In conjunction with

A Survey of Discontinued Insurance Business in Europe: *Ninth edition / September 2015*

Unlocking value in run-off

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Introduction

Welcome to the ninth edition of PwC's Survey of Discontinued Insurance Business in Europe. We are delighted to have once again published the report in conjunction with IRLA and would like to thank everyone that completed our online survey.

In tandem with reporting on the Survey results this edition includes features on key run-off themes from a number of our insurance specialists. We also include an update on the life run-off scene in Europe as we see increasing investor interest in this sector.

In this introduction we reflect on developments in the non-life sector with Dan Schwarzmann, PwC Executive Board Member responsible for Clients & Markets and Head of the Solutions for Discontinued Insurance Business team and Paul Corver, Chairman of the Insurance & Reinsurance Legacy Association (IRLA). The highlights of their conversation are set out here and a film of the discussion is available at www.pwc.com/surveyofdiscontinuedinsuranceeurope

Legacy remains an active sector. The impending implementation of Solvency II and continued M&A in the live environment will focus minds on how best to deal with the challenges of retaining and managing run-off liabilities. We expect to see further opportunities to unlock value in run-off over the year ahead.

We hope you enjoy reading this edition of the Survey and the PwC team look forward to discussing the legacy market and other areas of interest with you over the coming year.

Interview:

Andrew Ward – PwC AW
Dan Schwarzmann – PwC DS
Paul Corver – IRLA PC

AW ***Dan, if I can ask you first, what is the key market activity that you have been seeing over the last year?***

DS We are seeing a lot of focus on Part VII activity and we have been very fortunate to be involved in one of the largest for a long time, the Hartford Part VII. The other thing we are seeing is much more focus on employers' liability books.

We are managing insolvencies of many books that include employers' liabilities and we have been saying for many, many years that as soon as those liabilities became more stable there will be M&A transactions of the liabilities. Employers' liabilities have become more stable for a number of reasons, including for example, market litigation. This has created a lot more certainty and so I think we are going to continue to see an uptick in transactions including employers' liability.

The other thing that we are seeing is in Continental Europe – there continues to be legacy activity but I just feel now with more focus than before. We are seeing this in a number of countries in particular Germany at the moment and there will be much more focus on run-off now and going forward.

AW ***Paul, we are nine years into publishing our Survey. There have been a lot of changes in the run-off market over that time – how have you seen things develop?***

PC Well certainly IRLA has changed significantly over that period. We now have a much wider membership since rebranding to be IRLA from the Association of Run-off Companies as it was before and we are now attracting more members from live companies who are managing legacy in-house. I think part of that is the focus in large companies such as QBE and Munich Re who now have dedicated in-house run-off units. They want to skill up. They see run-off as an embedded part of the insurance cycle, it is no longer in the closet.

AW ***Run-off is here to stay evidently, but what are the challenges that you see companies facing both in Europe and the UK?***

PC I think one key challenge is with regulation. In the UK, Dan has mentioned there are a number of Part VIIs going through. We are doing three at the moment within Randall & Quilter. There is no doubt the Regulator is overworked, under resourced and they have got a stock pile of transactions to process. Now that is obviously delaying businesses from achieving what they want. However it is something that hopefully will be resolved when we get into 2016 and beyond as the pressure perhaps to do reorganisations ahead of Solvency II passes. In Europe, the regulatory challenge is more on the ability of some Regulators to fully understand and appreciate the Directives that are there for insurance business transfers especially cross border ones and cross border mergers. We are looking at a number of those and are assisting the Regulators in understanding that process in order to effect the business transfer.

"Overall, I think certainly the interest in run-off will remain and there will continue to be capital providers supporting it."
Paul Corver, IRLA

AW *Dan, as we enter this Solvency II age, what are your predictions for the future of run-off?*

DS Well one thing is for sure, that I am absolutely definite about, run-off liabilities are going to grow. Paul you have already said membership of IRLA is growing – totally understandable. Why is it going to grow? It is going to grow because of Solvency II and as companies focus much more on their capital. We are also seeing a lot of merger activity between live companies. As those deals occur, they will focus much more on what books should go into run-off and then how to deal with them.

Again Paul you have said that companies are creating centres of excellence to deal with books of business in run-off. We are also seeing that happening, and as a result, we will see much more activity around disposals of books of business in run-off.

Where will we go with schemes of arrangement? We have seen a lot of innovation in this market – so the Orion Scheme is out at the moment and it has got an innovative twist which could be used in a number of ways. I think we are going to see more creative ways of creating certainty around books of business in run-off. Let me give you a quick example – Members Voluntary Liquidations, I don't like that term – it just means solvent liquidations. This is another tool that could be used to close books of business in run-off. You might see this or similar techniques being used as alternative solutions to schemes of arrangement if that is what the stakeholders want.

AW *It is fascinating to hear Paul that Dan thinks there are going to be more transactions in the market and I think that is really being supported by our Survey results this year. How do you see the future for the run-off consolidators and perhaps the attraction of new capital into the market?*

PC The future is definitely bright. We have got a very healthy pipeline of transactions, we know a number of them are out for open tender, so that means there is business there for the other consolidators. As for new capital coming in, I think that really depends on the health of the economy generally. There has been interest in it because of the good returns from run-off but with the economy's strength and interest rates potentially rising is new capital then going to look into its more traditional areas and move away? Overall, I think certainly the interest in run-off will remain and there will continue to be capital providers supporting it.

AW *Gentleman, just to wrap up today perhaps some final thoughts – Dan if I can come to you first?*

DS I think Andy we have covered the key points in this session. I would just say, run-off has always been and will continue to be a very exciting area, we will continue to see innovation and we will continue to see creativity.

AW *Paul, some final thoughts from you?*

PC I think just that pro-active run-off management is on the agenda of most companies and that will continue to be the case whether it is managed in-house or outsourced. There will be challenges to address for the ongoing transaction activity across Europe, but they are ones that we look forward to tackling head on.

AW *That's great. Paul, Dan, thank you very much for your thoughts today.*

> *"One thing is for sure, that I am absolutely definite about, run-off liabilities are going to grow."*
> Dan Schwarzmann, PwC

Key findings

In the following two pages, we capture a summary of the key findings of our online survey. It seems clear that respondents are anticipating ongoing M&A run-off activity in Europe. Respondents also predict that Solvency II is set to increase workloads and opportunities for those involved in the sector. In addition, more recent lines of business are increasingly being classified as run-off, and respondents also believe that the current landscape is on balance a helpful one for dealing with run-off liabilities.

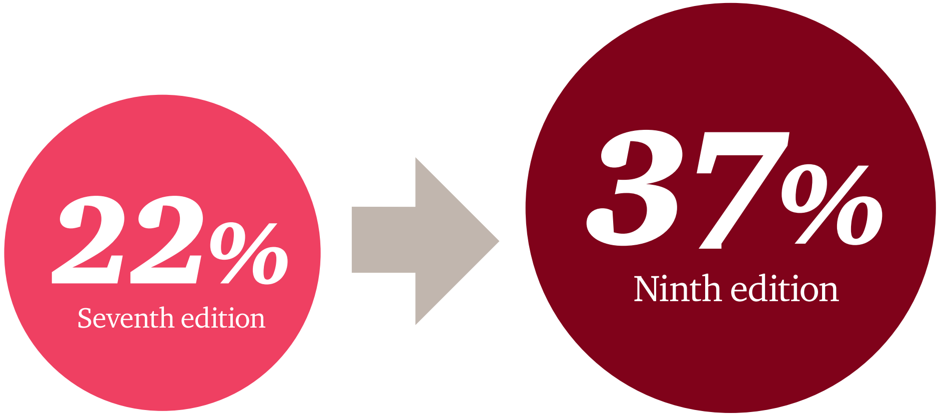
What are the top three key objectives of your organisation's or client's strategic run-off plan?

What would increase the likelihood of you or your clients implementing a legacy solution including exit, restructuring and reorganisation for one or more legacy portfolios?

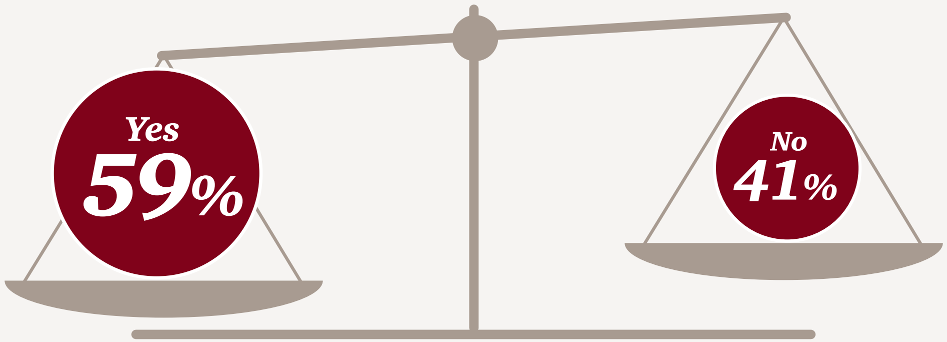
55%

of respondents think the implementation of Solvency II will lead to an increase in their workload / opportunities.

Proportion of organisations that classify some business written since 2010 as run-off



Is the current landscape a helpful environment for (re)insurers wanting to deal with their run-off liabilities?



Nick Watford

Market size

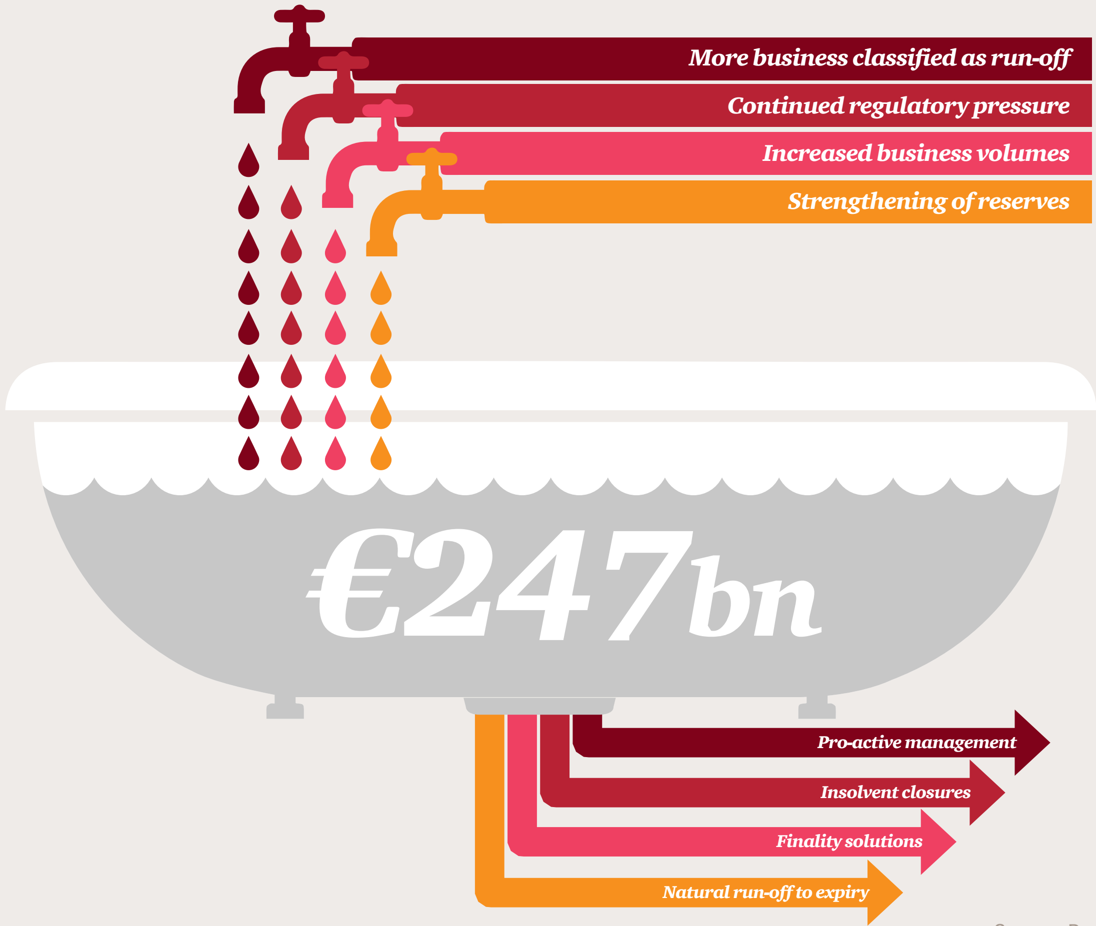
This year we have once more seen growth in the size of the European market, continuing a trend that has developed since the fourth edition of this Survey, published in 2010. The growth has been driven by a sharper focus on core business by many firms influenced by Solvency II preparations and increasingly earlier re-classification of business into the run-off category.

