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Exits from Run-Off Article

GIRO Convention 2004

Given the sheer scale of the world's insurance and reinsurance business that is in run-off it is hardly surprising that much has been written about the techniques available for exiting discontinued business. However, due in part to the relatively short time that those techniques have been in place, rather less has been written about any potential pitfalls that have emerged, and how they can be addressed.

The market for exit solutions is maturing. Just a few years back, the only solutions for getting out of run-off involved either a commutation programme or a large scale reinsurance. Then, largely because commutation is slow and the reinsurance solution can be expensive without actually providing "finality", sales and schemes of arrangement came into vogue.

Since, there have now been some 27 solvent schemes of arrangement in the UK and Bermuda (counting pool and group schemes as one), as well as a number of sales it has finally become possible to speak of an established market for these alternative solutions.

As is only to be expected now that the market has had time to react to the use of sales and solvent schemes and to test the boundaries of how they can be applied, it is also possible to discern some concerns about the techniques and their application.

SALE OF DISCONTINUED BUSINESS

The sale of discontinued business is becoming a very popular method of achieving an exit and there is a small (but growing) number of specialist purchasers with dedicated finance available in the market.

The advantages of this approach to an insurer with run-off business embedded within a live company or group are obvious: the liabilities and potential for adverse claims development are removed from the balance sheet, and the company, its shareholders and the rating agencies can concentrate on new business.

However, there are pitfalls emerging of which the major one relates to slow claims payments damaging the reputation of the seller and, indeed, that of the acquirer.

A purchaser may see it as advantageous to delay payment of claims in order to maximise investment returns so as to maximise the capital realised as shareholder when the business is closed.

However, such a policy is likely to prove to be short-sighted as, if those in the market take the view that the delays are unreasonable and deliberate, they will seek revenge. This could take the form of a complaint to the Financial Services Authority (FSA), and pressure on the seller - assuming it is still in the live market. For the purchaser, obtaining regulatory consent to the next purchase would be difficult if the FSA is concerned about its treatment of policyholders.

SCHEME OF ARRANGEMENT

Solvent schemes of arrangement have because the key technique by which portfolios are closed – whether by risk carriers or by buyers of run-off books. In order to go ahead, solvent schemes of arrangement have to be approved by a majority in number, representing 75% by value of those who vote.

To date it would appear that only one solvent scheme has been rejected at a creditors' meeting (and it was re-presented and accepted at a subsequent meeting), and most if not all which have gone through have done so with majorities in the 90% range for both number and value.

With the greater use of such schemes it is perhaps unsurprising that some creditors have used their potential vote as a bargaining chip to push for favourable commutations ahead of schemes.

However, this is a double-edged sword in that few creditors can be sure that their vote alone holds the key to the success of a scheme, and therefore is the means to block it.

Tactical voting, or the threat of it, may give the appearance of a push back against schemes, but in reality the voting figures to date suggest that it is a commercial lever rather than the symptom of discontent.

That said, there are signs of disquiet about a few aspects of some recent solvent schemes, and these need to be heeded by those who are promoting them in future if the perception of one of the few really useful tools that exists to deal with legacy issues is not to be irreparably damaged.

Three particular examples have resulted in concerns being expressed not just within the market, but also to the FSA.

The first issue revolved around Bar Dates – the deadline by which claims must be notified in a scheme. Failure to notify means no claim and no payment. Although most schemes allow for discretion to accept late notification, the potential consequences of missing the deadline are obviously severe.

Obviously if creditors, and particularly those based overseas, do not learn of the scheme's existence until some time after it becomes effective, their time to react, consider, take advice and to file claims will have been much reduced.

In the case in point, the Bar Date was three months after the scheme became effective - a short period and probably the shortest that the FSA would permit in normal circumstances.

As such, some overseas creditors and their advisers felt that they had not been given sufficient time to prepare and submit their claims, so triggering suggestions that the whole solvent scheme process is inherently unfair.

