The Legacy Market

Innovation. Flexibility. Creativity. Capital Appeal. That Order.

Eleni Iacovides

The insurance industry has shown through the years that it has a remarkable ability to respond to challenges, and to adopt and adapt, whether this relates to a new financial or regulatory framework or to respond to demands for new products and solutions. One of the biggest challenges that the European industry faced in recent years was the implementation of Solvency II, the European legislation that codifies and harmonizes insurance legislation across the European Union.

In this first of three articles, we will consider the transfer mechanisms used widely for decades now across Europe; we will then compare the European and U.S. frameworks, especially in light of the relatively new framework in Rhode Island. In the final article, we will examine where the U.S. market finds itself two years on from the enactment of the Rhode Island IBT framework and discuss what may have influenced the way in which the market and other states reacted to this development.

The way we were

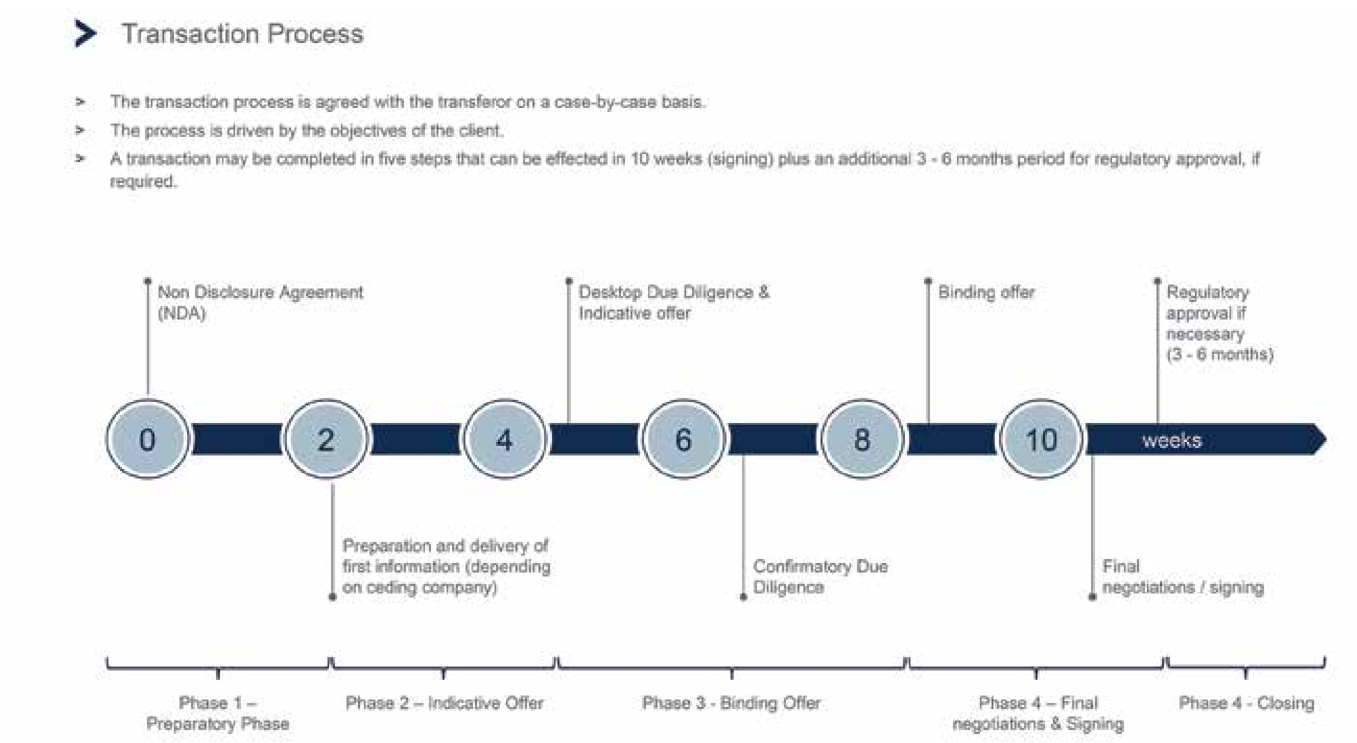
When I started my career as a lawyer in the early 1990s, insurance litigation was seen as the poor relation of insolvency litigation. For those who were around at the time, this was the era of Asil Nadir and Robert Maxwell, to name a couple of non-insurance colourful characters. I had the pleasure and honour to work on both insolvencies. The first insurance "novel" I had to read when I qualified was the Department of Trade and Industry report on the collapse of the Weavers Pool. It was fascinating and had all the ingredients of a good novel: money, men with power and authority, a business empire, allure and a twist at the end. We then had Pacific and General and Pine Top. Then came the Independent and HIH. Life for contentious lawyers was great, the issues were untouched, it all went to litigation and the settled legal principles that we all take for granted today were made then. Still, run off was seen as second class and perhaps so were we! And today? Run off is an integral part of the insurance industry and specialist acquiring vehicles operate alongside insurers offering them additional tools with which to profitably and efficiently manage their business. The recent impressive investment into new vehicles and growth of existing vehicles is evidence of the market's profitability and therefore, appeal to investors.