The illustration in Figure 1 highlights the factors contributing to the inflows and outflows of the non-life European legacy insurance market which is now estimated to comprise run-off reserves of €247bn. The balance of inflows to outflows is such that the market has continued to experience some growth over the last year. The estimated size of the run-off market across Europe is also shown in Figure 2.

The largest increase this year has been in the UK and Ireland. This market has experienced another year of strengthening in long-tail employers' liability reserves coupled with the same increased classification of more recent business as run-off seen across Europe more widely. This reclassification has contributed to Germany and Switzerland seeing continued growth in run-off liabilities which may also have been influenced by a continued focus on core business lines by an increasing number of German / Swiss (re)insurers ahead of Solvency II and the activities of European consolidators in turning attention to the opportunity to dispose of legacy books.

In the short-to-medium term Solvency II will continue to generate run-off disposal and restructuring activity, which as we suggested last year, should lead to an increased number of transactions. This has been partially borne out with more portfolios changing hands. However we believe that the full effect of Solvency II on Continental European firms' willingness to engage in legacy transactions has not yet been fully realised.

Figure 1: Inflows and outflows of the non-life European legacy insurance market



Source: PwC

A look back and a look forward

We have now been conducting the Survey for almost a decade with this Survey marking the ninth edition. Since the first edition was published in 2007 the market has been transformed.

The legacy landscape has experienced significant change since the first Survey was published. The financial markets and world economies more widely experienced significant stress during 2008 and 2009 and have since begun to recover. This global recession also triggered greater vigilance among Regulators, and we have seen this impact on both live insurance markets and the run-off sector.

Key exit mechanisms, such as schemes of arrangement, are now much less common than they were seven years ago, with greater regulatory barriers to their execution now existing. Increased scrutiny of insurers' capital has driven a greater focus on core activities and an accompanying large-scale reassessment of what constitutes run-off business. In the UK, the process for releasing capital underpinning run-off liabilities has not become any easier.

Looking to the future we expect the European run-off market to continue to grow at a rate similar to that of the past few years as these effects persist. In addition the increased volume of business written in the live market over the last few years will begin to feed through to the run-off market together with new run-off in emerging markets.

We also acknowledge the potential for alternative scenarios to emerge. Should the insurance market grow faster than expected, reserves deteriorate further and scheme activity remain at an all time low, then there is the possibility that the total size of European run-off liabilities will increase beyond our central forecast as shown in Figure 3. Conversely, should insurers undertake reserve releases in light of benign experience, and scheme and other true finality activity pick up, then the market may grow at a much slower rate, or even reduce in size.

Figure 2: Estimated size of the non-life European legacy insurance market

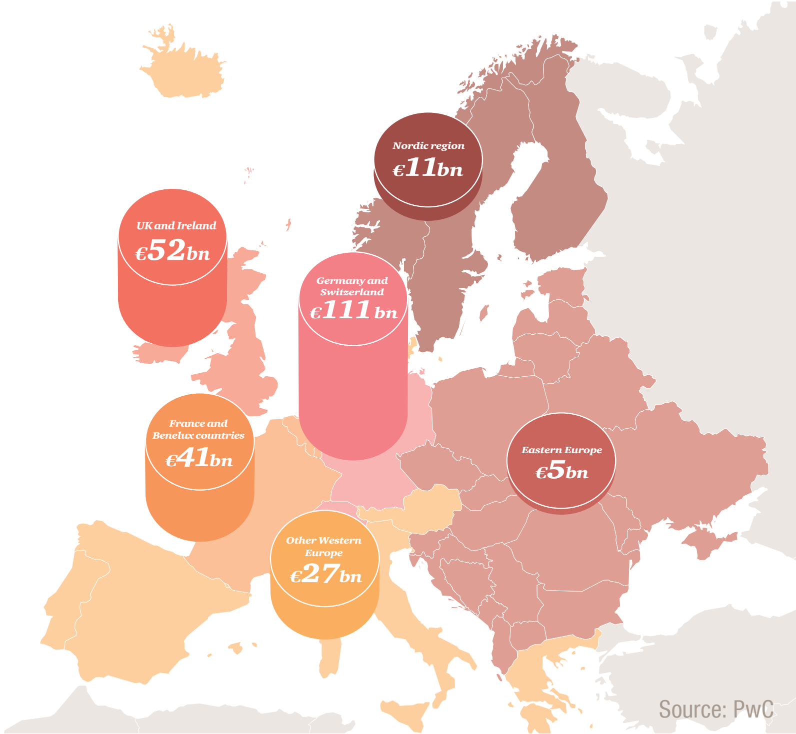
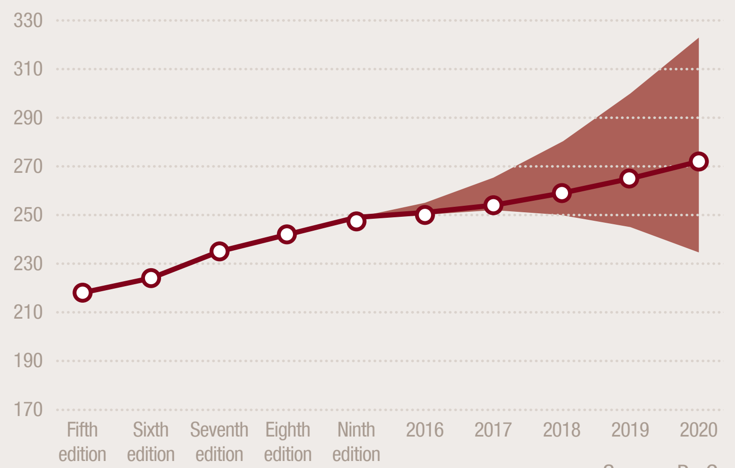


Figure 3: Estimated size of the non-life European legacy insurance market (€bn)



Run-off highlights from the past year

In this section we summarise developments that have taken place in the legacy market over the last year.

As might be expected with only a few months to go until implementation, Solvency II has been regularly cited as the driver of much market activity in the last year. Over this period there have been developments in the guidance of how Solvency II should be interpreted by UK run-off business. Following an initial consultation paper, in August 2014 the Prudential Regulatory Authority (PRA) issued a supervisory statement 'Solvency II: supervision of firms in difficulty or run-off'. The statement indicated that the PRA would require a firm that did not meet Minimum Capital Requirements under Solvency II and had no realistic prospect of restoring its compliance to 'bring its business to a close in as rapid and orderly manner as is consistent with the generality of policyholders best interests'.

The statement also confirmed the requirement for firms in run-off to inform the PRA of an assessment of their circumstances prior to 1 January 2016 and to provide a credible plan for transferring or extinguishing their existing insurance liabilities by 1 January 2019 (or 1 January 2021 for companies in administration). It is understood a number of such plans have been discussed with the UK Regulator to date and while few are in the public domain it is expected that a number will take the form of a Part VII transfer. Indeed, the PRA issued a market letter in January 2015 noting the significant number of firms looking to complete a Part VII transfer before Solvency II's implementation.

September 2014

- The Association of British Insurers (ABI) warned that industrial deafness had become the new cash cow for claimant lawyers and claims management companies. The ABI said claimant law firms are turning their attention to industrial deafness claims which attract substantially higher legal fees than personal injury claims.

October 2014

- QBE and Armour Group were reported to have agreed a deal to transfer the risk in respect of QBE's Italian and Spanish medical malpractice books.
- PRA published a consultation paper regarding proposed changes to the rules for insurance policyholder protection. These included increased limits for compensation under the Financial Services Compensation Scheme (FSCS) for certain insurance products.

March 2015

- UK employers' liability books with estimated gross liabilities of more than £5bn were reported to be available for sale. Each of the books contained significant asbestos liabilities. It was reported that Aviva are the first of these insurers to formally commence a sale process for its employers' liability business which has gross reserves of £1bn.

April 2015

- AXA Liabilities Managers acquired the GERA Pool (European Aviation Reinsurance Group) an aviation specialist vehicle that entered run-off in 1998. The deal saw AXA Liabilities Managers take over the shares of the 25 GERA Pool members. Whilst AXA Liabilities Managers was established in 2001 to manage AXA's in-house run-off business, it has now completed more than ten external market acquisitions.

November 2014

- Catalina Holdings reached an agreement to acquire PX Re from Tawa Associates. Consideration for the acquisition was $11m and represented Catalina's sixteenth transaction in the run-off market.

December 2014

- A report by the UK government's chief scientific advisor indicated that potential risks from fracking could be comparable with those from asbestos, tobacco and thalidomide.
- Meetings of Scheme Creditors of OIC Run-Off Limited and The London and Overseas Insurance Company Limited (the Companies) were held to approve an Amending Scheme of Arrangement which seeks to amend the existing run-off scheme of arrangement. The Amending Scheme sets out a claims crystallisation process which will allow the Companies to agree Scheme Liabilities and to distribute the Companies' assets to Scheme Creditors earlier than would be the case under the existing run-off scheme of arrangement.

January 2015

- R&Q transferred a portfolio of Tryg Forsikring AS's discontinued marine business to R&Q Insurance (Malta) Ltd, the group's EU run-off consolidator. The policies being transferred through the cross-border EU transfer provided marine insurance cover for the years 1998 to 2010. The transferring liabilities total DKK 30.1m.
- Catalina Holdings, via its subsidiary, Catalina Insurance Ireland Ltd, agreed a portfolio transfer of legacy insurance liabilities from Quinn Insurance Ltd (under administration). The transfer of the portfolio, which consists of €463m gross run-off liabilities, was subject to regulatory approval in Ireland and approval by the High Court of Ireland.