In reality, of course, this has not normally been an issue. In many complex schemes the Bar Date is up to six months after the scheme becomes effective. What is more, even before a scheme becomes effective, companies should send "practice statement letters" and must send notifications of the proposed creditors' meetings to give creditors and potential creditors plenty of early warning of Bar Dates and their effect.

Communicating with 'policyholder – creditors' is vital and not only involves writing to those identified on the scheme company's records, but also advertising and contacting brokers and other advisers. In addition, road-shows and help-lines can be made available in countries where there are likely to be significant numbers of creditors. The use of the Internet is also greatly improving this process, as each scheme can have its own web site. One obvious related concern, which can also impede communication with creditors, is language. A complex scheme is hard enough to master for those whose primary language is English, so it has been important to consider using translations of schemes, or at least the main features, to help increase the understanding of overseas readers.

The second issue which triggered comment to the FSA revolved around a scheme whose structure meant that some creditors found it hard to work out both whether their claim was caught by the scheme and how set-off worked for insurers that were involved in the scheme.

Such points highlight the crucial role of scheme engineering and drafting, particularly in complex pool environments. By the nature of the business, many pool schemes are going

to relate to pool business that was only one part of the participating companies' overall underwriting activity.

As such, the scheme document must be so limpidly clear that a reader can tell for certain if a particular claim falls within it is or excluded, otherwise creditors with bona fide claims may be left without a remedy – and market reputations could be tainted.

What is more, where such uncertainty exists most creditors will file claims far beyond the intended scope of the scheme, leaving the company to sort out those which are covered from those which are not, so driving up costs and causing delay and aggravation.

To avoid such problems it is critical to "stress-test" schemes in their draft stage with representative policyholders and others to make sure they are understandable and effective.

Stress-testing is a vital part of scheme engineering, as it enables others to run problem scenarios at the scheme structure and see if it responds properly to all of them.

A related contentious issue is the requirement in some schemes for creditors to resubmit claims data which they have already provided, in order to be eligible for payment.

Regarded with resentment in many quarters as creating an unreasonable administrative burden on policyholders, this process can be avoided by including the data on the claim forms which are sent out after the scheme becomes effective. Creditors can then simply confirm details as correct without re-submitting all the information from their own records.

The third key issue which has recently raised its head with the FSA is that of independent oversight of the scheme process. If something goes wrong in a scheme, who do creditors talk to? They may feel the company running the scheme is not going to give a truly

independent response to complaints, and they will almost certainly not want to go to Court as a first step.

The best answer may lie in the role of what is often described these days as the 'Scheme Adviser'. This function is created by the scheme and can give the office holder the role of 'whistle blower' in the event that some aspect of the scheme process is not being followed. The existence of an independent whistle blower should serve to comfort creditors voting for a scheme, and that is a vital function.

To fulfil this role, the Scheme Adviser obviously needs to be independent of the company and its scheme, and have no financial interest in its outcome.

Overall, solvent schemes still offer the best device by which the market can tackle its legacy problems, making them a vital tool in the market's ability to remain viable in the future. But as a potentially powerful force for changing relationships with policyholders, the industry must take real care to ensure policyholders' concerns receive full attention when creating schemes.

Fundamentally, the reputation of the companies promoting schemes is vital, hard-won and easily damaged. If they are seen to take advantage of the scheme or sale process in a way which appears to exclude legitimate claims, then the Courts, the regulators and the market will react adversely.

As Paul Taylor at the FSA, the man who has the unenviable task of overseeing the UK general insurance run-off market, points out: "These comments have been made to us as well. We are mindful of them, and have raised them with those who formulate solvent schemes and sales. However, we recognize that schemes in particular are one of the few mechanisms - possibly the only one - available to close discontinued business.

"We are closely involved in the regulatory oversight of the process of formulating them, and we are certainly happy that they work in principle. We are confident that the recent

comments can be addressed by the adoption of best practice on the part of all parties involved in the carrying out of schemes."