may do so only after commuting outwards reinsurance protection. Such decisions will clearly impact results to this question in the future.

Figure 12 **How many disposal transactions will there be in the Continental European run-off market over the next two years?**



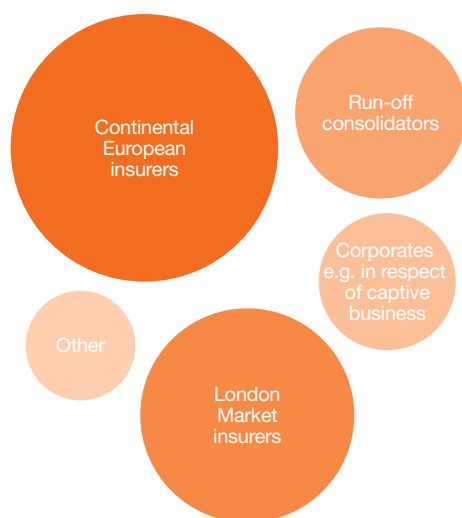
The most significant development in the run-off market over the next 12 months will be:

“Disposals of capital intensive lines from live companies”

As shown in our summary of key events over 2012, there has continued to be a steady flow of disposals in the run-off market. We have seen a number of small Continental European portfolios be acquired by run-off consolidators, a continuing trend of banks disposing of non-core legacy run-off operations, Tawa selling two of its risk carriers to Catalina and we are also aware of ongoing sale processes for significant run-off portfolios in the UK.

Respondents to the Survey believe that this activity is set to continue with 78% anticipating that there will be more than five run-off disposals in the next 24 months, and 33% considered there will be more than ten such transactions. A number of responses to the Survey indicated a continued expectation of additional activity as Solvency II's implementation draws nearer, but with further delays expected to the Directive it appears that any resulting significant wave of legacy business disposals may still take some time to materialise.

Figure 13 Which type of entity will these disposals come from?

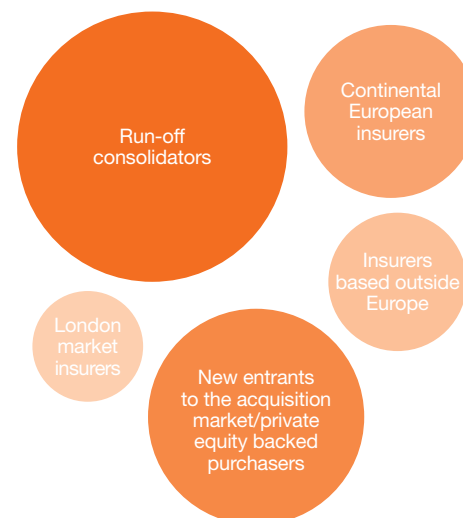


Source: PwC

Respondents expressed a strong view that most disposals will come from Continental European (re)insurers, followed by their London Market counterparts. This may reflect respondents' views that the volume of run-off business housed within ongoing Continental European (re)insurers represents a significant opportunity for restructuring and

that as these (re)insurers gear up for Solvency II there will be a greater focus on core underwriting and disposal of legacy liabilities. With the delay to Solvency II's implementation it will be interesting to see if such disposals do materialise in the short term. There is also a belief that run-off consolidators will start to make disposals.

Figure 14 Which type of entity will buy this business?



Source: PwC

Respondents believe that existing run-off consolidators will be the major purchasers of run-off businesses. Over the course of the last 12 months we have seen activity from major consolidators such as Catalina, Enstar and Riverstone and we expect these parties to remain heavily involved in run-off acquisitions for some time to come.

Respondents also identified new entrants to the run-off market, including private equity houses, as likely purchasers of run-off business. From a PwC point of view we have seen considerable interest in the run-off space from these funds and, while there have yet to be any transactions of note, we expect this to change in the next year.

Survey results

Solvency II

There remains some ambiguity as to when the full implementation of Solvency II will commence. The European Parliament vote on the final agreed package has continued to be delayed and it now looks highly likely that full implementation will not commence until 1 January 2016.

The decision making process for finalising Solvency II involves the European Council, the European Parliament and the European Commission. Currently, only the European Council has addressed run-off specifically, and it is unclear at this stage whether their proposals will be accepted by the European Parliament and European Commission. These proposals include provisions that insurance or reinsurance undertakings which are in run-off at the date of implementation of Solvency II and exclusively administer their existing portfolio in order to terminate their activity, may choose not to be in the scope of Solvency II.