February 2015

- DARAG signed its first deal with an insurer from Greece, to acquire a portfolio of inactive motor vehicle liabilities from Aigaion. The Greek transportation insurer was understood to have made the decision to sell in preparation for Solvency II.
- Enstar Group announced it was to acquire Nationale Suisse's subsidiary, Nationale Suisse Assurance SA (NAB), a Belgium-based insurance company writing life insurance and non-life specialty insurance. As part of the transaction, NAB will be placed into run-off whilst some of NAB's renewal business will transfer to Torus, an existing Enstar subsidiary.
- CBPE Capital LLP announced its investment in run-off specialist Compre Limited. CBPE will provide additional equity to support new business acquisition of European run-off portfolios.

May 2015

- Randall & Quilter Investment Holdings announced plans to acquire IC Insurance Ltd from its indirect owners AstraZeneca UK and Imperial Chemicals Industries. This UK registered captive entered run-off in 1996 and will be managed by R&Q Market Services Ltd. Following change of control approval by the Financial Conduct Authority (FCA) and PRA the intention is to undertake a Part VII transfer of the remaining insurance business to the group's consolidation vehicle R&Q Insurance (Malta) Ltd.

June 2015

- Successful Scheme meetings were held in respect of the Scheme of Arrangement for Independent Insurance Company Limited. The Scheme is a valuation (or cut-off) Scheme with two classes, one for FSCS protected policyholders, the other for non-protected policyholders. This is a major step towards the closure of Independent which has been in provisional liquidation since 2001.
- A University of St. Gallen study indicated that the market for Insurance Linked Securities will double over the next five years. Run-off business is highlighted as one of the key areas potentially suitable for securitisation.

July 2015

- Rhode Island's Department of Business Regulation confirmed it was amending the states 'run-off' legislation on commutation plans to facilitate insurance business transfers of legacy business into Rhode Island. The new laws were expected to become effective at the end of August 2015.
- The Hartford Group notified policyholders of a proposed Part VII transfer, aimed at simplifying and consolidating the legal structure of its UK run-off business into a single UK incorporated company. This restructuring is expected to reduce costs and achieve greater capital efficiency in preparation for Solvency II.

"I think what we saw over the last year demonstrates that the legacy acquisition market continues to gain traction and credibility with large insurers seeking finality. The market is becoming more competitive with an increasing number of acquirers willing to address the needs and concerns of insurers through attractive commercial structures."
Survey respondent

Source: PwC

Kurt Mitzner

Alan Augustin

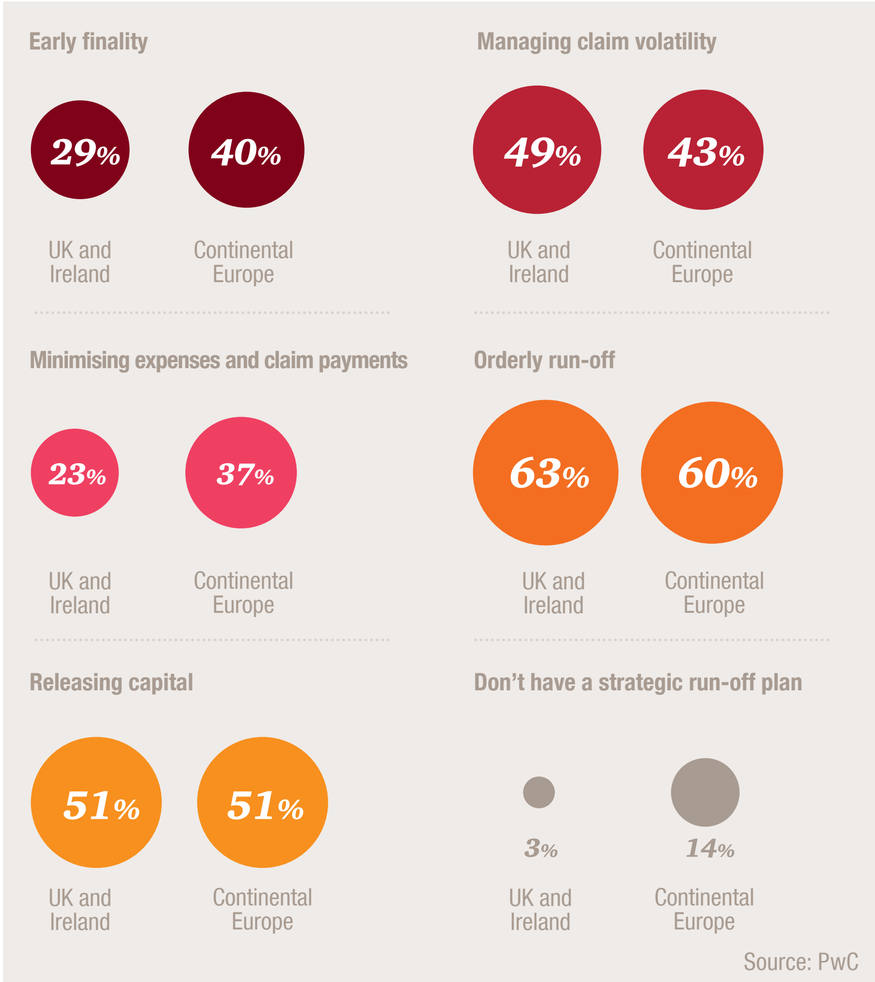
Finding the optimum run-off strategy

Successful run-off management has long been built on models of consolidation, economies of scale and the creation of centres of excellence. Taking a 'firm but fair' approach to claims management and adopting pro-active commutation strategies have been key tools in reducing liabilities and volatility in discontinued books. These techniques support the overall goals of managing claim exposures and costs and exiting liabilities, alongside minimising the capital burden of run-off.

There remain differences in how run-off management has evolved across Europe. Some markets such as Germany have historically taken a more reactive approach, with concerns around reputation and client relationships suppressing material activity to date. Until recently, unlike in the UK market, there have been fewer run-off deals in Continental Europe. However, since the financial crisis, increasing regulation, cost pressure and the interest rate environment have led to changes in attitudes. A number of transactions have now taken place, driven by strategic repositioning and capital optimisation in preparation for Solvency II and cost reduction.

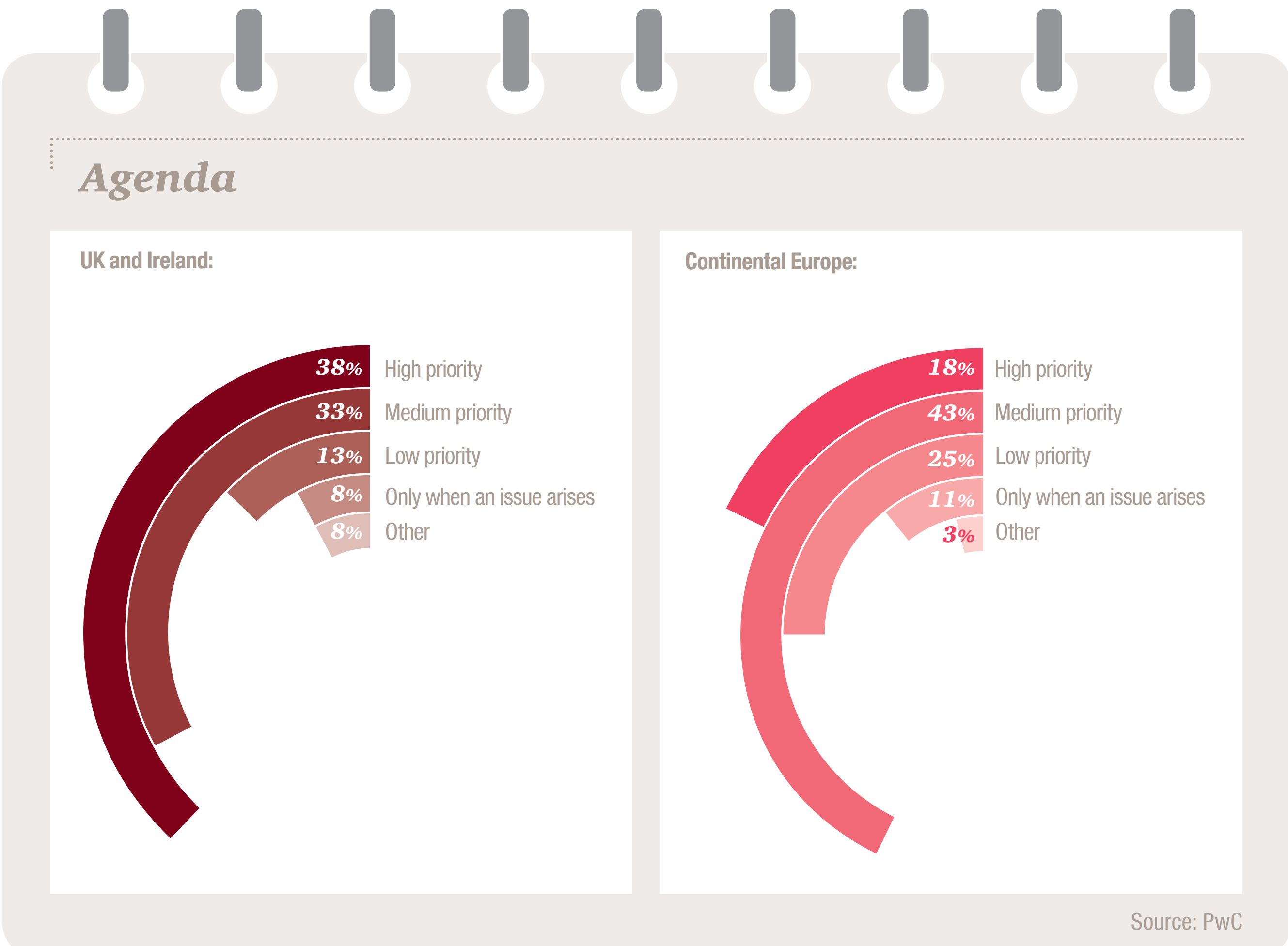
For some time one of the key challenges in successfully managing run-off across Europe has been establishing a clear delineation between ongoing and run-off business. This is important in enabling a focussed run-off strategy to be applied and it is positive that we are seeing legacy business now getting more attention and a higher profile at Board level. This is supported by the Survey results shown in Figure 5, although Board level engagement is still perceived as a challenge as shown in Figure 6. The last eighteen months have seen increased investment in both in-house and specialist run-off handling platforms, including examples for life business in Germany, as well as the evolution of existing non-life players such as Compre and DARAG.

Figure 4: What are the key objectives of your organisation's or client's strategic run-off plan?



> *"Organsations are in my view recognising the challenges of their legacy portfolios and allocating focus to them."*
> Survey respondent

Figure 5: Where do run-off and legacy management feature on the board agenda of your organisation or that of your client?



Source: PwC

38% *in the UK and Ireland and* **18%** *of Continental European respondents say that run-off and legacy management feature on the Board agenda as a high priority*

Financial considerations appear to be challenging reputational concerns, causing market participants to review lines of business and evaluate hold / sell strategies and also determine whether portfolios should be managed in-house or outsourced. As indicated in Figure 6 managing reputation has fallen to fifth in the rankings of challenges facing Continental European (re)insurers with run-off business identified by Survey respondents. This represents quite a substantial change from previous editions of the Survey and it will be interesting to see if this trend continues.

There has also been a noticeable shift away from the wholesale outsourcing of run-off to instead adopting a more bespoke approach to outsource selected lines of business. Figure 4 shows the importance of managing claim volatility for Survey respondents. Outsourcing potentially volatile books of business such as employers' liability and medical malpractice will require significant technical expertise from third party providers.

