GILC

GLOBAL RUN-OFF AND LEGACY TRENDS 2021

GLOBAL INSURANCE LAW CONNECT

INTRODUCTION

Many of those in the insurance and legal communities expect to see an increasing number of run-off and legacy deals in 2021. The reasons for this are multiple and varied. COVID-19 has taken a toll of many international insurers' reserves, changed the profitability of some significant lines of business; and forced everyone in the industry to examine contract wordings, both historic and current. Brexit and the requirements of Solvency II and IFRS 17 also continue to act as drivers, while in the US, the increasing use of IBTs (Insurance Business Transfers) in different states is also driving 'whole entity' deal numbers.

The impacts of COVID-19 on various books of business are likely to stretch into the long- and medium-term, having an asbestos-like impact in many ways for our industry, with issues such as causation, long Covid and complexities around remote working yet to be fully tested.

PwC's 2019 *Global Insurance Market Run-Off Survey* anticipated deal values of $101 to $300m in the UK alone over the period 2020 to 2022 and estimated global non-life run-off reserves at circa $790bn, with legacy management becoming part of the "new normal".

And yet globally the picture is not aligned. In many markets, run-off is an untested concept, and in more than one territory, our legal specialists told us that they believed the regulator would be willing to accept run-off transactions, but that insurers are unwilling to put themselves forward as the first 'test case'. As a result, there are a number of territories around the globe where transactions do not occur, in spite of the presence of global TPA specialists and interested international buyers.

In order to understand how the global run-off market is really moving, we recently asked each of Global Insurance Law Connect's members in 20 countries around the world to classify their local run-off market, in terms of both its maturity and direction of travel. The results are presented here, in our first ever global report on the run-off and legacy market, capturing trends across 20 countries.

LONG COVID

"THE IMPACTS OF COVID-19 ON VARIOUS BOOKS OF BUSINESS ARE LIKELY TO STRETCH INTO THE LONG- AND MEDIUM-TERM, HAVING AN ASBESTOS-LIKE IMPACT IN MANY WAYS FOR OUR INDUSTRY."

RICHARD LAWSON, PRO GLOBAL

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RUN-OFF: THE BUYERS

A run-off or legacy purchase is a sophisticated financial transaction, requiring complex modelling by specialist analysts. In the two biggest markets, the UK and USA, there is a full spectrum of interested run-off portfolio buyers, with the industry 'regulars' sitting in three overall categories:

- Reinsurers such as Berkshire, Swiss Re, and Munich Re - who remain very active at the top end of the market, typically initiating large deals where the buyer needs the rated paper for capital relief.
- The larger established specialists are also looking to provide finality, although using cheaper paper through Bermuda (this includes Enstar, Catalina, R&Q, Premia and Armour Risk). This group target the true run-offs and discontinued lines of business.
- Regionally-focused or smaller specialists, startups and PE companies such as Darag and Comp Re, whose market presence is growing, but currently focus on small to mid-size transactions.

Alongside this group, the UK and US see regular start-ups and approaches from interested capital, and this looks likely to continue as long as deals continue to be floated.

However, in the smaller run-off markets, such as Australia, the Netherlands, France or Belgium, the group of buyers is much smaller and less specialist. There are fewer sophisticated specialists active in these markets, and reinsurers and international insurers (sometimes looking for licenses or a presence in the country, rather than for a true run-off purchase) are the main participants.

RUN-OFF BUYERS

REGIONAL REVIEW

UK

LLOYD'S DEALS MAKE UK THE MOST ACTIVE MARKET

The most mature European legacy and run-off market is, of course the UK. However, BLM Partner and Head of Occupational Disease Practice Group, Chris Fletcher considers that "there is still growth to come in the sector. The legacy EL/PL longer-tail claims aspect of the market is at the more mature end; other lines of business are becoming more common. Clients are telling me that although some established players may be nearing their ceiling in terms of proportion of their business devoted to this market, there are a number of other acquirers interested in investing capital in this area, and still much interest from the traditional primary market and especially from Lloyd's to drive transaction activity."