However, importantly, this is only permitted where the undertaking has satisfied the relevant supervisory authority that it will terminate its activity within three years of the implementation date of Solvency II. If at any point the Supervisor is not satisfied that they are going to meet their plans, they may become subject to Solvency II rules. Insurance and reinsurance undertakings which are part of a live underwriting group do not fall under the scope of this proposed exemption.

The most significant development in the run-off market over the next 12 months will be:

“Companies striving to make their capital work as effectively as possible”

Figure 15 illustrates 2012's responses to the practical implications of Solvency II on run-off business and compares them to those received in the second edition of this Survey. It was noticeable to us that the answers from respondents based in the UK and Continental Europe vary widely, possibly providing an indicator

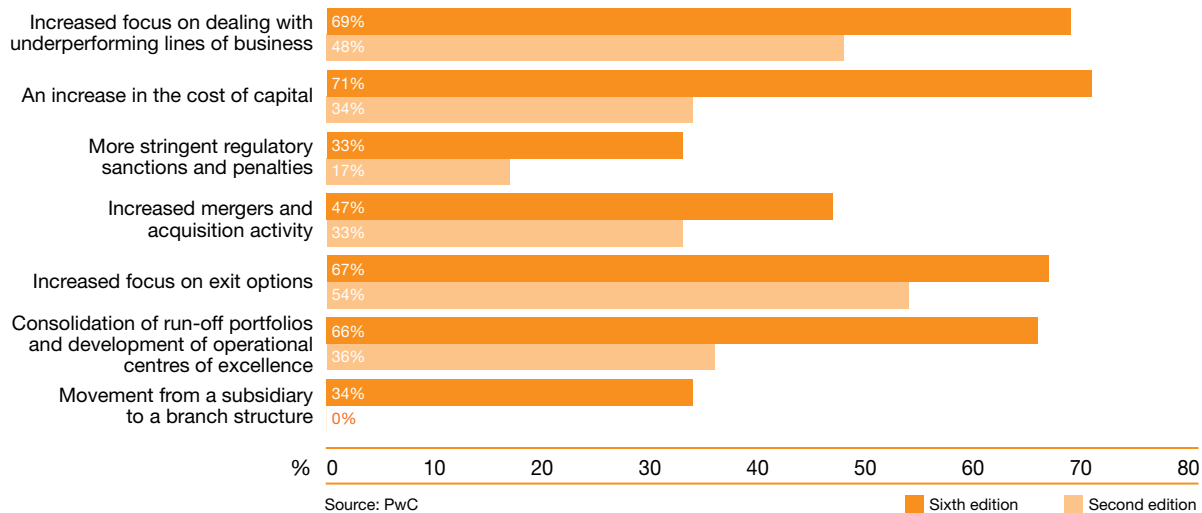
as to where respondents in different territories are in respect of their Solvency II journey.

In total 71% of respondents expect Solvency II to drive an increase in the cost of capital for Continental European (re)insurers in relation to their related to run-off business. This is a substantial increase from the 34% of respondents that predicted this in

the second edition of the Survey. This outcome is expected by a greater proportion of Continental European respondents (at 81%) than UK respondents (at 59%). 69% of our total Survey population highlighted that Solvency II is likely to lead to an increased focus by Continental European (re)insurers on underperforming lines of business.

It was interesting to note that the perceived impact on run-off business differed between the answers of UK and Continental European respondents. For example, nearly three quarters of Continental European respondents believe that Solvency II will lead to an increased focus on exit options compared to only 59% in the UK. 81% of UK respondents consider that there will be increased consolidation of run-off portfolios and development of specialised operational centres of excellence compared to 52% in Continental Europe. These responses might be explained by the relative maturity of the UK run-off market where many stand alone run-offs have already been the subject of exit mechanisms such as schemes of arrangement and, as a result, the remaining business may be more suited to the run-off models used by some of the run-off consolidators.

Figure 15 What are the likely practical implications of Solvency II for Continental European (re)insurers with regard to their run-off business?



Survey results

Finality

Some 76% of respondents believe that their run-off business will take over six years to reach natural expiry, with over 50% believing the time span to be in excess of 10 years. Again, there is a notable difference in responses between the UK and Continental Europe, with 38% of UK respondents confirming their run-off will take over 10 years as compared to 57% of Continental European respondents. This may provide some further evidence of the relative maturity of the two territories in terms of run-off business and explains the continued interest in exploring finality solutions to remove the run-off tail.