The run-off M&A landscape remains active, however concerns continue regarding the regulatory environment, particularly in the UK, where it is widely seen to be more difficult to transfer or exit run-off business and extract capital than before.

In Germany BaFin has historically closely scrutinised run-off restructuring activity, and been quite restrictive especially if retail business was involved. However, recent German transactions, which include life books, have shown a more pragmatic approach. Specific challenges still remain, for example in effecting solutions for German life insurance products within a single portfolio of business that includes hundreds of different variations of policy tariff.

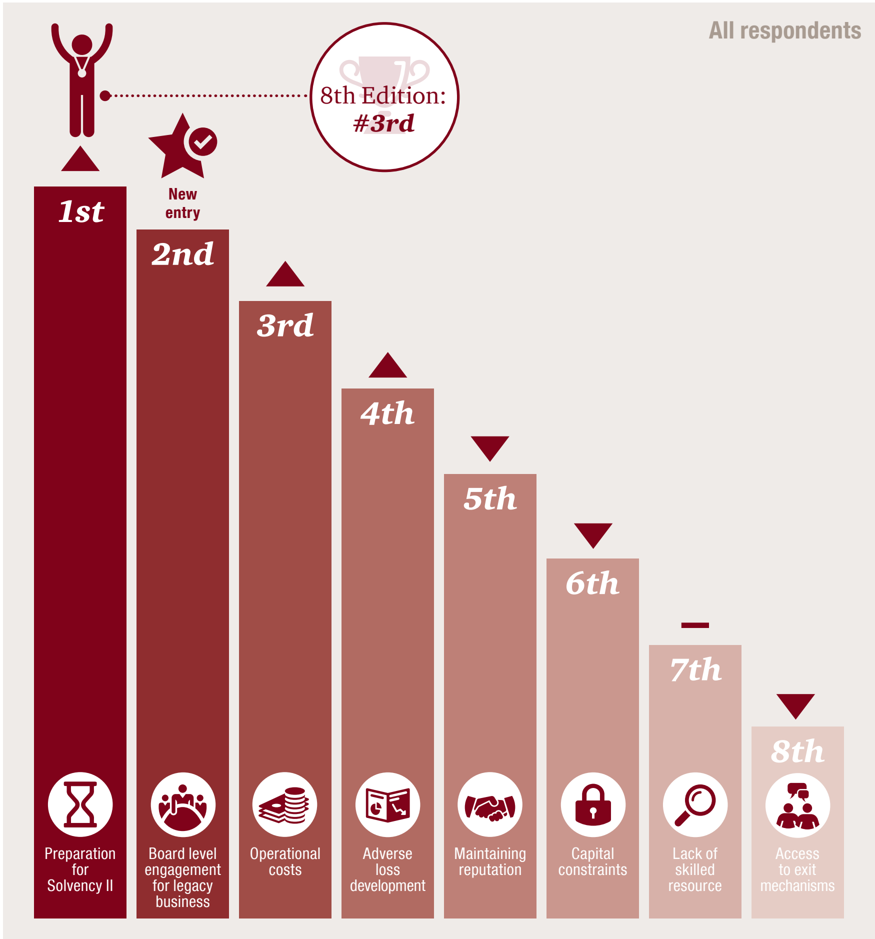
It is therefore of no surprise that certain run-off players have sought to domicile their business in alternative jurisdictions (e.g. Malta and Gibraltar) where they perceive that it is easier to do business. Whilst the upcoming Solvency II regime should lead to a certain degree of standardisation, local differences will remain, for example in business transfer and capital extraction processes. It will be of interest to see how this impacts run-off strategies in the medium to long term.

Continuing to look towards the future, the vibrant M&A environment in the live sector will undoubtedly create more run-off opportunities. We expect that many in-house teams and run-off acquirers will increasingly identify opportunities in existing live books at an earlier stage. As shown in Figure 7 the trend in classifying ever more recent underwriting years as run-off has continued in this edition of the Survey. 37% of respondents classify business written post 2010 as run-off compared to 22% two years ago. We are also seeing closer partnerships becoming established between legacy and live companies to facilitate the transfer of discontinued (or soon to be discontinued) business at the right time.

As illustrated by the move of certain run-off consolidators to diversify into live underwriting, life insurance and less developed European markets, the run-off landscape will continue to evolve. This will mainly be driven by the economic environment and the appetite for returns from investors. We also expect that the digital revolution and technology developments will bring benefits that will reach the run-off sector. Successful run-off operators will be those that embrace more sophisticated data collection and analysis tools to help build and run their businesses.

What is clear is that the run-off environment never stands still and new strategies need to evolve to optimise run-off opportunities.

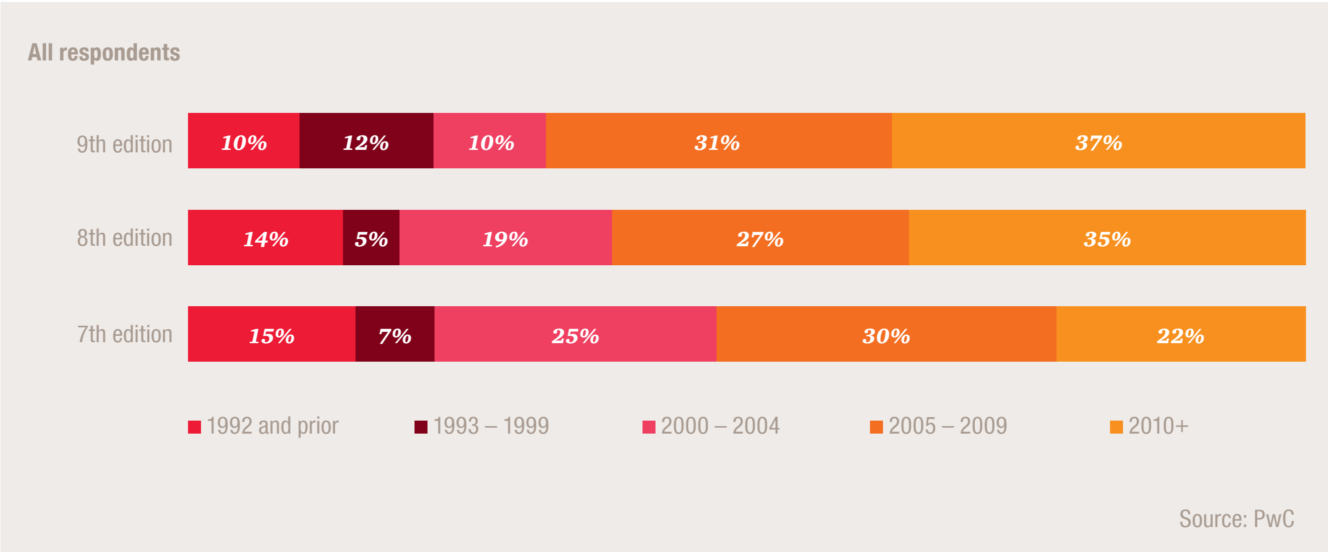
Figure 6: Please rank the challenges facing Continental European (re)insurers with run-off business

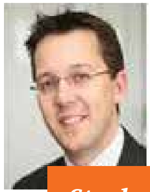


Source: PwC

Managing reputation has fallen to fifth in the rankings of challenges facing Continental European (re)inurers with run-off business

Figure 7: What is the most recent underwriting year that your organisation or that of your client classifies as run-off business?





Stephen Arnold

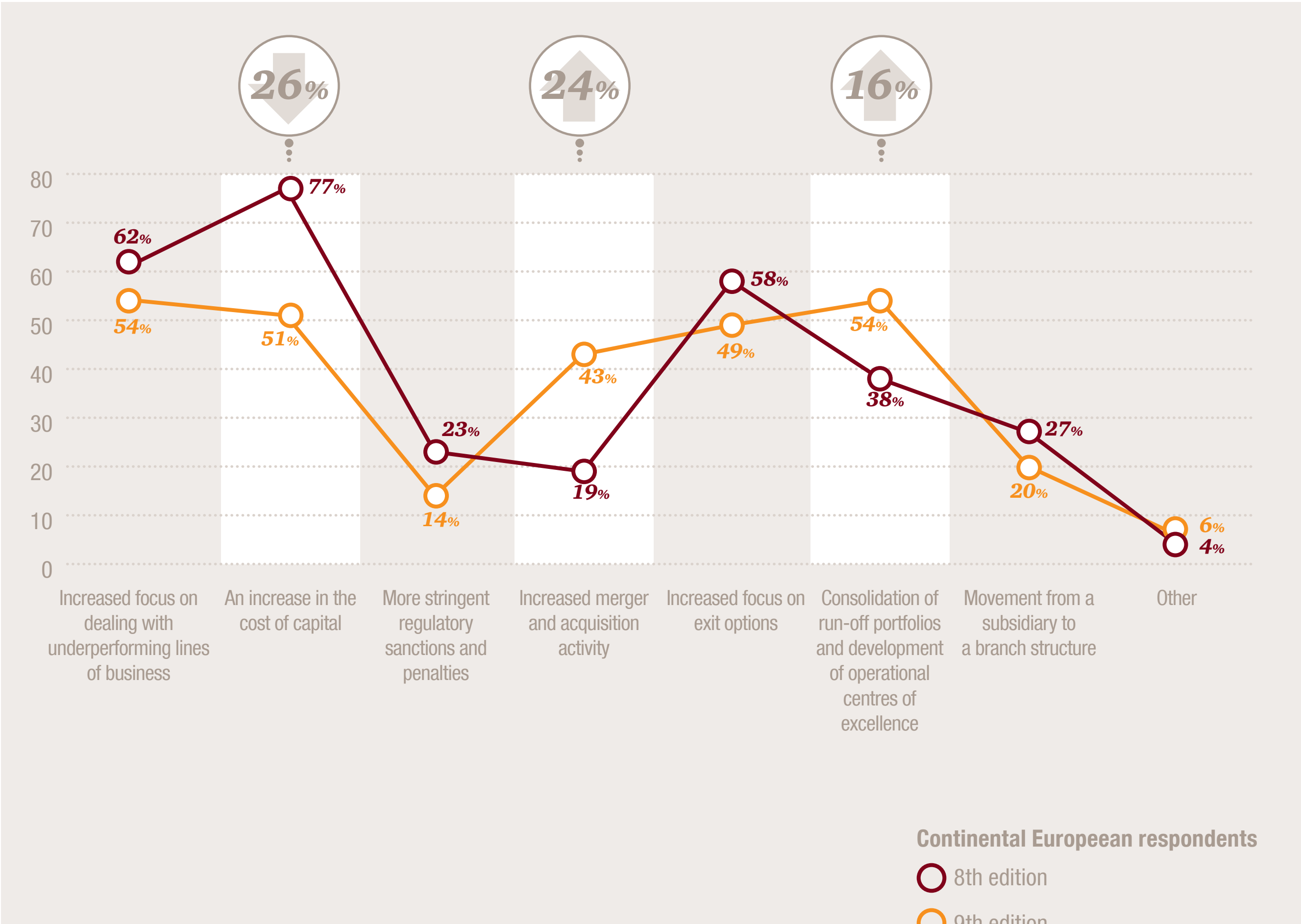
Mark Lawson

Run-off in the Solvency II era

The insurance industry has enjoyed increased volumes of capital inflow over recent years which has resulted in a greater spotlight on, and an increase in, the required return on equity (ROE). This has challenged many insurers' models, led to mergers and sales and also highlighted the value and costs of run-off business

The decision to hold or sell a company or block of business has traditionally been driven by a focus on ongoing profitability that took a limited view of risk management. By bringing in a risk based capital requirement and including a greater emphasis on broader risk management, Solvency II challenges the historical basis on which such decisions are made. The need to operate in a Solvency II environment means (re) insurers must consider the implications of compliance with Solvency II as part of their sell / hold strategy assessment and this could result in different decisions than in the pre-Solvency II era.

