

First edition – February 2007

Unlocking Value in Run-Off

A Survey of Discontinued Insurance Business in Europe





Foreword

As this valuable insight into the European run-off scene rightly observes, London has become the acknowledged leader in the recognition and proactive management of discontinued insurance and reinsurance business. That leadership owes something to London's traditional qualities of innovation and business acumen – qualities that have evolved in the London insurance market over more than three centuries – but also, it must be said, to the stern demands of necessity.

London developed as a market of small, entrepreneurial, risk carriers. Often subsidiaries of European, US or worldwide parent groups, these companies accepted shares of volatile risk in a broker-driven subscription market. Many paid the price for dabbling in the highly-g geared LMX market of the 80s and early 90s; others fell victim to the unforeseen liabilities stemming from liability coverage given to US cedants. Asbestos-related diseases, pollution clean-up costs and the unexpected side-effects of prescription drugs, all generated enormous – in some cases unquantifiable – losses that found their way across the Atlantic to London EC3.

It is not surprising, therefore, that faced with these catastrophic liabilities, many London companies either became

insolvent or were put into solvent run-off. It was equally predictable that the reaction from those that made their living from advising and managing those companies would be inventive and positive. In barely a decade, London has developed a veritable run-off industry with a vocabulary and a business culture all of its own, underpinned by a professionalism and range of expertise unrivalled in the world. ARC itself, which celebrates its first decade of existence next year, now has approaching two hundred members, representing the full spectrum of risk carriers, service providers, consultants and professional advisers.

London's success is well-rehearsed, but what makes this survey timely and relevant is that it looks at discontinued business in a less-developed environment – Continental Europe – and at a period when the legislative, regulatory and indeed the business landscape is undergoing rapid change.

It is fair to say that many insurance companies in countries such as France and Germany have tended in the past to deal with their legacy portfolios in a less than proactive way; the prevailing wisdom has perhaps been that to acknowledge that one has business in run-off is to admit to a failure of proper husbandry of shareholders' funds.

However, as the congruent pressures on insurance group capital, of ratings agencies and regulators grow, ignoring or, worse still, burying unproductive legacy business is no longer an option.

Fortunately, as European senior managers wake up to these new drivers of their business strategy, the range of tools at their disposal, courtesy of the march of European insurance and reinsurance legislation, is rapidly expanding.

PricewaterhouseCoopers (PwC), who have been at the forefront of much of the innovation in the discontinued insurance sector, have produced a thoughtful and well-researched analysis of the challenges that discontinued business poses to European insurers and of the opportunities that the evolving legislative and regulatory environment affords them. ARC welcomes this valuable contribution to our understanding of what is sure to be a highly significant market for the future of the run-off management sector.

Philip Grant
Chairman
Association of Run-Off Companies

Introduction – a new era for run-off in Europe

In this, our first survey of the discontinued insurance market* in Europe, we consider some of the challenges facing those who are responsible for managing this type of business as well as the available solutions. We will produce this survey in conjunction with ARC on an annual basis, and we would appreciate any thoughts or comments you have in respect of this edition or on any subjects you would like to see covered in future editions. Please use the following email address for any communication relating to this publication or for European issues more generally: europediscontinuedinsurance@uk.pwc.com

To date the London Market has dominated the European insurance and reinsurance run-off arena on this side of the Atlantic, not only in terms of the number of companies either wholly in run-off or with significant amounts of discontinued business, but also in terms of the growth of specialist advisors offering a range of run-off support services and exit options.

However, it is becoming increasingly clear that Continental Europe has a significant

amount of discontinued insurance business which, up until now has scarcely been acknowledged publicly. This is beginning to attract management attention as pressures increase to reduce costs, focus resources and extract capital.

Through our research it has become evident that the amount of business known to be in run-off across the European insurance market is just the tip of the iceberg. In Continental Europe almost all discontinued business is managed as part of an on-going business and so the true extent of, and the costs associated with, legacy businesses are often unknown.

Whilst the majority of Continental Europe's insurers and reinsurers have traditionally opted to handle most of their discontinued business in-house alongside their on-going business, there are signs that this is starting to change. Many of the larger organisations are now starting to recognise the need for a different set of management skills to deal with run-off more efficiently and effectively. Some of

the early activity appears to be around the grouping together of discontinued lines in order to apply more effective management practices and to achieve economies of scale on an operational level.

From our discussions with some of the parties operating in the discontinued insurance market in a number of the larger Continental European territories, it is clear that there is a greater awareness and appreciation of the tangible benefits of focusing on this business. Some of the drivers cited have been around the desire to reduce the risks of deterioration, decrease the costs associated with the run-off business and to manage the release of surplus capital. In addition many parties are starting to recognise the increasing number of options for business restructuring – for instance, the Third Non-Life and Reinsurance Directives create greater flexibility for business to be moved around Europe through portfolio transfers. This tool is already being used by insurance businesses in Europe and, by the end of 2007, portfolio transfers will also be an option for pure reinsurers.



One thing is clear, ignoring the issue of run-off business is not an attractive option as the challenges facing the industry increase. Those addressing this issue now recognise they will position themselves significantly ahead of their competition.

Dan Schwarzmann
Partner – Solutions for Discontinued Insurance
Business, PricewaterhouseCoopers

* We have considered as part of this survey entities that are wholly in run-off as well as discontinued business which forms part of continuing operations. Branch business is included in the domicile in which the branch is regulated. We found in our research that the terms 'run-off', 'discontinued', 'legacy' and 'closed business' were all used interchangeably, and we have done the same throughout this survey.