The profitability exercise conducted by Lloyd's in autumn 2018 led to a rash of syndicates exiting non-core lines of business. As a result, the run-off transactions seen in the last year have been led from this segment of the market. These Lloyd's run-off deals cut across many classes, property, casualty, political risk, marine, aviation, to mention but a few.

This has meant that UK market was more active than that in the US, and the number of deals in Q3 2020 outpaced the same period last year (35 deals in 2019 versus 40 deals in 2020).* PWC have predicted that even more deals are likely to come through in the coming year.

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> CHRIS FLETCHER, BLM

* Source PWC 'Non-life insurance run-off deals' October 2020

EUROPE

In Europe legacy portfolio transfers have traditionally been most favoured as solutions in Germany, France, Switzerland and the Netherlands.

One step further away are the Southern and Eastern European territories, including Turkey, where run-off is not yet regulated, and portfolio transfers are still almost unknown. This is also the case in the Nordic countries. Norway's Riisa reports "There are very few examples of one insurer or entity buying claims, save in situations where an entire insurance company is being bought."

However, some markets are beginning to look at closure mechanisms that include portfolio transfers. Here we see a group that we could call 'the ones to watch' – several countries where the run-off market is beginning to develop, and Part VII style deals to occur. Two good examples are Italy, where the first legal mechanism to allow run-off transactions was passed into law on December 18th 2020; and Luxembourg, where regulation was created in 2013, and where there are now two active players putting together run-off deals. GILC member in Luxembourg, Molitor explains that "although run-off exists in Luxembourg and is increasingly developing, it is much less developed and less important than in the UK.

The EU is a big driver in these developments. Alberto Batini of BTG Legal in Italy explains, for example, that "Italy is modifying its policy on the transfer of portfolios in run off in order to be aligned to the EU approach towards this kind of transfer, already allowed in many Member States." This is a trend that we believe will only continue.

Drivers for deals in Europe include a continent-wide trend for consolidation among insurers; and the widespread issue of motor's non-profitability as an insurance class, which is causing many insurers to look at creative ways to close out their exposure to that market.

Most important, however, is the stimulus provided by Solvency II and IFRS 17, both of which drive insurers to walk away from segments of business that they cannot sustain reserves to support.

Some countries have their own causes for a shared growth in run-off transactions, and the quotes below give a flavour of what countries are seeing.

In Germany, Arnecke Sibeth Dabelstein reported that "the need for non-life legacy solutions is growing in Germany. Insurance companies are trying to focus on their core business, as well as on digitization. They are worrying about the unpredictable outcome of Covid-19 and the preparation for IFRS17. Of these, the last is most significant. We believe IFRS 17 could be a major driver for new legacy solutions over the next few years as management begin to receive transparent information about core and non-core portfolios."

Dutch firm WIJ Advocaten believes that consolidation is critical in their region: "what we see in the Netherlands is that insurers are seeking economies of scale and are focusing on possibilities for consolidation.

Solvency II is an important reason for consolidation, as it is becoming increasingly difficult and expensive for small insurers to comply with the stricter requirements of the regulations. To maintain profitability, insurance companies are exploring different ways to reduce their total costs and increase their variability, including the disposal / acquisition of portfolios."

Meanwhile in the Swiss market, there is a steady and well-established exchange of reinsurance portfolios between reinsurers. The tightening of supervisory practice by the Swiss Financial Market Supervisory Authority FINMA and Brexit have, however, led many foreign insurers to seek exit solutions, leading to an increased demand for legacy and run-off solutions.

Dominik Skrobala of GBF says that "Foreign insurers have had to learn the hard way that, according to FINMA, the transfer of direct insurance portfolios under Swiss law requires the concerned policyholders to be domiciled in Switzerland. This makes it tricky to transfer an entire Swiss direct insurance business to a different risk carrier and thus exit the Swiss market. It should also be noted that the Swiss regulator FINMA requires insurers to evidence legal certainty that no more claims can arise out of a portfolio to demonstrate its finality – which is in stark contrast to other jurisdictions, where a high probability might already be deemed as sufficient."