Figure 8: What are likely to be the practical implications of Solvency II for Continental European (re)insurers with regard to their run-off business?



Source: PwC

Over half of Survey respondents think the implementation of Solvency II will lead to an increase in their workload / opportunities

Figure 9: Following Solvency II's implementation on 1 January 2016, what will Solvency II mean for your day-to-day involvement with run-off business or that of your clients?

All respondents

"More focus on compliance and capital extraction."

"IT-solutions not yet ready."

"Awareness of cost of capital for underperforming lines will translate into proper run-off management getting into focus."

"Increased focus on run-off from a cost of capital and cost of administration point of view."

"Increased reporting requirements."

55% *Increase in workload / opportunities*

45% *No difference*

0% *Decrease in workload / opportunities*

Source: PwC

In recent years, the ability to extract value and generate profit from a UK run-off book in-house has become more strained as a result of the persistent low interest rate environment and the PRA / FCA's stance on capital security. These conditions have reduced the ability of companies to redeploy capital to more profitable areas of their business that are aligned to their core strengths. Preparing for the implementation of Solvency II has made (re)insurers review both the definition of run-off and whether holding run-off represents part of their core strategy.

Solvency II will also introduce broader risk management obligations including more onerous administrative and documentation requirements as identified in Figure 9. Applying the same rigour used on core operations to non-core business, often including discontinued portfolios, can be challenging. Dealing effectively with run-off business in the Solvency II era for some live (re)insurers could result in considerable additional costs in complying with regulatory requirements as well as providing a distraction for management.

Run-off portfolios within live entities can sometimes be neglected relative to entities where run-off business is part of core operations. For example, where run-off portfolios are within live entities, pure tier 1 equity is often used as capital and capital management is not optimised. This is due to the different issues and considerations involved in managing live business compared to run-off. In these situations, returns can be low and capital trapped for longer. However, Solvency II brings new ways to capitalise a business at a much lower cost. Alternative methods such as letters of credit, guarantees and uncalled share capital are now available to cover part of the capital requirement. Using such instruments and employing capital optimisation techniques allows capital to be deployed more effectively and presents an opportunity for value to be extracted more quickly.

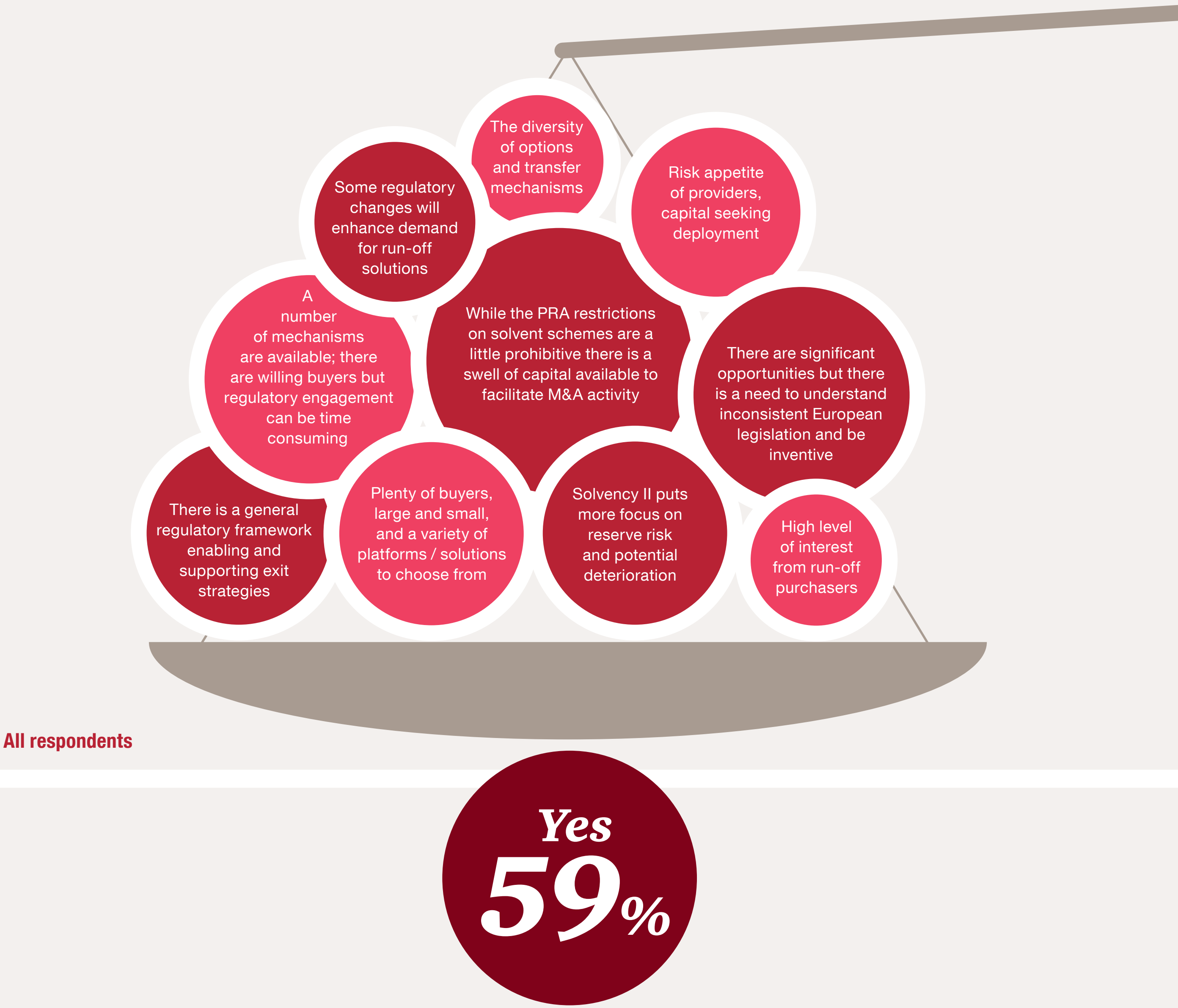
Run-off business can have a substantive impact on the ongoing results and operation of (re)insurers. Potential consequences can include increased earnings volatility, high long term expenses, long term trapped (cost of) capital, ROE drag and reputational concerns. To make a sell / hold decision, (re)insurers need to assess these impacts over the lifetime of the run-off business. They also need to consider the potential premium payable to a third party purchaser and the resulting net capital release. Figure 8 confirms that merger and acquisition activity, and therefore disposals are projected to increase compared to the results of the last Survey.

It is critical that Boards are presented with a coherent view of the value of retaining or disposing of run-off business as the decision can have a material long term impact on profitability and shareholder value.

The run-off landscape

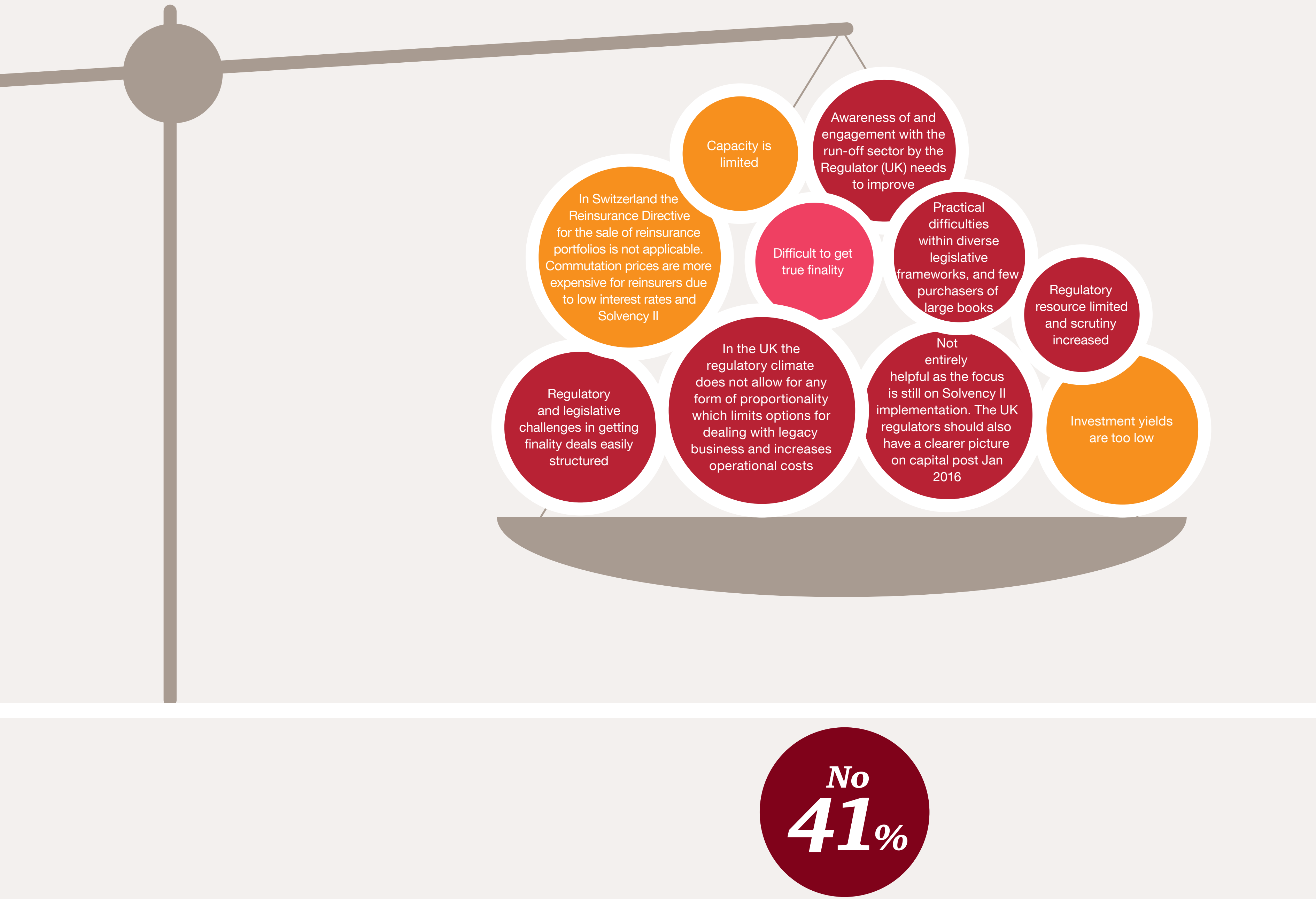
Figure 10: Is the current landscape a helpful environment for (re)insurers wanting to deal with their run-off liabilities?