Twenty plus years on, judging from the new players and capital invested in it, I and quite a few others, find our market more appealing than ever…

Our world today

Solvency II, the relatively new European regulatory framework, along with the low investment returns, soft market and pressure on underwriting profit has forced insurers to focus, more than ever, on the cost of capital and consequently on capital efficiency, in addition to the need for optimization of internal resources and cost reduction. Reserves held for old, discontinued or non-core business have become more capital intensive, therefore restricting insurers' ability to deploy capital elsewhere such as new products, digitalization or a strategy to increase one's market share in core business or a new jurisdiction. The disposal of such portfolios to specialist acquiring vehicles has long been used in the United Kingdom and

The Legacy Market (continued)



more recently in Continental Europe as a way in which insurers deal with portfolios they no longer wish to keep on their balance sheet. The harmonised regulatory framework makes this process predictable and efficient, both key advantages in any business transaction.

Capital release solutions through retrospective reinsurance, the assumption of insurance portfolios or the acquisition of entire legal entities provide insurers with much needed additional tools in their tool kit when considering how to manage demands on capital and resource efficiency.

Our tool kit

Different business needs and priorities require different solutions and here, we will examine four key structures which are being widely used to provide finality or exit.

Sale / Acquisition of a legal entity

If a legal entity (e.g., a subsidiary) is in run off, this can be disposed of in its entirety and of course, the technical reserves are automatically transferred. This is a well-known process and subject to the legal requirements in the relevant jurisdiction, a relatively straight forward process, particularly for small entities.

Retrospective Reinsurance and Adverse Development Cover

A loss portfolio transfer (LPT) is a financial reinsurance transaction, typically offered by leading reinsurers through the usual broking route; this solution has been used much more widely than a statutory portfolio transfer (below), perhaps because it is quicker to achieve and it does not require regulatory or judicial approval. In such a transaction, the gross reserves of the ceding insurer are fully reinsured retrospectively. In order to obtain full cover for the covered reserves in the event that there is deterioration, the cedent may additionally obtain an adverse development cover, which would cover all risk in excess of the reserves covered by the LPT. The combination of these two instruments gives the cedent full economic, but not legal, finality, as it is conceivable that reserves may deteriorate to the extent that the ADC is blown and therefore, the risk reverts to the cedent.

Twenty plus years on, judging from the new players and capital invested in it, I and quite a few others, find our market more appealing than ever…

Statutory Portfolio Transfer

This is the only instrument (apart from an outright sale of a legal entity) that delivers full economic and legal finality to the cedent. In Europe, the legal and regulatory framework is harmonized across the Union and apart from Great Britain, (soon to submit its own exit solution) where a transfer needs to be approved by the court, all EU member states proceed on this with very few and not significant differences. In this case, the ceding insurer transfers all policies including outstanding expected claims and IBNR to the acquirer together with the assets that cover the entire book of business being transferred. Once the transfer is approved by the home regulator (the regulator of

The need to be more operationally efficient and to deliver higher returns to shareholders drives us all to transform, innovate and perhaps disrupt.

the jurisdiction in which the policies were issued) having been engaged in a consultation process with the acquirer's regulator, then the transfer is binding on all policyholders. There is of course a period of publication of the intended transfer during which policyholders may object to the transfer on the basis that their interests would be materially jeopardised by the transfer. Such a transaction need not be lengthy but it does need to take into account the regulatory process which has rigid time frames. In transactions where time is of the essence, parties typically combine an LPT/ADC solution, which can quickly deliver economic finality followed by a legal process, which will then deliver the legal finality. In this case, the LPT and ADC covers fall away and are replaced by the transfer; the premium under the two covers becomes the risk premium for the SPT.

Why do it?

The need to be more operationally efficient and to deliver higher returns to shareholders drives us all to transform, innovate and perhaps disrupt. The solutions described above release capital, allow the cedent to achieve higher ROE by investing released capital in more profitable and/or core business, reduce the insurer's exposure to potentially long-tail and volatile business and reduce operational overheads. Employing these solutions also often receives support from the cedent's regulator as regulators are now more than ever, keen to support any steps taken by insurers which are likely to avoid failure. Our niche market is perfectly positioned with capital, knowledge, expertise and creativity to face any challenge. We look forward to seeing more states in the U.S. adopting legislation that will allow statutory portfolio transfers across a market with huge potential. ●

Eleni Iacovides, Group Chief Client Officer at DARAG Group Ltd.
e.iacovides@darag.eu