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Size of the European non-life run-off market

PwC estimates that run-off business in Europe exceeds Euros 204 billion.

The UK run-off environment has evolved considerably since the losses of the late 1980s and early 1990s and is now an established market in its own right.

Traditionally, industry commentators have tended to focus on UK run-off, but our research has shown that this makes up only a quarter of the total legacy liabilities across Europe. With the exception of a few high-profile run-offs and corporate restructurings in Continental Europe, the bulk of run-off is usually fragmented and contained in old, long-forgotten subsidiaries or its existence is obscured by the live businesses of significant, well-rated international insurers.

The true cost of dealing with this type of business is therefore buried but can be a significant drain to an organisation. It is encouraging that the larger Continental European insurance groups are now, almost without exception, starting to recognise the need to tackle the management of this business proactively.

PwC estimates European non-life run-off liabilities are distributed as per the diagram below:

Contrary to the perceived stigma of run-off being associated with 'insolvency' across Europe, only a very small portion of European run-off liabilities are attributable to insolvencies. This is due to Regulators in Continental European countries tending to manage exits from potentially insolvent business by enforced merger activity.

With many of the major worldwide reinsurance groups having their roots in Germany or Switzerland, it is perhaps not surprising that the largest proportion of European run-off is based in North-Western Continental Europe where insurer insolvencies are rare. The well-publicised run-offs of Globale in 2002 and Alea Europe in 2005 might be the most obvious members of the pure run-off market here, but the size of their 'visible' liabilities is almost inconsequential compared to the legacy liabilities tied up in the otherwise strong insurers in Germany and Switzerland.

At the other end of the scale, based on size of liabilities, are those run-off liabilities emanating from the former State-owned Eastern European reinsurers' activities associated with the London Market in the 70s and early 80s.

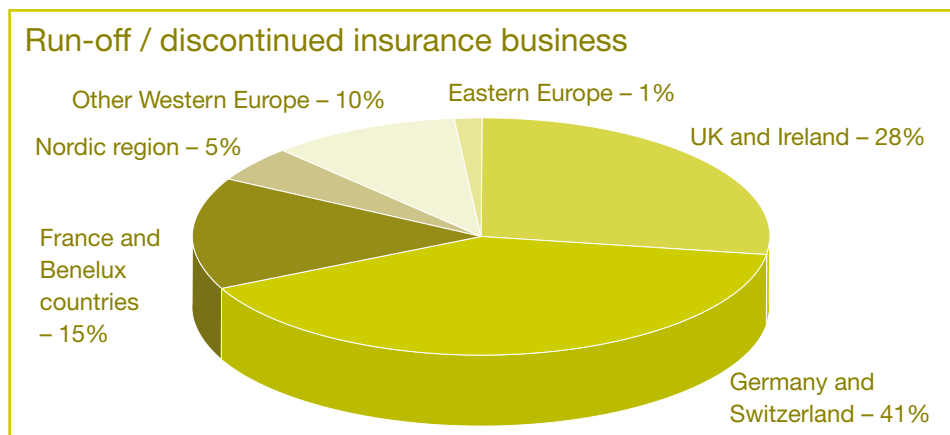
The Nordic region has a comparatively small, but mature, run-off market. The region saw a spate of run-offs in the early 90s, but there have been specialist teams involved in run-off there for several decades.

Run-off in the rest of Continental Western Europe is perhaps best characterised as being the result of corporate mergers and/or acquisitions, following which organisations tend to focus on reviewing their strategic direction often resulting in some level of discontinued business.

More recent catalysts for the growth of run-off business in Europe have included the loss of the all-important 'A-' financial strength rating required of reinsurers by their larger cedants. Run-off is not an inevitable result of such a downgrade but the loss of a rating usually has a dramatic impact on the reinsurer's ability to retain renewals.

Local insurance regulation and associated capital requirements across Europe are also proving to be a crucial factor in prompting insurance groups to review their strategies.

This increased focus on the opportunity cost of tied-up capital is likely to prompt insurers to focus on innovative solutions to extract value from their run-off business.



For the purposes of this analysis the categories are made up of the following territories:

- France and Benelux countries – France, Belgium, Luxembourg and The Netherlands
- Nordic region – Denmark, Finland, Iceland, Norway and Sweden
- Other Western Europe - Austria, Cyprus, Greece, Italy, Malta, Portugal, Spain and Turkey
- Eastern Europe - Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, European Russia, Serbia and Montenegro, Slovakia, Slovenia and Ukraine.

Discontinued insurance business in Continental Europe – understanding the challenges

Run-off in Continental Europe is not as well recognised or accepted in comparison to the more established UK run-off market. It is clear that businesses have been reluctant in the past to own up to having run-off business. However, this situation appears to be changing, perhaps as some of the solutions available to deal with this type of business are becoming more widely acknowledged and understood across Continental Europe.

Few external advisors have really made their mark in Continental Europe to date, and only France and The Netherlands have territory based run-off associations to offer support to those operating in this market.

Whilst there are some differences between the run-off markets in the UK and the rest of Europe, increasing pressures from shareholders and rating agencies are driving management teams in Continental Europe to focus on developing run-off strategies.