The run-off landscape is continually evolving influenced by regulatory change, market conditions and strategic priorities. On balance, respondents do find the landscape helpful. This is a selection of the responses:



Key

- Regulatory
- Exit and finality
- Market conditions


Capacity is limited
Awareness of and engagement with the run-off sector by the Regulator (UK) needs to improve
In Switzerland the Reinsurance Directive for the sale of reinsurance portfolios is not applicable. Commutation prices are more expensive for reinsurers due to low interest rates and Solvency II
Difficult to get true finality
Practical difficulties within diverse legislative frameworks, and few purchasers of large books
Regulatory resource limited and scrutiny increased
Regulatory and legislative challenges in getting finality deals easily structured
In the UK the regulatory climate does not allow for any form of proportionality which limits options for dealing with legacy business and increases operational costs
Not entirely helpful as the focus is still on Solvency II implementation. The UK regulators should also have a clearer picture on capital post Jan 2016
Investment yields are too low
No
41%

Andrew Ward

Gregory Overton

Restructuring and exit considerations

The legacy market has evolved significantly over the past 30 years, with a number of insolvencies and solvent standalone run-offs in London and Continental Europe being wound up or exited. This has led to a different type of legacy market where run-off is contained predominantly within ongoing entities. Whilst APH liabilities still feature heavily, the legacy players today are increasingly dealing with a wide range of claim types including employers' liability, motor and more recent run-off lines from non-core operations. Consequently we are seeing a trend for restructuring and exit of legacy liabilities as a strategic initiative rather than as a reaction to distressed situations.

Our run-off Survey has forecast for a number of years that Solvency II will result in a significant amount of restructuring activity by owners of discontinued insurance business. We have seen this first hand over the past 18 months with activity from both standalone run-off clients and live clients with legacy portfolios taking the initiative to restructure their discontinued operations. They regularly reference Solvency II as the key driver of this activity.

We have also seen clients assess their run-off business with increasing sophistication as to what holding versus disposing of a run-off book will mean from a capital perspective for their operations as a whole. The results of this type of analysis are not always predictable and we have seen disposals potentially delivering diversification benefits from the seller perspective when that has seemed fundamentally counterintuitive.

A question mark still exists for us as to whether restructuring and exit activity will taper off once Solvency II's implementation occurs in 2016. The results of this edition of the Survey appear to predict material run-off disposal activity in the next year or two particularly in Germany and the UK and while some of our ongoing projects were initiated with the implementation deadline in mind others are certain to continue past 2016.

"There are plenty of buyers, large and small, and a variety of platforms and solutions to choose from."
Survey respondent

A current hot topic in respect of exit is the extent to which sellers of discontinued portfolios will seek to obtain full finality through the actual transfer of legal title to policies to the buyer, or whether they are happy to rely on a reinsurance that transfers the economic interest alone. In an environment where reinsurance pricing is competitive, the in-trays of UK Regulators are full of Part VII applications drawing increased scrutiny and management time is scarce, the full legal finality route could be perceived as a luxury.

As shown in Figure 11, the popularity of either outright sale or portfolio transfers including reinsurance continues at the expense of schemes of arrangement as the preferred exit tool for solvent run-off portfolios although we have seen instances of standalone run-offs continuing to contemplate schemes. The regulatory guidance published in the UK in relation to run-off insurers that fail to meet Minimum Capital Requirement has been interesting, with the supervisory statement explaining the requirement to put in place a credible plan to extinguish liabilities within three years of Solvency II's implementation. This would appear to fit naturally with a scheme solution or potentially some innovation around other solvent exit tools such as a Members Voluntary Liquidation.

60% of UK and Ireland and 57% of Continental European respondents that have considered exit have assessed the insurance business transfer option

The restructuring scene rarely stands still and the current landscape remains relatively active despite a benign macroeconomic environment. A major economic catastrophe might create some volatility in the market but the availability of capital remains so strong that restructuring and exit seems set to continue. However, as shown in Figure 13, respondents predict this will be for strategic reasons, in light of the continued drive for efficiency gains, and in response to regulatory change rather than as a reaction to distressed situations.

Figure 11: If your organisation or client has considered restructuring or exit for any discountinued business, which options have been considered?

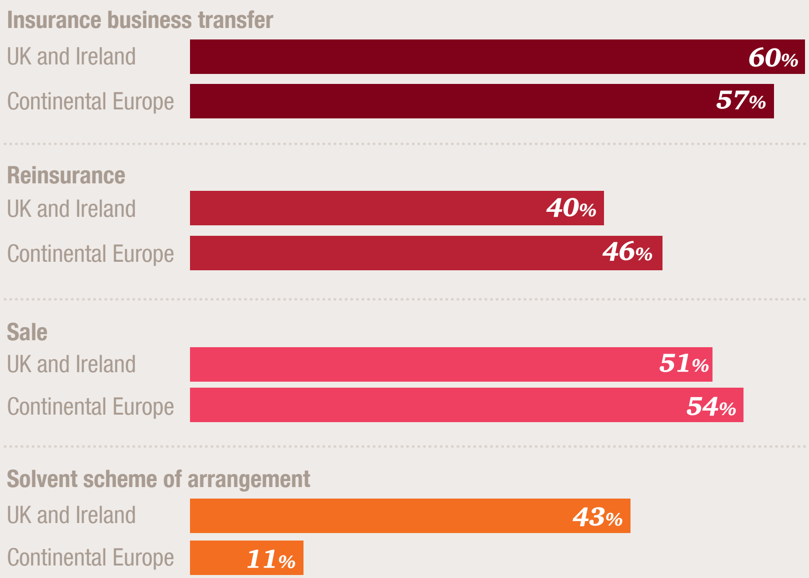


Figure 12: If exit has been considered, was this within the last 12 months / more than 12 months ago?

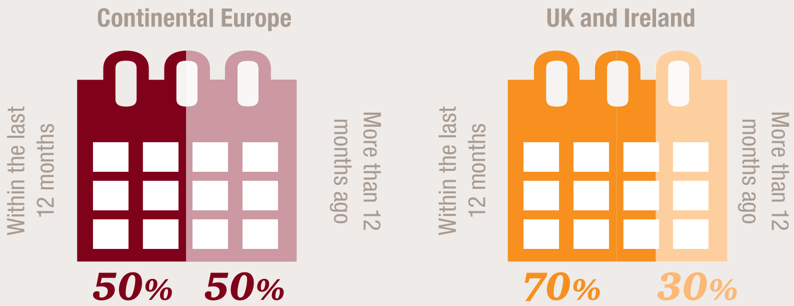
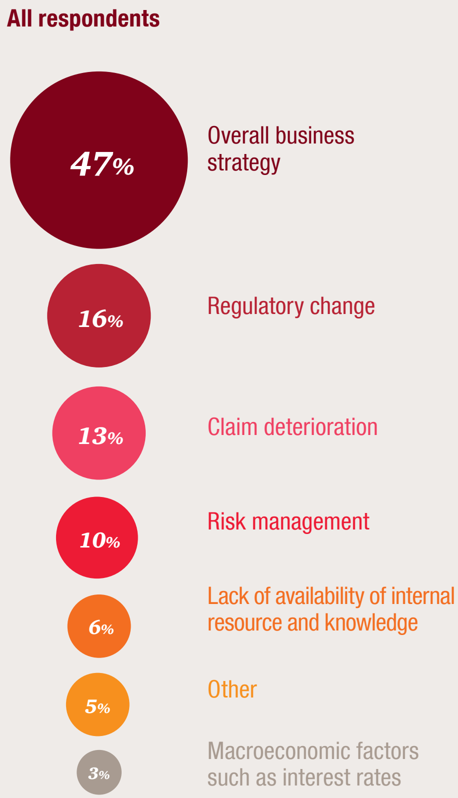


Figure 13: What would increase the likelihood of you or your clients implementing a legacy solution including exit, restructuring and reorganisation for one or more legacy portfolios?



Source: PwC

68%

of Continental European respondents think there will be more than 10 transactions in Europe over the next two years

Figure 14: How many disposal transactions will there be in Europe over the next two years?

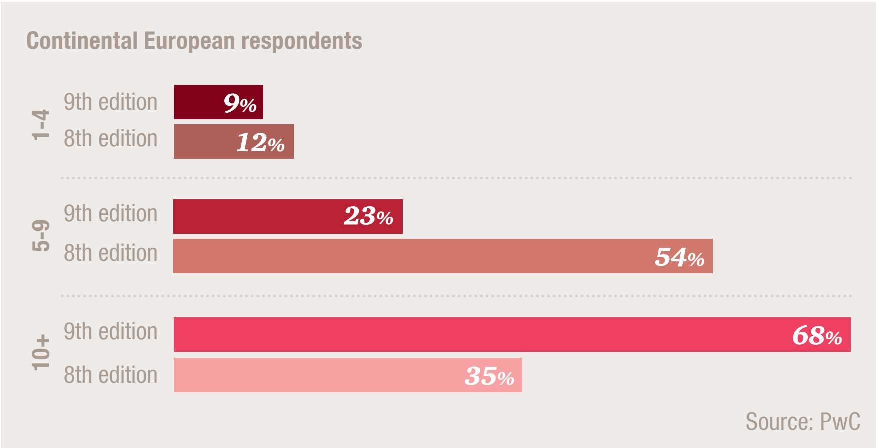


Figure 16: What portfolio liabilities sizes will be most commonly disposed of by way of a sale or portfolio transfer over the next two years?

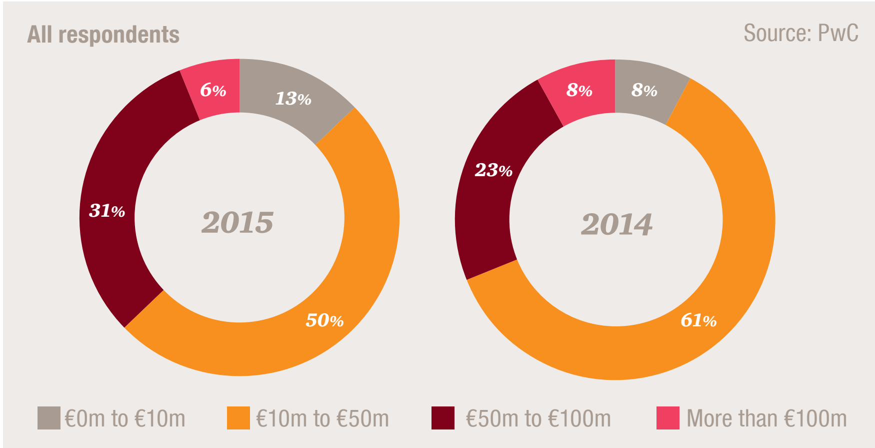


Figure 15: In which territory do you think the most disposals will occur?

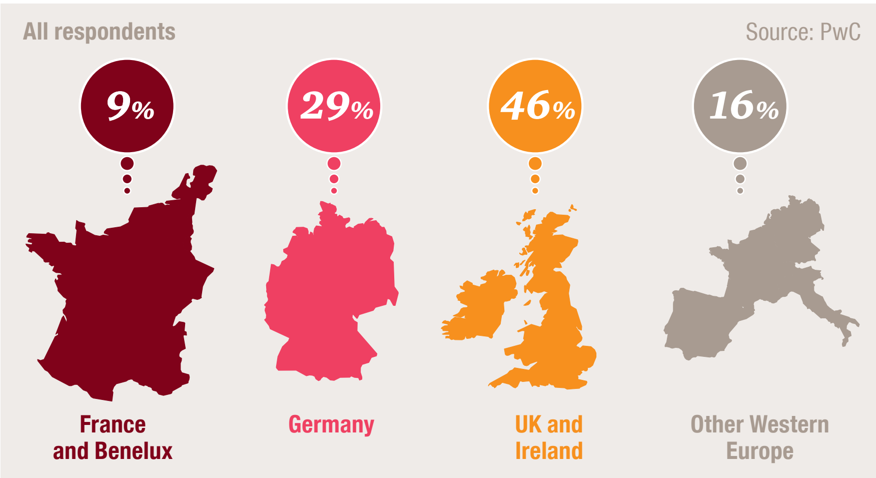


Figure 17: Which lines of run-off business are most likely to be sold?