In Turkey, we found that there is no official run-off market, but that some form of 'closure' is achieved through the termination of broker agencies or withdrawal from the market.

For example, in Turkey, Dubai Starr Insurance has applied to the insurance regulator to cancel its motor insurance license. This strategic move will prevent Dubai Starr from generating revenue from motor claims. However, with any mechanism to offload claims, they will remain subject to 10 years of long tail accountabilities arising from statute of limitation under Turkish law. As Turkish insurance law specialist Durukan notes, this is a good example of a market which is ripe for run-off deals to be concluded, but which is held back by the lack of a regulatory structure within which this can be achieved.

NORTH AMERICA

The US market continues to be very active and the increased interest from brokers is driving more and more transactions, with the vast majority being reinsurance structures such as Loss Portfolio Transfer (LPT) and Adverse Development Cover (ADC). The use of a specialist Third Party Administrator (TPA), such as Pro Global, is becoming far more integral in deals, especially for new entrants, as increasingly cost conscious and competitive processes mean that buyers are looking for operational and claims support.

Pro Global's Richard Lawson commented that "we expect the US market to continue to remain active in terms of run-off transactions driven by a combination of brokers being more active and the increased capital enjoyed by larger players. We also expect state regulators to continue to approve proof of concept for Insurance Business Transfers (IBTs), provided their confidence in the mechanism and the run-off market in general continues to grow. In most cases, IBTs result in more efficient capital allocation for the carriers, and increased transparency for regulators, which is why their use is growing."

"While the categories of insurance included in deals remain a widely mixed bag, the most prevalent are workers compensation, a range of motor liabilities and asbestos, pollution and hazard (APH) risks often transferred through a reinsurance portfolio."

The busy US market is positive in many respects. Multiple competitive tenders are occurring between run-off managers to purchase books of business, but the market must be careful to maintain pricing discipline. Richard Lawson of Pro says: "One trend that might be seen in 2021 is the influx of capital and highly competitive tenders pushing pricing and risk in the wrong direction. This is a concern for everyone." Run-off portfolio transfers are a new type of transaction for many states in the US and major failures will not go unnoticed by the regulators.

"IN THE US MULTIPLE COMPETITIVE PARTICIPANTS RISK DRIVING PRICING TOO HIGH, AND ATTRACTING REGULATORY REPROOF."

SOUTH AMERICA

South America remains largely a no-go area for portfolio transfer transactions. In Brazil, the market is stable and Santos Bevilaqua Advogados believe that there are grounds to believe that light-touch regulatory structures would allow reinsurance-based portfolio risk transfers to be approved. Here, as in India, the project has yet to be tried, but a driver does exist, in that some long-tail risks (eg pension and life) are proving costly and are burdened with poorly constructed mortality tables or over-generous rate guarantees. Currently insurers are unable to dispose of these portfolios, although many have an appetite to do so. Local discussions about structures to deliver this remain active.

In Mexico the legacy and run-off market remains almost entirely undeveloped, in spite of rumours of possible activity a few years ago. There have been (rare) transfers of pools of risk to reinsurers, but Part VII transfers do not exist, and in most cases insurers must keep any long-tail risks that they own. Mexico's Ocampo Law state that even the use of TPAs is not common.

ASIA PACIFIC

Much of Asia remains closed to portfolio transfer activity. In both China and India, such deals are not authorised by the regulator, and remain unknown quantities for insurers with books that they would like to bring to conclusion. In India, Khaitan Legal Associates remain positive that the regulator would be sympathetic to a portfolio transfer, although run-off is "not at the top of their mind" – understandably in such a young market, with only twenty years of legacy in play.

As a result, the market has yet to find an insurer who is willing to approach the regulator and trial the concept, although in some cases, the same position has been achieved by the retrocession of an entire book to another insurer. It is the same story in China, where Buren report that "the only relevant regulation on run-off is the Provisional Measures on Administration of Transfer of Insurance Businesses by Insurance Companies published by the China Insurance Regulatory Commission in 2011. However, we have not seen any deals following the publishing of the regulation.