Our survey has confirmed that many Continental European books and portfolios have strong similarities to and connections with the London Market. Significant amounts of reinsurance business written by the large Continental European firms, including that written by their London based branches or subsidiary companies, is very similar in nature to UK run-off business. In addition to this, large numbers of Continental European reinsurers historically wrote in the London market through UK agents and brokers and by using UK pools. For these reasons, valuable lessons and experience gained from years of developing specific

techniques that support proactive run-off approaches and exit strategies in the UK, can now be applied in other European countries.

It is important however, to recognise that there are some differences between the UK and Continental European markets which will impact the approach to dealing with run-off business:

Market participants

The insurance market in Continental Europe is very much like the UK composite market in that each country's insurance market typically comprises a small number of large players selling predominantly both life and non-life products, including personal and commercial lines. This is in direct contrast to the London Market which comprises a much larger number of small non-life reinsurance companies writing mainly excess and surplus lines policies covering large corporations as well as Lloyd's and Equitas. The majority of the countries in Continental Europe, with the notable exceptions of Germany and Switzerland, simply do not have a significant market for the sale and purchase of reinsurance to the same extent as London.

Short tail versus long tail

Much of the domestic business written by Continental European companies is typically shorter tail than that written in the London Market. On balance, the degree of uncertainty surrounding an estimate of reserves for a UK run-off business is likely to be greater than for a Continental European portfolio. The difference in levels of uncertainty in reserves between UK and Continental European run-off portfolios is heightened by the presence of significant volumes of global reinsurance

business in the UK, which is not present in most Continental European markets.

Underlying exposures

A 'typical Continental European company' is likely to have written a broad based portfolio of mainly domestic risks with some exposure to other European risks, whereas a UK company, in general, is likely to have more exposure to worldwide risks because of the position of the London Market as a centre for the underwriting of major global insurance and reinsurance risks. The main problem emanating from the worldwide market in recent years is in respect of exposure to US asbestos, pollution and health-hazard 'APH' claims.

Whilst APH claims are increasingly being dealt with by actuaries and cedants who are confident in estimating, processing and settling these claims, they are still subject to a degree of uncertainty.

The majority of reinsurance business written in Continental Europe has tended to be on a proportional (including facultative) basis. This means that the insurer has either more information on premiums and claims (in the case of facultative covers) or more predictable flows for pro-rata covers. These features make the business much easier to deal with from a reserving perspective than the predominantly non-proportional business prevalent in the London Market.

It is important to understand both the similarities and differences between the run-off markets in the UK and in Continental Europe when considering how best to apply the experiences and lessons learnt from dealing with issues in the UK run-off market.

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The challenges facing those managing run-off in Continental Europe

The operational costs of run-off

When a business is discontinued its only income will usually be from investment returns. In a relatively low interest rate environment and with unpredictable stock markets, the task of generating sufficient returns to cover the costs of dealing with the run-off is a challenge. Whilst this may be a hidden cost in a live business it should be considered separately in order to provide management with accurate information about both their on-going and discontinued businesses and enable them to make informed decisions.

As a run-off continues over time, the number of transactions handled reduces but the unit cost of handling these transactions increases, a pattern that is exacerbated by the impact of inflation on both variable and fixed costs. This means that the fund available to pay claims, more often than not, erodes at a faster rate than would have been originally anticipated. As such it could well be the case that the profits of the live business are unwittingly being used to subsidise the legacy business.

Brokers, who also do significant work for clients in respect of live business, may not be as willing to focus on work relating to discontinued business. This can mean increased costs of doing work themselves for the insurance company or, having to pay someone else to do this work.

Our experience of the UK has shown that run-off costs average 2.5% of gross reserves every year. If you consider the whole run-off market in Europe on this basis, the run-off costs associated with the Euros 204 billion of discontinued liabilities will be costing businesses upwards of Euros 5 billion per annum.

Adverse loss development

A number of sizeable European companies have exposure to APH claims and other long-tail liabilities. When companies originally wrote the business many simply did not realise that they would be covering such losses, which can take decades to manifest themselves. There is significant danger of adverse loss development, particularly where long-tail business is involved. Our experience is that this type of business generally deteriorates over time because:

- the initial reserves are likely to have been based on limited knowledge
- improving knowledge leads to a decrease in the level of uncertainty and permits the quantification of that uncertainty
- improving medical knowledge allows better detection of medical conditions, which in turn are becoming more expensive to treat
- the insurance industry is becoming increasingly litigious and Court awards, particularly those made in the US, continue to rise.

Reinsurer identification and IT support

The last two decades have seen an increased level of mergers, acquisitions

and name changes within the reinsurance sector. Many companies are simply unable to identify who and where their reinsurers are, assuming they have not failed. Identification of reinsurers is an additional cost to many businesses that would not have been foreseen.

Few companies had particularly sophisticated IT infrastructures when they started writing business and consequently many find their IT systems inadequate for running off their portfolios effectively. Indeed many systems may work well for live business but be less suitable for managing discontinued business.

Loss of staff knowledge

Another challenge faced by companies entering run-off or with discontinued books of business is the loss of staff with key knowledge about the history of the risks and reinsurance/retrocession business written, the meaning or intention of contract wordings as well as the content and location of records. This is a real threat because of the significant value associated with knowing this information.

Other challenges

In addition to the challenges inherent within the industry, there are new external challenges such as the imminent arrival of Solvency II, with which insurers and reinsurers in Europe will have to contend.