81%

of respondents believe that the most commonly disposed portfolio size will be between €10m and €100m

The wave of M&A activity that continues to sweep the live industry should be expected to provide restructuring opportunities to drive capital and operational efficiencies for some time to come. The pipelines of run-off acquirers are likely to be healthy as newly merged insurance giants consider what will be core going forward, what it might make sense to discard or where run-off business may be able to be consolidated and managed in-house or via outsourcers.

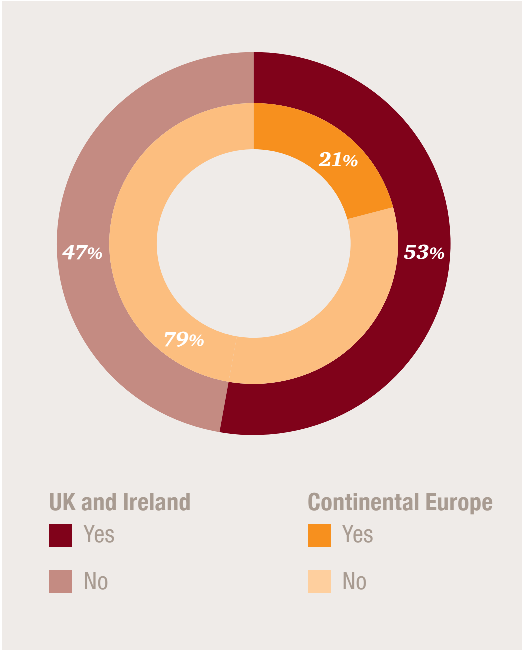
Our Survey results in Figure 14 to 17 indicate that respondents anticipate significant transaction activity over the next two years, while predicting more transactions in the €10-50m range. The types of business Survey respondents expect to be the subject of these transactions include employers' liability, motor and aviation in addition to the more traditional asbestos books. It was interesting to note that the number of respondents that predicted Germany would be the territory in which most disposals will occur decreased slightly from our last Survey, but that this decrease was offset by an increase in the number predicting disposals in other Western European territories.

Claims: past, present and future

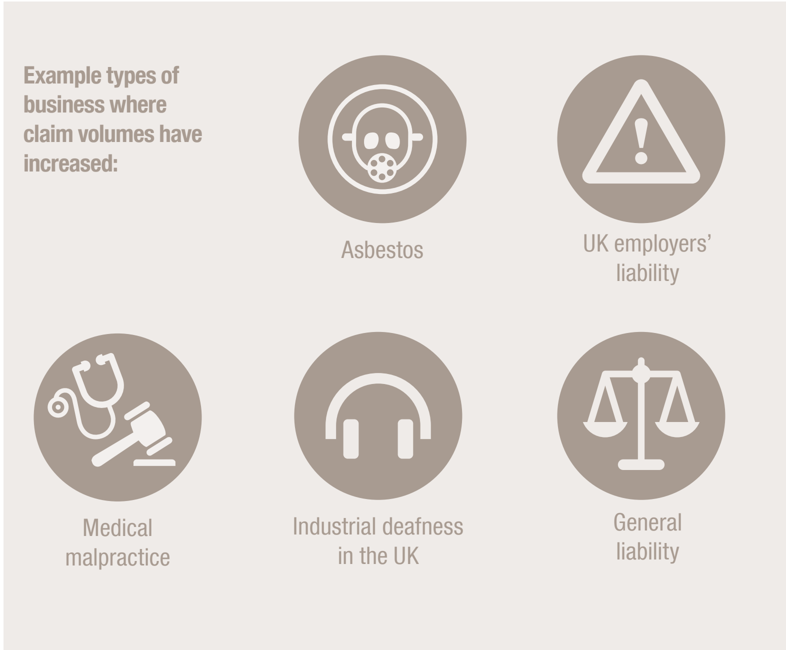
Patricia Clarkson

Michael Cook

Figure 18: Have you or your clients experienced any increase in claim volumes in respect of legacy business over the last year?



Source: PwC



Source: PwC

Over half of UK and Ireland respondents experienced an increase in claim volumes in respect of legacy business over the last year. Our experience indicates that an increase in industrial deafness claims is the key driver of this

The role of the claims function is fundamentally changing, driven by the increasing demands of customers and Regulators. Technology is allowing (re) insurers to respond to those demands by operating new business models and offering innovative solutions. Effectively the claims function is now 'front of house' and often the main, if not only, point of engagement between customers and (re) insurers. This is reflected in the regulatory focus areas of conduct risk, data and reserving.

Owners of legacy business have a delicate balancing act to manage claim volatility, control indemnity spend and minimise costs. They must also consider the impact of their actions on reputation and treating customers fairly whilst maintaining a robust claims management approach that will meet their commercial targets.

US APH claims have been the traditional focus of legacy managers, but the UK insurance run-off market has experienced a surge of industrial deafness claims in recent years. Given the age and profile of the claims, many are managed by legacy teams sitting within the major live insurers. This increase in claim volumes has been driven partly by changes in case law, as well as

50%

The number of deafness claims made annually grew at the rate of over 50% from 2010 with volumes reaching 85,000 in 2013

legislative changes aimed at introducing proportionality for legal costs on low value claims.

An unintended consequence of these developments was a surge in industrial deafness claim numbers in 2013 as claimant lawyers sought to submit claims prior to the introduction of changes aimed at reducing their costs. Since then increased advertising has also led to an enhanced general awareness that claims can be made and a rise in public appetite to bring such claims. The number of claims made annually grew at a rate of over 50% from 2010 with volumes reaching 85,000 in 2013. Between 2010 and 2013 it is estimated that the cost to the insurance industry of these claims was £675m, with claimant solicitor fees estimated to account for 70% of this figure. As many deafness claims are currently excluded from the fixed fee regimes which apply to other claim types, farming deafness claims has been very attractive to claim management companies and claimant firms.

Many speculated that 2013 would be the high point for new deafness claims. Indeed, 2014 afforded a short-lived respite with a 19% reduction in claims volumes compared to 2013. However, there is an upward trend in 2015 with the latest ABI figures released this August indicating that notifications in the first half of 2015 have exceeded the 2013 'peak' by 3%. Figure 18 confirms that Survey respondents have experienced an increase in the volume of this type of claim. Although deafness claims generally only represent a small proportion of insurers' reserves, and average claims costs have remained reasonably stable since 2007, the rise in volumes places considerable pressure on claims teams, potentially diverting valuable resource from higher value claims. Managing deafness claims effectively can have important benefits for insurers and uninsured corporates.

Our team at PwC manages tens of thousands of claims valued in the £billions. A significant proportion by number emanate from UK employers', liability business, including a large volume of deafness related claims. We are observing at least 50% of deafness claims settling at nil cost, with much higher nil rates in the year of notification. The reasons for this include claim quality, with claims frequently being submitted by claimant solicitors prior to full investigations being undertaken, as well as the identification of effective defence strategies by insurers. Claims settling at nil cost are still proving expensive for insurers in terms of the administration time associated with dealing with them and in diverting attention away from meritorious claims.

Key to controlling both claimant and legal costs on these claims is the use of experienced resource, either an in-house claims team or third parties. Where third parties are used, clear, well structured outsourcing agreements are required which incentivise the right behaviours, maximise nil claim settlements, pay valid claims promptly and control overall claims spend.

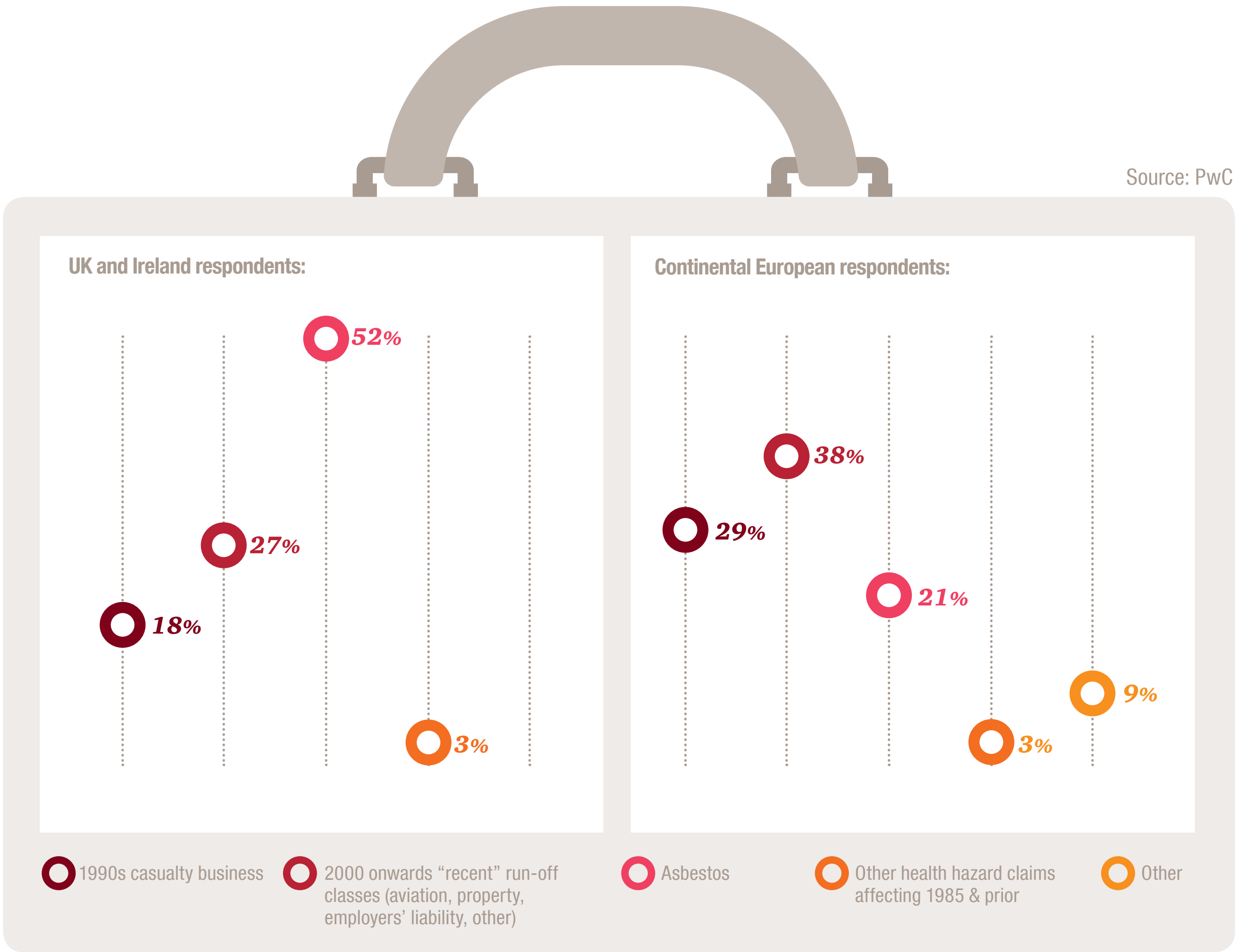
Comprehensive management information can also provide insights into portfolio-wide claims performance and detailed claims activity, enabling the right strategies and tactics to be deployed. This is by no means a static market – strategies and processes need regular review to ensure that resource is focussed on effective settlement and improving financial outcomes.