Elsewhere, the picture is more positive. According to Australian insurance law heavyweight Sparke Helmore, the run-off market in Australia is starting to gain more traction and in 2021 it looks likely to continue to grow and gather momentum. Large global players are looking to run-off specialists to acquire legacy portfolios, which enables them to have a clean and decisive exit from lines of business which are taking up capital and capacity. As markets have consolidated, there have also been players offloading those lines which are not core to where they want to be in the market. Some recent examples are Enstar completing the transfer of certain run-off portfolios from Great Lakes Insurance SE, and HSB Engineering Insurance Limited (both subsidiaries of Munich Re) and the NSW CTP portfolio from Zurich.

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CLAIMS ARE CRITICAL TO SUCCESS

"THE DECISION TO INSOURCE OR OUTSOURCE IS ONE THAT IS MADE ON CONSIDERATION OF WHAT DELIVERS BEST VALUE TO THE OWNER OF THE PORTFOLIO."

Run off is, of course, not just about the deal. The real work begins once the acquirer takes on the management of the portfolio of claims.

Claims handling in the run-off market is almost universally praised as being typically more efficient and proactive than that carried out by traditional insurers. Often portfolios in run-off have been neglected, sit on legacy platforms and generally underperform. Focused legacy managers invest in people and processes to drive returns while also ensuring valid claims are paid.

The decision to insource or outsource is one that is made on consideration of what delivers best value to the owner of the portfolio. Pro Global's Richard Lawson comments that "Any third-party claims handler (TPA) has to offer greater value through combinations of specific skills, market insight and a price point that compels the decision to outsource. Every run-off acquirer will have utilised an outsource model somewhere, while a number have also acquired or created their own TPAs."

With the cost of claims a critical issue for the profitability of run-off deals, it doesn't help specialists that in the last year most claims have become less easy to predict than they once were. Costs have risen in many supply chains, healthcare systems are under pressure with rising prices, and businesses themselves are seeing fluctuations in their own pricing and profitability, making long-tail claims harder to predict.

In the UK, the potential existed for a divergence of approach and philosophy between the primary and run-off markets in relation to claims handling, given the fundamentally different models involved in each. However, such divergences have perhaps not fully materialised and in general a pragmatic approach prevails. IRLA (Insurance and Reinsurance Legacy Association) has acted as an outlet for discussion within the market and has allowed pragmatism to develop. The run-off market has some differing priorities from the primary market because legacy and run-off players do not have ongoing policyholder and broker relationships to manage, although in an active transactional market, reputation remains important.

In addition, there may be some degree of hesitation in adopting radically different approaches to claims handling whilst the regulator is still, to an extent, "taking stock" of a growing and maturing market. The UK regulator, the FCA, has begun to recognise that the run-off model, in claims, is different to the traditional or primary market and has indicated that it is likely to carry out a thematic review in relation to claims activity to allow it to compare the primary and run-off market during 2021.

DIFFERENT COUNTRIES PREFER DIFFERENT WAYS TO MANAGE CLAIMS

In most countries, the majority of legacy and run-off claims are long-tail disease. In the UK, the complex nature of these claims means that most claims and portfolio administration activity is outsourced to third party organisations. In general terms, capital providers prefer to avoid taking on the claims handling activity directly in house, nor do they wish to absorb the HR and other administration issues relating to operating a claims staff. Even with respect to Enstar's recent acquisition of the legacy RSA book, which saw RSA's staff transfer to Enstar, an agreement was quickly reached with Pro Global to handle the claims, resulting in the transfer of staff on to Pro. One exception to this outsource model is Catalina, which has thus far invested in maintaining its own experienced claims-handling skill base. RiverStone is another.

In the smaller markets, such as Australia and the Netherlands, the size of the market means that other players may be involved. For example, some live insurers will also offer claims handling for run-off portfolios without owning the portfolio, particularly in cases where detailed and specific knowledge is required.