‘The main challenge is to have continued expertise to deal with the run-off – to have staff who know the business, how to manage it, know what they are talking about – for example when it comes to dealing with US casualty and/or asbestos issues’

Martin Rebisz, ING, The Netherlands

Implications of the changing European landscape

The regulatory framework for insurers and reinsurers across Europe has developed significantly in recent years. As can be seen from the diagram below, some key Regulations and Directives have already been implemented and more are planned. These regulatory changes will create both challenges and opportunities for those operating in the insurance industry, whether this is within live operations or business in run-off. They mark key milestones in the European Commission's policy to create a single market in insurance and its aims of removing obstacles to competition and creating fairness across Europe. Three of these key regulatory changes are explored below.

Third Non-Life Directive

The Third Non-Life Directive became effective in June 1992 and implementation was required by each member state by July 1994. This Directive built on the foundations that were laid down by the First Non-Life Directive in the 1970s, in developing a common platform for the supervision of insurance business across the EEA* and the principle of home country control. Amongst other things, the First Non-Life Directive permitted EEA insurance undertakings

Solvency II represents a fundamental shift from the existing simple quantitative approach of monitoring solvency to a more sophisticated holistic approach. Although its implementation is still some way off its impact is likely to be far reaching.

the freedom to establish branches in other member states. The Third Non-Life Directive took this one step further with the creation of the 'single passport' authorisation which allows EEA insurers the freedom to conduct business across all EEA territories without the need to establish a branch.

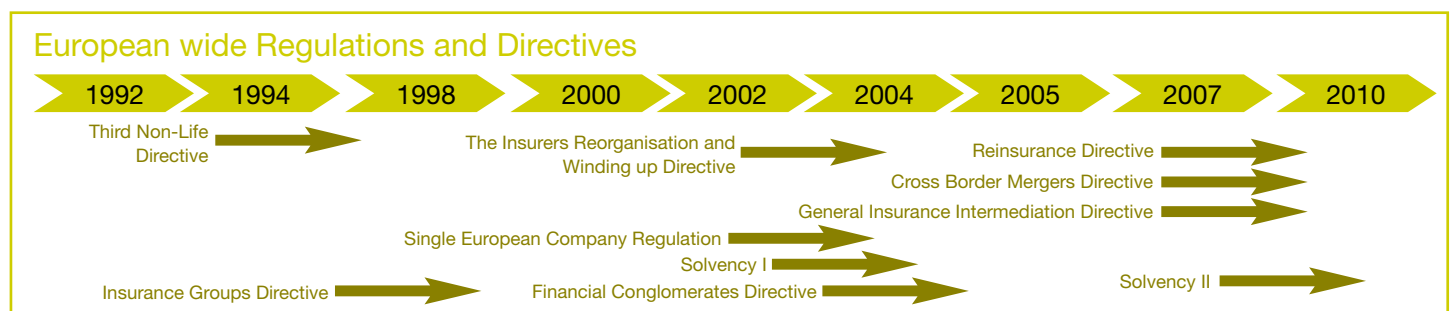
Reinsurance Directive

Pure reinsurance entities, which in many territories across the EEA may have been subject to less stringent regulatory requirements than entities underwriting direct insurance business, will soon find themselves caught in the Europe-wide regulatory net once the Reinsurance Directive is implemented. This Directive became effective in December 2005 and must be implemented by each member state by December 2007. The benefit of this Directive for pure reinsurers will lie in the extension of the 'single passport' regime, which will open up new markets to them.

As at the end of 2006, there were few member states that had fully implemented the Reinsurance Directive. In Germany for instance, most of the requirements were adopted under the Amendment to the Insurance Supervision Act in 2004 in anticipation of the Directive. However, this implementation did not, for example, include the provisions relating to the cross border transfer of business for pure reinsurers and it is anticipated that the remaining requirements of the Directive will now be fast tracked into German legislation.

Solvency II

The Solvency I regime, introduced in 2002 with a requirement to be implemented across the EU* by 2004, made modest changes to the existing formulaic based minimum capital requirements for insurance companies. Solvency II represents a fundamental shift from the existing simple quantitative approach of monitoring solvency to a



Definitions

*The European Union (EU) is the successor organisation to the European Community and was officially established on 1 November 1993 when the EU Treaty came into effect. The goal of the EU is a closer economic union of its member states, including the European Monetary Union (EMU), a greater unity

in matters of justice and domestic affairs, and the development of a common foreign and security policy.

*The European Economic Area (EEA) encompasses all the members of the European Union (EU) as well as the members of the European Free Trade Association (EFTA), with the exception of Switzerland. The EEA

was established in 1993 and came into effect on 1 January 1994 and is a single market for the free movement of labour, services, capital (with some restrictions on investments) and most products. EFTA members have agreed to accept EU Regulations in many areas, including company law, education, environmental protection, mergers, and social policy.

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more sophisticated holistic approach. Although its implementation is still some way off, its impact is likely to be far reaching. Solvency II aims to map the regulatory capital requirements of each company against its individual risk profile and embed that profile into the risk management and internal control functions of the organisation. This will encourage, if not force, many companies to integrate new policies, strategies and processes within their businesses.

The future of run-off liabilities cannot be assessed without giving consideration to the impact of Solvency II on the reserves and capital of companies. The movement towards a framework for assessing solvency capital which is based more on the underlying risk and volatility in a book of business (at a discounted best estimate level and including an identifiable risk margin) may increase the capital requirement. This will lead to a focus on the more volatile areas of a company's claims experience which in many cases will be the run-off business; by its nature if this business was known and could be settled it would not be in run-off.