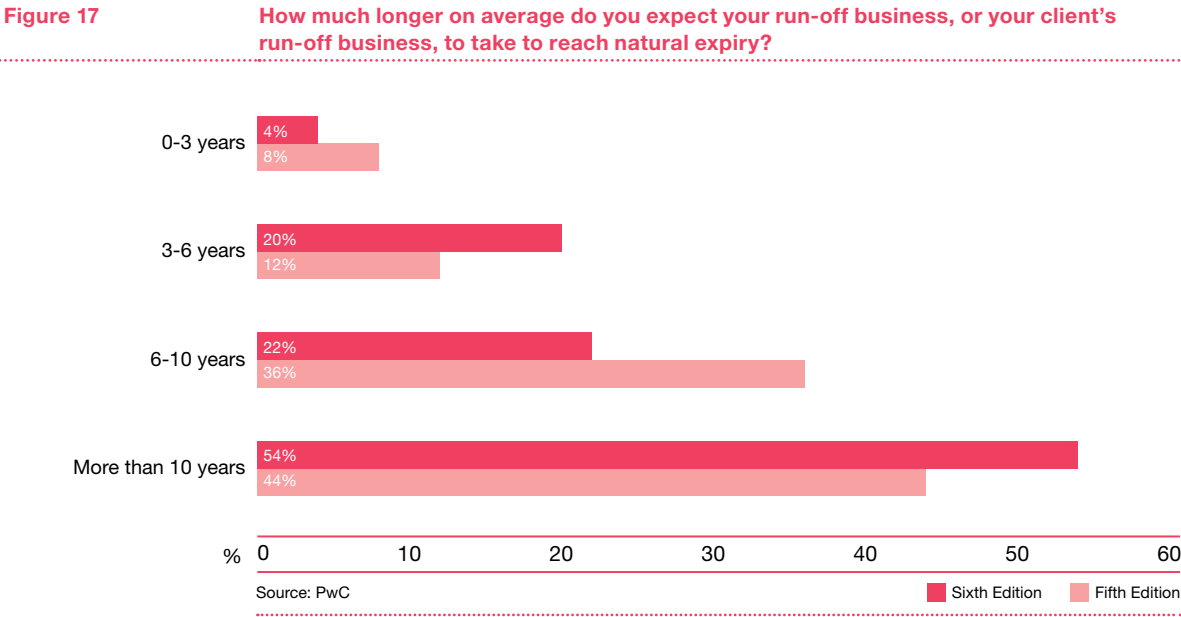


Figure 18 Which is the single most important concern influencing the ability to gain finality for run-off business in the UK?



Source: PwC

Figure 19 What is the single most important concern influencing the ability to gain finality for run-off business in Continental Europe?



Source: PwC

Consistent with 2011's Survey, respondents indicated that long-tail claims represented the greatest challenge for finality with UK books. There was a greater spread of responses from Continental European respondents where the greatest challenge was seen to be reputational risk followed by the availability of exit mechanisms.

It is interesting to note that reputational risk and the availability of exit mechanisms were perceived to be significantly more material issues influencing the ability to gain finality in Continental Europe as compared to the UK. Reputational risk has often been cited as a barrier for Continental European (re)insurers in seeking finality for their legacy business but the results of the Survey perhaps indicate that this is more a perception than reality.

Our own experience indicates that whilst reputational risk is an important factor for large European (re)insurers considering finality, it is an issue that is capable of being managed through careful planning of exit solutions and consultation with stakeholders. The Survey results continue to indicate that organisations are increasingly pro-active in dealing with legacy liabilities and in 2012's Survey we noted a theme of educating and working with ceding counterparties to ensure their support for finality solutions. There is also a distinct focus on better data management to facilitate more constructive commutation discussions. Respondents forecast that after a period of commutation activity legacy portfolios would be sold in the future and that there was an appetite to look at a variety of finality options including reinsurance transactions, schemes and cross-border transfers.

The most significant development in the run-off market over the next 12 months will be:

“Opt-out schemes of arrangement that may reopen the solvent scheme calculation”

Figure 20

What claims exposures form a significant part of your run-off portfolio, or your client's run-off portfolio?