TPAs are also frequently a core element of the claims delivery model – commonly used in countries such as France. And on some occasions law firms are asked to handle the claims (but only if the insurer remains involved for administrative back-up etc.)

It is clear that in smaller markets, with fewer players, there are fewer pure specialist handlers in-country, and that different types of businesses will offer the services required in this market.

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THE RUN-OFF MODEL DELIVERS FOR CLIENTS IF WELL-MANAGED

Across all countries, it was agreed that separating a portfolio from its original insurer can improve outcomes for all parties – something that is not always the public perception.

One UK-based manager of a large portfolio of EL and PL claims commented that he had expected to "see the reopening of dormant arguments as new owners wanted different results from their claims and were less concerned with reputation or renewal business. I expected to see a rehash of trigger or dosage arguments and a reintroduction of a modicum of distrust between co-insurers. In actual fact, relations have improved as the shackles of working under the auspices of live carriers have been released."

The same manager also spoke in favour of separating closed portfolios of business from their original underwriting team. In his view: "policy arguments have much more teeth at the run-off end". For example, arguments over failure to adhere to conduct clauses or the application of exclusion clauses have much more force when the handler is released from the concerns of a more closely linked underwriting team.

In Germany, it is similarly the case that specialist companies bring a size and focus that allows better outcomes. One run-off client said "we feel that the cooperation is much closer, problems are solved more quickly, and individual approaches are easily enabled. A proactive claims management is a key piece of the service offering, while traditional insurers are mainly reactive."

In Australia, lawyers Sparke Helmore commented that the run-off model tends to encourage reduced, early settlement offers to remove the liability from the books and that specialist firms are more receptive to innovative proposals in relation to claims handling.

The overall view about the positive impact that a specialist can have on closed portfolios is best summarised by Arnecke Sibeth Dabelstein. "Compared to more traditional insurers there is certainly a larger focus on each individual case. Overall, the responsiveness and proactivity in run-off claims is greatly improved over claims handling in traditional claim departments, leading to favourable results not only for the insurer but the claimants and policy-holders alike."

"OVERALL, THE RESPONSIVENESS AND PROACTIVITY IN RUN-OFF CLAIMS IS GREATLY IMPROVED OVER CLAIMS HANDLING IN TRADITIONAL CLAIM DEPARTMENTS, LEADING TO FAVOURABLE RESULTS NOT ONLY FOR THE INSURER BUT THE CLAIMANTS AND POLICY-HOLDERS ALIKE."