Companies may be able to gain a competitive advantage by optimising the use of capital and this opportunity is likely to lead to a greater focus on identifying and dealing with the capital inefficiencies which are likely to exist in underperforming or discontinued lines of business.

Identifying and dealing with capital inefficiencies

Whilst it is too early to evaluate the ultimate impact of Solvency II, it is clear that there will be an increased emphasis on the efficient use of capital. As a result

'We regard run-off as being a normal part of an insurance lifecycle... and in the Nordic markets various finality and exit products are now being used and further developed'

Heikki Saalamo, Compré Nordic, Finland

of the new proposed regime within Solvency II, all current and future risks of the business will need to be measured, monitored and managed effectively. This, in turn, is likely to lead to a greater focus on the viability of individual lines of business as previously hidden capital inadequacies are revealed.

The impact of this is undoubtedly that the underperforming or capital intensive lines of business will be under greater scrutiny and this may well prompt an increase in restructuring and rationalisation of insurance business. There will also be the need to deal with closed books of business and it is envisaged that there will be a shift to a more proactive and strategic approach for dealing with this business as organisations realise the potential to extract capital tied up in these closed businesses.

In this context we are also likely to see more run-off business being consolidated across Continental Europe as this will enable capital to be released.

This may take place either internally within organisations, for example as a result of internal reorganisation and/or relocation of run-off business. The consolidation may alternatively be directed externally as specialist sources of capital become available or run-off consolidators move in to purchase these books of business. Specialist professionals are also likely to play an important part in the evolution of this market as businesses recognise the need for different skills to manage the discontinued business effectively.

The emphasis on capital efficiency is also likely to encourage some businesses to consider earlier exits from books of business in run-off, so that capital can be recycled faster in order to underwrite new business, or expand existing lines of business. The exit strategy approaches in this context are likely to include the use of reinsurances, sales, portfolio transfers, solvent schemes of arrangement or indeed a combination of these options.

Using portfolio transfers

We have already mentioned that the Third Non-Life Directive and the Reinsurance Directive have created greater flexibility for companies to move business around the EU member states by introducing the concept of 'portfolio transfers' to this market.

One of the attractive features of transferring business is the ability to include reinsurance contracts that 'attach' to the portfolio being transferred. In the UK, the transfer mechanism was reformed with the introduction of The Financial Services and Markets Act in 2000. Part VII of this Act replaced the old mechanism in the UK, which did not enable the transfer of the attaching outwards reinsurance asset without individual reinsurer consent. Since this change, the use of the transfer mechanism in the UK has risen rapidly. In Europe the ability to transfer the attaching reinsurance without reinsurer consent has not been included in the domestic laws used to implement the Third-Non-Life Directive and Reinsurance Directive to date.

There are broadly three main reasons for companies in Europe to utilise a portfolio transfer:

- to improve efficiency
- to deal with closed or discontinued books of business
- to restructure for other reasons.

Improving efficiency (capital, regulatory or operational efficiency)

Companies wanting to improve capital efficiency are already using portfolio transfers to reduce the number of subsidiaries in a group and hence release the capital tied up in them. This option is particularly relevant to active underwriters who may find a branch structure is much more effective in terms of capital efficiency.

As an EU insurer, if you write business through branches in multiple jurisdictions, 'passporting' applies so that you are regulated only in your home territory as a single company. For regulatory purposes and capital requirements, the home territory Regulator will look at all the total business written by the company including that written through its branches. This means a company effectively holds one 'big pot' of capital instead of a number of smaller ones. As an example, the capital required to write Euros 1 billion of business in one company is less than the aggregate capital required to write Euros 200 million in each of five companies. Whilst the principal driver in this situation may be capital efficiency, it is also important to remember that there are tax implications which need to be considered including the ability to match group profits and losses and maximise the recoverability of overseas taxes.

Companies wanting to lighten their regulatory burden are also using portfolio transfers to reduce the number of regulated entities and hence minimise the number of regulatory returns and insurance company accounts that they need to prepare. Again this could be achieved through the use of a branch structure which can result in considerable administrative savings.

Companies wanting to save management time or reduce administrative costs have also used portfolio transfers to move business into a reduced number of entities and use dedicated and, most likely, reduced resource. There may also be cash flow efficiencies from dealing with counterparties at a group level, including applying set-off at that level.

The portfolio transfer mechanism can be used to combine subsidiaries after a merger. This may result in tax efficiencies if historic tax losses can be consolidated.

Whilst the primary objective of a company undertaking a portfolio transfer may be to either improve capital, regulatory or operational efficiency, it is often the case that all three efficiencies are achieved as a result of a transfer.

Dealing with closed books of business

Companies looking at options for dealing with discontinued books of business are now able to move liabilities around more easily to prepare for a sale or other transaction. For example, a portfolio transfer could be used to separate ongoing business from discontinued business, to group together old liabilities or to unravel involvement in underwriting pools.

Restructuring for other reasons

Our research has shown that companies may want to restructure their business for several other reasons which could include:

- restructuring between countries – for example if a company wanted to move businesses to an integrated European platform within an EU territory
- relocation to a member state where specific skills can be accessed or where a lower cost workforce can be obtained
- optimisation of tax
- re-branding
- acquisition of specific portfolios rather than acquisition of a company as a whole.