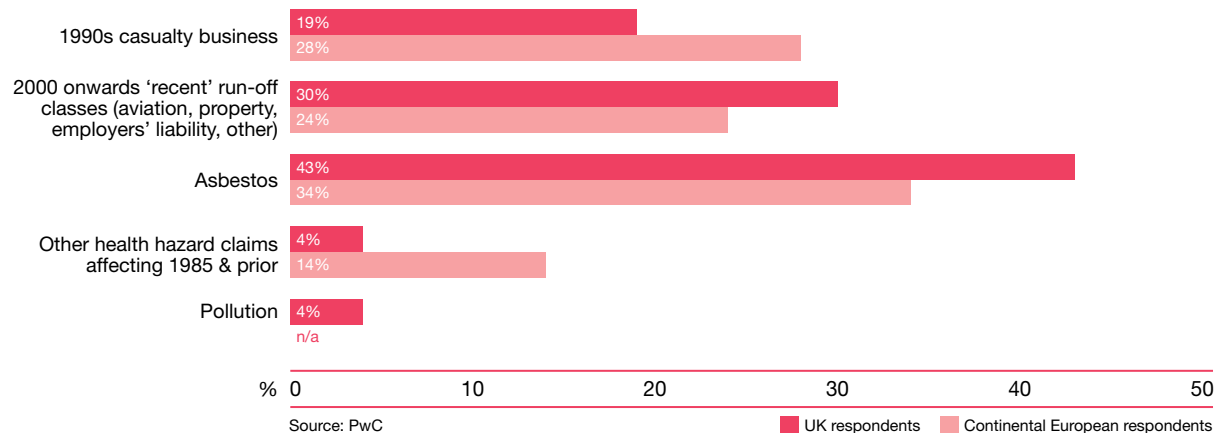


Figure 20 shows the difference between UK and Continental European respondents' views on the most significant exposures in their run-off portfolios. Overall, nearly 40% of total respondents cited asbestos liabilities as the most significant exposure. This was followed by 27% stating that post 2000 run-off exposures and 23% confirming that 1990s casualty business were the largest element of their discontinued books. This is consistent with the recent feeling in the market which suggests that,

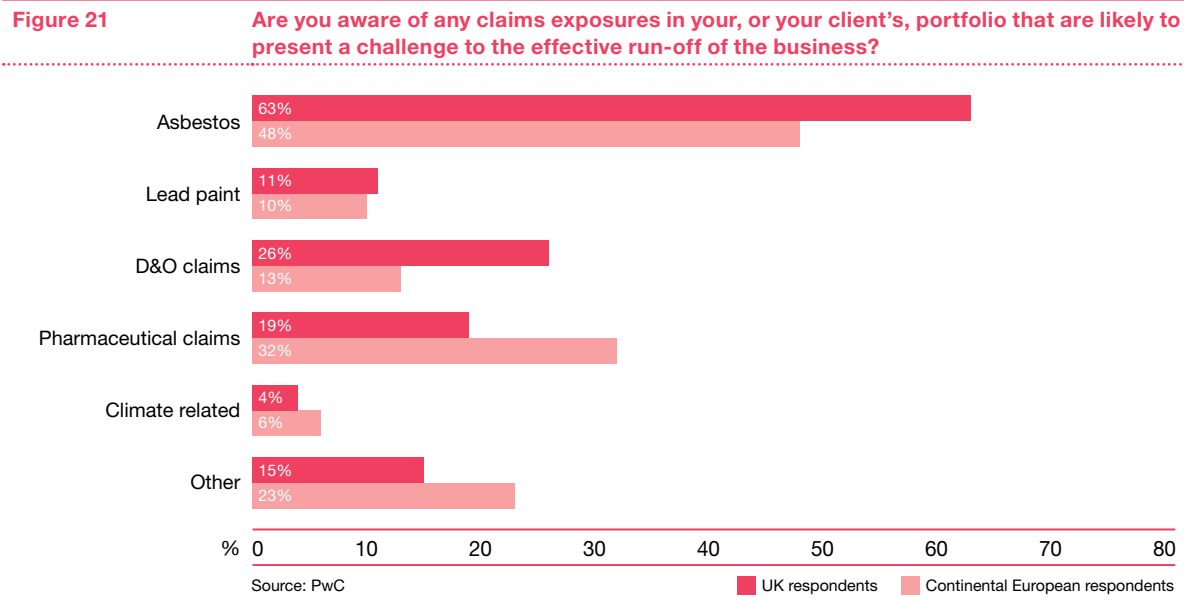
whilst traditional run-off issues such as asbestos and other long-tail claims remain a key challenge, there is a gradual and natural shift towards a focus upon more recent run-off exposures.