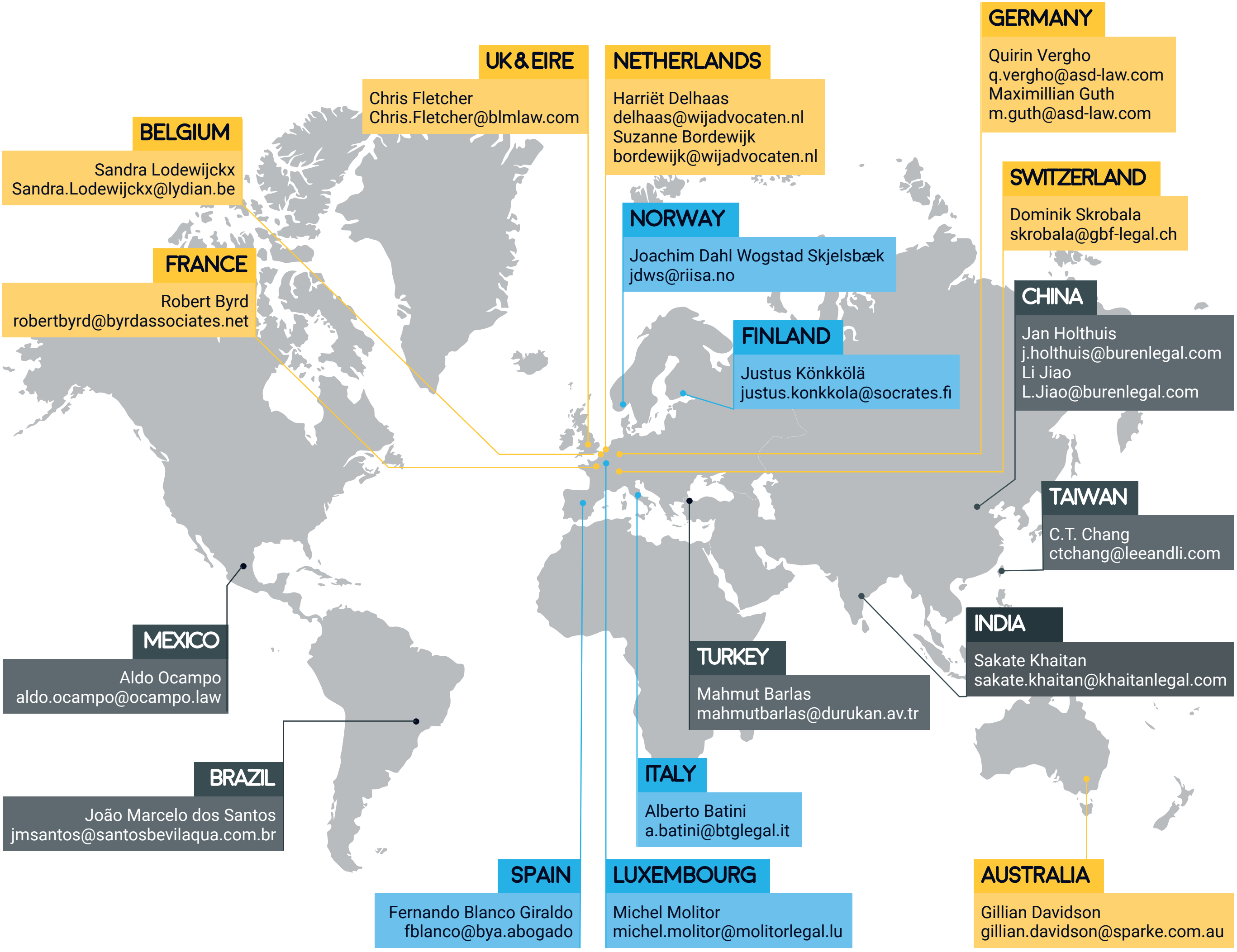
CONCLUSION

Perhaps the best way to sum up the results of our global survey is "growth held back by legislation". One universal truth, from South America to India is that in every market insurers are looking for opportunities to divest themselves of unwanted legacy portfolios. While some of the exact drivers may differ, we see a common pattern: in markets where regulation permits portfolio transfers, creative solutions flourish, with multiple parties cooperating in flexible ways; and, very often, delivering a more positive outcome for all parties.

In this positive frame, we hope to see more markets open up to this sort of transfer, with China and India both being high on the wanted list. Many believe that COVID will have an impact on the market very soon, with Robert Byrd of Byrd & Associates in Paris commenting "Covid-19 exposure will also be a likely cause of an increase of run-off for certain risks, in particular in France, we expect BI related claims resulting from government ordered closing of restaurants, bars etc." Let's see what 2021 brings to this often-overlooked and yet innovative corner of the insurance world.

"IN MARKETS WHERE REGULATION PERMITS PORTFOLIO TRANSFERS, CREATIVE SOLUTIONS FLOURISH, WITH MULTIPLE PARTIES COOPERATING IN FLEXIBLE WAYS; AND, VERY OFTEN, DELIVERING A MORE POSITIVE OUTCOME FOR ALL PARTIES."

YOUR RUN-OFF AND CLAIMS CONTACTS



Market status

Mature, with established routes for run-off transfers and claims handling.

Market status

'Emerging' – infrequent or no transfers of entire portfolios

Market status

Non-existent – untested

GLOBAL INSURANCE LAW CONNECT

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If you'd like to find out more about Global Insurance Law Connect, contact one of our member firms, or our chairman, Jim Sherwood at jim.sherwood@globalinsurancelaw.com

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