It is important to remember that portfolio transfers can often be used as a supporting tool within a wider range of options. For example, we have seen transfers used as a precursor to, or in conjunction with, a sale or a solvent scheme of arrangement.

To date in Continental Europe transfers have tended to be used for group consolidation and although there have been a number of intra-state transfers

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within the EEA, there have been relatively few cross-border transfers between member states. This may have been due to the perceived difficulties of transferring direct business and we expect that the implementation of the Reinsurance Directive, together with the introduction of Solvency II, will almost certainly lead to more cross-border portfolio transfers.

Other restructuring tools

Both the Cross Border Mergers Directive, which became effective in December 2005 and must be implemented by all member states by December 2007, and the Single European Company Regulation, enable the consolidation of companies that are incorporated in different member states. A possible application of these mechanisms could be to access exit tools that are not available in a particular territory. For example, by merging a German and UK company and then selecting the UK entity as the 'surviving entity', there is then the ability to use solvent schemes of arrangement as an exit strategy if appropriate.

In summary, there is considerable regulatory change taking place within the EEA which is affecting the conduct and supervision of insurance and reinsurance business across Continental Europe. This is creating challenges and opportunities in respect of risk, capital and operational management and is placing greater focus on the management of, and exit from, discontinued lines of business.

Tax aspects of cross border transfers

The EU Tax Mergers Directive mirrors the Third Non-Life Directive and was updated in 2006 to allow part transfers of business. The aim of the legislation is to allow cross-border transfers of business in a tax neutral way and this can usually be achieved providing the company maintains a tax presence in its home territory. One way of satisfying this is by the use of a branch structure. It is important to note that although tax authorities in most EU countries have introduced this Directive within their legislation, it has been interpreted in different ways and consideration needs to be given to the local laws when carrying out cross-border restructuring to ensure that the best tax result is achieved. Even where there is a tax exit cost attached to the migration of a business this needs to be balanced with the commercial objectives and any long term tax advantage which could be realised in the new jurisdiction.

VAT issues

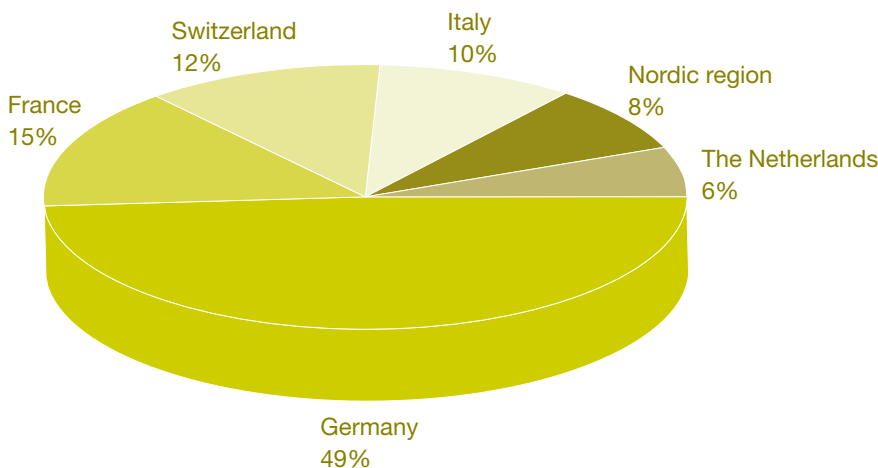
Groups also need to be aware of the potential for increased VAT costs when considering cross-border transactions in the light of the far-reaching Andersen's case. The result of this is that 'back office functions' which include run-off management services and other advisory services provided externally to support insurers do not relate to insurance transactions and thus will not be accorded the normal VAT exemption. Tax authorities in EU countries have reacted to the case in different ways, and it will take time for the legislation to be amended. It is therefore important to consider the local countries' laws before entering into any outsourcing arrangements.

'I am optimistic for the future of the run-off market here... the implementation of Solvency II is a key factor which will force French groups to identify their run-off and deal with it – keeping run-off as it is will be far too expensive.'

Robert Bisson, CMGL, France

A comparison of discontinued insurance business issues in Continental Europe

The relative sizes of the run-off markets



‘One of the main concerns is that highlighting run-off and dealing with it differently (to the rest of the business), may adversely affect on-going relationships’

Klaus Kune, Hannover Re, Germany

We have spoken to a number of parties operating within the discontinued insurance business arena in Continental Europe in organisations that have already begun to acknowledge and deal with the pressures associated with run-off business proactively. These individuals were able to provide valuable insights as to how some of the territories are already responding to the challenges and changes affecting Continental European insurance business. They also enabled us to gain an appreciation of any country-specific issues relating to discontinued business. We would like to thank all the parties who took part in the discussions for their time and valuable views.

For the purpose of this survey we focused on the territories with the most material

run-off liabilities, which together make up 65% of the run-off market in Continental Europe. The relative sizes of their run-off markets are compared above:

We have summarised the results of our discussions in the following table. These focused around the type of support available for management dealing with discontinued business, some of the challenges and pressures they are facing, and known and accepted solutions for dealing with discontinued business at the current time.