Traditionally, many observers have suggested that dealing with claims arising from asbestos is purely a London Market issue. However, it is clear that asbestos as an issue is also increasing in profile in Continental Europe. Over a third of Continental European respondents cite this type of exposure as the most significant in their portfolio. This is also reflected by the support that organisations such as IntAP (The International Alliance of Asbestos & Pollution reinsurers) have in the run-off market, acting as a useful knowledge sharing and networking facility across Europe.

For many years now commentators have been trying to predict the next asbestos. Based on Survey responses it is clear that asbestos claims remain the number one claims challenge. Whilst a number of potential alternative claim types have been identified, none currently appear to have, or are considered likely to have, the same impact as asbestos. Examples of these potential claim types include those caused by exposure to welding rods and public nuisance claims levelled at lead paint manufacturers. Tobacco claims, which share many of the same latent claim characteristics as asbestos, are not seen by respondents as a major cause for concern at this stage.

Asbestos also clearly still presents a key challenge for effective run-off management. The UK response rates for this option were higher at 63% when compared to Continental European responses of 48%. One key challenge faced by run-off (re)insurers seeking to value their asbestos liabilities lies in the availability of good quality data regarding exposure and claims experience. The more information that is available to a (re)insurer, the better it will be able to understand the sensitivities within the underlying liabilities, and the more flexibility it will have around the valuation method to use. In addition, the better the data the more able the (re)insurer is to fully understand the reserves at an individual counterparty level, thus enhancing the (re)insurer's negotiation position when undertaking commutations.

Looking beyond asbestos claims to the other challenges that were identified, pharmaceutical claims were seen as an issue by about a third of Continental European respondents compared to a fifth of UK respondents. These claims share some similar characteristics with asbestos claims in that they typically arise on Product Liability contracts several years after the policies have expired and are heavily influenced by legal judgments. In the London Market there are also some key differences between pharmaceutical and asbestos liabilities in that the former are typically 'claims made' in nature. Reporting delays are also much less than for asbestos claims.



Notwithstanding this, the approaches taken to the management of pharmaceutical claims within a run-off portfolio appear to be very similar to the way in which asbestos claims are managed.

Finally, it is perhaps surprising that other categories of claim are not appearing on the radar of legacy portfolio managers. For example, motor claims in many European territories are becoming increasingly complex and could present a future challenge to run-off management.

A further sample of respondents' predictions of the single most significant development in the run-off market over the next 12 months follows:

“An insolvency”

“Consolidation within the UK market to produce a ‘best of breed’ professional run-off provider”

“Emergence of new sources of capital”

“M&A will lead to fewer players in the market”

“The emergence of the first opt-out scheme of arrangement”

“Active companies looking for solutions to legacy portfolios”

“Banks separating from insurance operations due to regulatory pressures”

We also asked respondents what one thing they would like to change about the run-off market. A sample of responses is shown below:

***“Need for greater flexibility
by Continental regulators”***

***“Make commutations
recoverable from reinsurers”***

***“More attention from
management to run-off issues.
Discontinued business in Europe
now carries significant asset
risk as well as liability risk and
should be disposed of”***

***“A better understanding of
what legacy means within
Lloyd’s syndicates”***

***“Regulatory impediments to
business transfers”***

***“More capacity for
transactions”***

***“Clarity on the impact
of Solvency II for the
run-off market”***

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 reinsurance 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:

- Releasing capital from run-off
- Bringing finality to run-off and extinguishing liabilities
- Considering options such as sale or transfer of liabilities
- Project managing complex (re)insurance business transfers and securing key stakeholder buy-in
- Rationalising operations to achieve efficiency
- Proactively managing outsourced run-off, including the development of a robust outsourcing contract
- Benchmarking the claims and reinsurance functions to assess their effectiveness
- Providing transactional support ranging from due diligence, claims reserving and tax considerations.

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

www.pwc.co.uk/discontinuedinsurance

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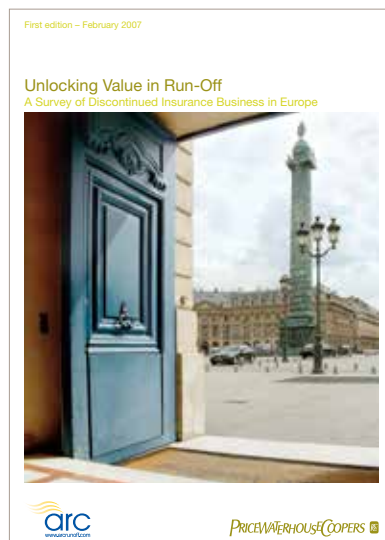
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