The question must be asked, is there a better way of dealing with these claims? Whilst the Ministry of Justice Claims Portal, a stakeholder solution introduced in 2013 and designed to provide a safe and secure electronic means of communication, has been successful in reducing costs for some low value claim types, particularly motor claims, it is generally seen in the market as not fit for purpose for deafness claims. This is borne out by the extremely low numbers of deafness claims settling in the Portal.

2014 afforded a short-lived respite with a 19% reduction in claims volumes compared to 2013. However, there is an upward trend in 2015

US asbestos reserves continue to remain broadly steady, however there have been a number of claims from previously unknown US companies that have begun to impact the London Market

Figure 19: What claims exposures form the most significant part of your, or your client's, run-off portfolio?



Other claim types are seeing localised surges, for example Europe is seeing high volumes of motor claims and medical malpractice

The Association of British Insurers is now looking for solutions to overcome the Portal's deficiencies including improving the evidence to be provided by solicitors at the outset and introducing fixed fees for cases which fall out of the Portal. In addition, the Ministry of Justice has asked the Civil Justice Council to look into the number and cost of deafness cases.

In the meantime insurers should ensure that their skilled resource is utilised effectively to concentrate on those deafness claim cases where costs savings can be made either through early settlement or robust defence. Some insurers may also consider 'bulk' commercial settlements as an effective solution to this problem, although the poor quality of many of the claims remains an issue.

To date, industrial deafness claims have been a UK phenomenon. However, while they have increased in volume the lower quantum associated with their settlement is reflected in asbestos and post 2000 run-off classes of business remaining the exposures that form the most significant aspect of respondents' run-off portfolios as illustrated in Figure 19.

US asbestos reserves continue to remain broadly steady, however there have been a number of claims from previously unknown US companies that have begun to impact the London Market. This continues to be an environment where new insureds may come to market as lawyers in the US target those companies where insurance coverage is still available. In the UK mesothelioma claims represent on average 80-90% of companies' UK asbestos related reserves. The market is monitoring whether mesothelioma deaths will peak in 2017 as predicted by the Health and Safety Executive and the Institute and Facility of Actuaries' UK Asbestos Working Party 2009 predictions.

Other claim types are seeing localised surges, for example Europe is seeing high volumes of motor claims and medical malpractice. In the future, claims such as chronic pain and fibromyalgia could possibly be material issues. A watchful eye is also being kept on emerging hazards such as brain cancers associated with wireless phone use and the use of nanotechnology in various industries, such as cosmetics, which may enter the bloodstream and reach organs, possibly causing harm in the longer term.

With new claim types on the horizon, insurers and uninsured corporates need to continue to evaluate and refine their strategies in order to remain ahead of the game.

Julie Pallister

Stephen Harrison

Consolidation in the European life insurance market

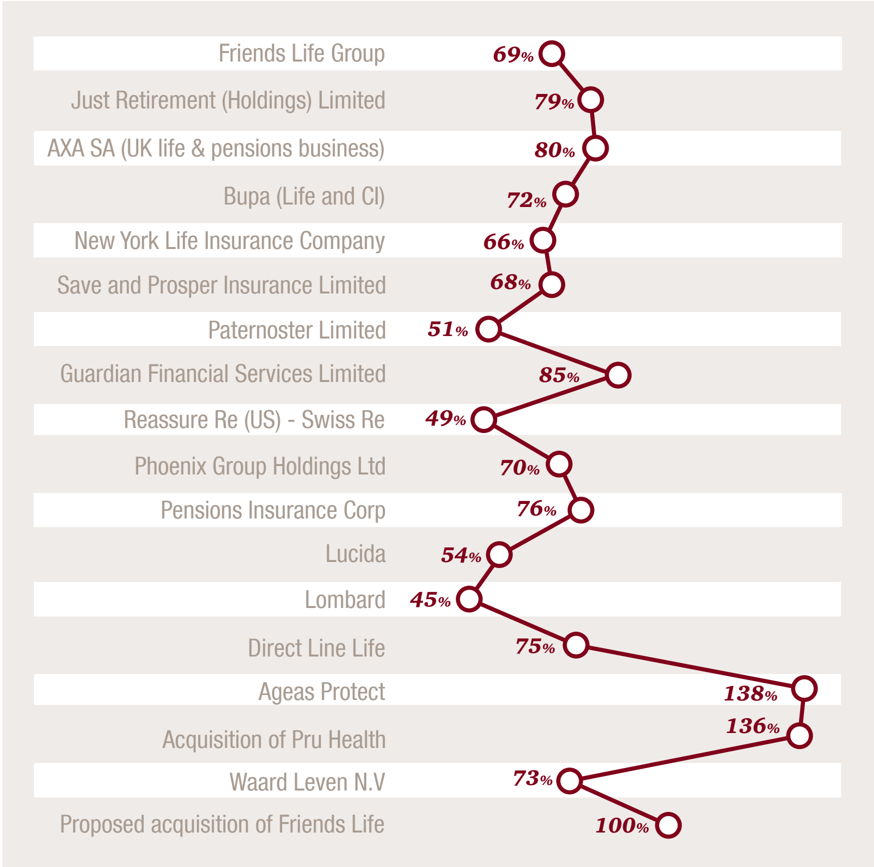
Consolidation of closed life insurance companies is very mature in the UK, but activity is increasing across Continental Europe with consolidators looking to new markets and increased interest from private equity firms in this area.

Consolidation across Europe is not as widespread as in the UK due to the issues of servicing clients in different languages, and also because there is not such an established administration outsourcing market.

However, this trend appears to be changing with a number of transactions across Europe in the last few years, partly as a result of the financial crisis and the changing regulatory environments affecting insurers and bancassurers. In addition, consolidation in the UK insurance market is not dead. Solvency II is providing the impetus for companies to dispose of non-core portfolios, in particular those which are capital intensive (such as annuities), or to seek to gain greater diversification benefit through making acquisitions.

Consolidation in the UK insurance market is not dead. Solvency II is providing the impetus for companies to dispose of non-core portfolios

Figure 20: Price to Embedded Value Transaction multiples for European life business transactions



Source: PwC

In the past year a number of German life insurance portfolios have come to market

The ongoing low interest rate environment across the Eurozone continues to represent a challenge for insurers. Many insurance products generate very low profitability given their reliance on investment return for profit. This problem is being exhibited in many insurance markets across Europe, but nowhere more so than in Germany. The nature of insurance products in Germany is that policyholders typically share in the profits generated across all products. This includes for example term assurance and leaves little for shareholders, especially in a low interest rate environment. Many German insurers are now questioning the ongoing viability of their business models as they battle for market share. At the same time businesses are suffering increasing costs for complying with regulation, meaning they are facing a similar situation to the UK mutual sector.

In the past year a number of German life insurance portfolios have come to market. Athene Holdings (Apollo) acquired the German insurance operations of Delta Lloyd with assets under management of circa €4.3bn in January 2015. In addition Cinven acquired the insurance operations of Heidelberger Leben in 2013. This was for the purposes of consolidation across the German insurance sector and Cinven subsequently acquired the German, Austrian and Swiss insurance operations of Old Mutual group in March 2014.

Similar activity is also being seen across Southern Europe, with transactions occurring in Portugal, Spain and Italy. These have been driven by the financial crisis and Solvency II. There has also been activity in the Netherlands such as the acquisition of Waard Leven N.V. by Chesnara, the UK consolidator.

In the UK, the annuity market has been turned on its head following the recent annuity reforms. Policyholders now have much greater freedom over their choices at retirement (which is likely to increase further still with the proposed secondary market for existing annuitants). This has led to a significant change in consumer behaviour, and uncertainties about the volume of future annuity sales. Coupled with this change in consumer behaviour, the capital requirements of holding annuity portfolios continues to be a challenge for insurers. This is as a result of the uncertainties arising from Solvency II implementation. There is a lack of clarity as to whether firms will receive approval for matching adjustment and equity release solutions which are often used to back annuity liabilities.

This has led to insurers disposing of non-core annuity portfolios. Recent deals include Equitable Life selling a portfolio of annuities to Canada Life, Zurich selling a portfolio to Rothesay Life and much of the Friends Life business being recently sold to Aviva.

Prices across the life insurance industry are also beginning to rise, making now a good time for sellers to dispose of non-core assets. Figure 20 shows a selection of open and closed transactions, where some large multiples of Embedded Value are being paid for open businesses. This compares to transactions for closed or near closed books or bulk annuities that are returning more to pre–crisis levels.

Fuelled by the impact of Solvency II, changes in legislation, improved pricing and the interest of new entrants and existing consolidators focusing more on Europe, we anticipate further activity in this area in the next few years.

Market predictions

We asked Survey respondents for their views on what the most significant developments in the run-off market will be over the next 12 months. The key themes are shown in Figure 21 below.

Figure 21: Market predictions key themes

Source: PwC

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 (re)insurance industry with run-off business.

Issues being faced by operations around the world where the team is able to provide advice, support and assistance include:

- Releasing capital from run-off
- Bringing finality to run-off and extinguishing liabilities for underwriters and brokers
- Restructuring through sale or insurance business transfers
- Project managing complex transactions and securing key stakeholder buy-in
- Rationalising operations to achieve efficiency
- Pro-actively 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, debt provisioning 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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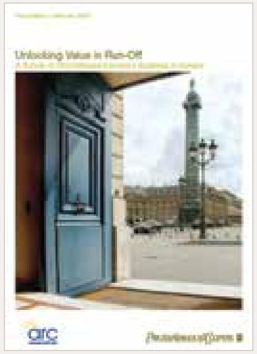

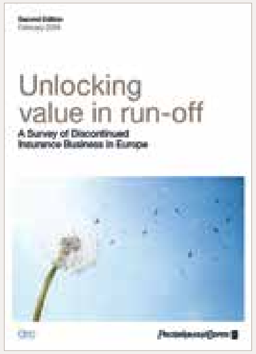

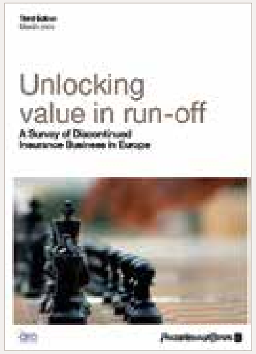

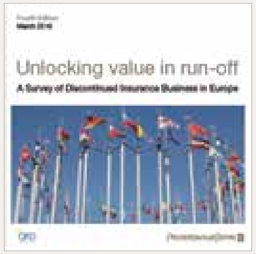

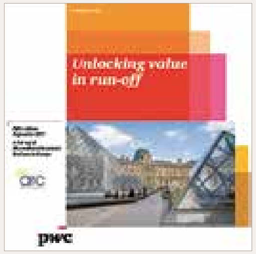

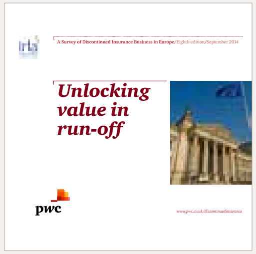

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