Whilst it is clear that there are concerns in some territories that acknowledging and dealing with run-off may have some adverse impact on ongoing relationships, this has not been the experience in

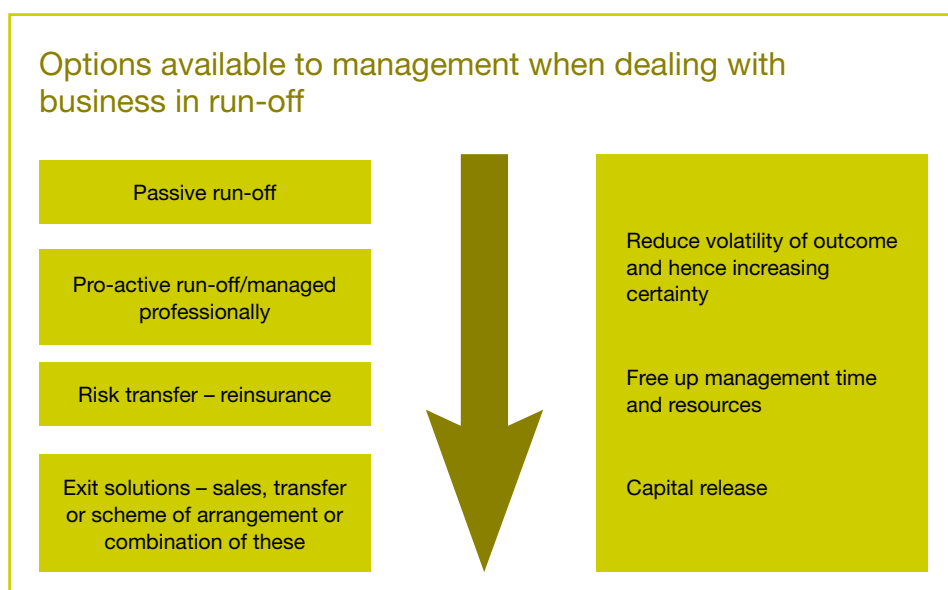
those that have already taken significant steps towards pro-actively dealing with their run-off business. On the contrary, a pro-active plan to deal with discontinued business is clearly seen as a positive move by the vast majority of stakeholders involved in these situations.

It is clear that things are changing at a rapid pace in some Continental European countries and we propose to focus in more detail on some of these issues and on some of the largest territories in subsequent editions of this survey.

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Territory	Organisations supporting run-off business	What is recognised as run-off business	Challenges highlighted in relation to proactively dealing with run-off business	Pressures to deal with run-off business	Tools currently used to deal with run-off business	Knowledge of scheme of arrangement technology and other options for dealing with run-off business
Germany	The International Alliance of Asbestos and Pollution Reinsurers (IntAP)	Business which: <ul style="list-style-type: none"> is no longer generating any premium income is with a party where there is no on-going business relationship 	<ul style="list-style-type: none"> Reluctance to accept run-off exists and requires separate consideration and management Stigma of run-off being linked with past failures Change of mindset of staff and change of policies required e.g. investment policy Retention and motivation of staff and labour laws Maintenance of the on-going customer relationships is key focus 	<ul style="list-style-type: none"> Rating agencies Pressure to reduce reinsurance levels Capital efficiency Solvency II 	<ul style="list-style-type: none"> Run-off to natural expiry Commutations First scheme of arrangement now in progress for German books with 'sufficient connection' to the UK 	Little currently but increasing appetite to understand options for business with connection to the UK or for transferring and scheming business. First scheme of arrangement is already in progress.
France	Syndicat Européen de Gestion des Sinistres (SEGS) and IntAP	Business which: <ul style="list-style-type: none"> is no longer written 	<ul style="list-style-type: none"> Reluctance to accept run-off exists and requires separate consideration and management Stigma of run-off being linked with past failures Labour laws Approach to dealing with direct business in run-off 	<ul style="list-style-type: none"> Capital efficiency Recognition of financial pressures Solvency II 	<ul style="list-style-type: none"> Run-off to natural expiry Commutations Portfolio transfers Schemes of arrangement for businesses with 'sufficient connection' to the UK have already been tested here 	Knowledge is expanding re options for dealing with run-off and schemes of arrangement are seen as a welcome tool for use where appropriate.
Switzerland	IntAP	Business which: <ul style="list-style-type: none"> is with a party where there is no on-going business relationship 	<ul style="list-style-type: none"> Run-off and related issues are dwarfed by the on-going business in Switzerland and so on-going business relationships are the focus Not part of the EU or EEA so Switzerland does not benefit from the ability to do portfolio transfers 	<ul style="list-style-type: none"> Recognition that proactive management of run-off and a clear strategy will have positive impact on the balance sheet – for an ongoing business this is critical 	<ul style="list-style-type: none"> Commutations where appropriate but critical focus is on the on-going relationships Schemes of arrangement for businesses with 'sufficient connection' to the UK have already been tested here 	Only able to use schemes of arrangement as an exit strategy for business which has 'sufficient connection' to the UK however one such scheme of arrangement has already been implemented so this opens the door for others.
Italy	IntAP	Business which: <ul style="list-style-type: none"> is no longer written generates no further premium income is with a party where there is no on-going business relationship 	<ul style="list-style-type: none"> Reluctance to accept run-off exists and requires separate consideration and management Quality of data especially for older books where records may be manually held 	<ul style="list-style-type: none"> Recognition generally that this area needs focus and a clear strategy Solvency II, although it is not seen as an immediate issue 	<ul style="list-style-type: none"> Run-off to natural expiry Commutations 	Little knowledge of schemes of arrangement and view exists that much of the business has little connection with the UK. Opportunities to use portfolio transfers, followed by schemes of arrangement, are not widely appreciated or recognised yet.
Nordic region	IntAP	Business which: <ul style="list-style-type: none"> is no longer written 	<ul style="list-style-type: none"> Mature but innovative market There has been a clear focus for many years in this region on run-off business so it is dealt with proactively Retention and motivation of staff however staff incentivisation plans are now used and recognised as effective 	<ul style="list-style-type: none"> Capital efficiency Solvency II 	<ul style="list-style-type: none"> Novation Sale Schemes of arrangement are being assessed as an exit strategy 	Various exit strategies are being used and developed and the market is clearly open to these developments. Schemes of arrangement are being considered for various entities in this region at the current time.
The Netherlands	NRV (Nederlandse Reassurantie Vereniging) and IntAP	Business which: <ul style="list-style-type: none"> is no longer written 	<ul style="list-style-type: none"> Open acknowledgement of run-off generally means run-off is proactively managed and dealt with Main challenge is ensuring there are staff to deal with older run-off business given that companies have moved away from international business and back to domestic writing over time 	<ul style="list-style-type: none"> Cross-border activity is recognised as something likely to cause pressure to deal with legacy business and to create opportunities for merger activity Solvency II, although not seen as an immediate issue 	<ul style="list-style-type: none"> Commutations Portfolio transfers Schemes of arrangement for businesses with 'sufficient connection' to the UK have already been tested here 	Good knowledge and acceptance of schemes of arrangement as these are already being actively used as an exit strategy here. Transfers for businesses without 'sufficient connection' are likely to be tested here given the country's flexible culture and willingness to use exit strategies where appropriate.

Options for dealing with discontinued business



Various options are available to manage a book or business which is discontinued (see diagram above). We have already seen an increasingly sophisticated market in the UK apply a combination of these techniques to form the building blocks of a strategy that takes them to finality at the appropriate time. Finality can either mean finality for the current liability carrier or ultimate finality where the liabilities are extinguished. The objective of finality is very closely linked to the drive for capital efficiency which is gaining momentum in Continental Europe.

Proactive management via commutation

A commutation programme may be appropriate in certain circumstances, for instance where there are only a small number of policyholders. A commutation programme will undoubtedly utilise significant resources and take considerable time if many commutations are negotiated individually.

Reinsurance

Reinsurance can be used in certain circumstances and this route is usually

speedy to implement. However, it does mean that the liabilities are retained on a company's balance sheet and, given there is limited capacity in this market with only a small number of companies offering reinsurance solutions for run-off business, premiums are often high. Even if the reinsurance can be purchased at an acceptable price there is the risk of future reinsurance disputes and some, albeit usually small, risk of reinsurer default.

Sale

Whilst a sale enables a company to remove the associated liabilities from its balance sheet it is likely to be at a value reflecting some discount on the net assets and may also include an array of restrictive and burdensome conditions which could result in finality for the vendor being delayed for a significant period following the sale. There are now, however, a number of specialist buyers in the run-off arena looking to purchase run-off portfolios and it is probable that these businesses will offer more attractive packages as they gain, for example, economies of scale.

Solvent schemes of arrangement are the only exit strategy that can extinguish liabilities altogether... giving complete finality for the company and other stakeholders in respect of the business subject to the scheme of arrangement.

Portfolio transfers

As we have stated already, portfolio transfers can be used on a stand alone basis, possibly to achieve regulatory or operational efficiency, or potentially as a precursor to a solvent scheme of arrangement if a business is situated in a jurisdiction which has no equivalent legislation itself.

Solvent schemes of arrangement

Over the last few years, solvent schemes of arrangement have increased in popularity. They are now seen as an effective Court-driven exit tool that provides a company with a practical and transparent way of embarking on a wholesale commutation programme leading to full and final payments being made in a timely manner.

Solvent schemes of arrangement are the only exit strategy that can extinguish liabilities altogether, so removing the risk of reserve deterioration and giving complete finality for the company and other stakeholders in respect of the business subject to the scheme of arrangement. It is important to remember however that solvent schemes of arrangement are not appropriate in all situations and feasibility studies must be conducted in advance of proceeding with any scheme of arrangement in order to ensure that the business being considered is appropriate for such a solution.

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Solvent schemes of arrangement are available to non-UK businesses and an English Court is able to exercise its powers to approve a scheme of arrangement for a non-UK book of business if it is satisfied that the relevant business has 'sufficient connection' with the UK. The Court will consider, amongst other things, whether:

- the company wrote business through a business presence in England such as a branch
- the company operated in the London Market via London Market brokers
- some or all of the policyholders are based in the UK
- some or all of the company's assets are based in the UK.

It is not necessary for all of the above factors to apply for there to be a sufficient connection and the Court will assess each case based on its individual facts.

Of the 80 solvent schemes of arrangement for insurers which have been implemented to date, 52% of these are in relation to non-UK businesses and 33% of them specifically relate to Continental European insurance and reinsurance business.

At the current time it is only the UK and Ireland who have scheme of arrangement legislation within the EU member states, however, it is wholly possible that some of the other territories in Europe may consider the merits of implementing their own scheme of arrangement legislation in due course.

In conclusion, we are witnessing increasing pressure on insurers and reinsurers in Europe to manage businesses effectively in terms of both costs and capital and this is leading businesses to proactively address their discontinued business in order to stay ahead of the competition.

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‘Arguably every contract is discontinued after its annual renewal but I would say it is only truly considered discontinued if there is no longer an on-going relationship’

Tom Freudenstein – GLOBALE, Germany

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