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The start of German run-off migration?

London is a prime destination for European run-off but those moving portfolios might consider other options, say IAN MARSHALL and JÜRGEN REHMANN

There has been much recent discussion about European run-off portfolios becoming the next wave of business to look to the London market as an exit strategy.

The perceived attraction of London comes from the combination of three main factors: the long-established run-off, regulatory and management infrastructure in London and the legal and regulatory processes of Part VII transfers and solvent schemes of arrangement. This view is further supported by the findings of the 2007 KPMG/Association of Run-Off Companies (Arc) run-off survey for non-life insurance - while commenting that run-off in the German-speaking market is still in its early phases, the study concluded: "The lag in these markets compared to the UK run-off market is estimated at 10 to 12 years. However, a clear convergence can be expected within a few years."

Portfolio transfer

During October, there was a transfer of a reinsurance portfolio of run-off business from Germany to London, which might seem to confirm this opinion of convergence and add to the expectation that Europe could be a source of run-off-related work for London. This transaction was completed by the German reinsurer, Deutsche Rückversicherung AG (Deutsche Rück), based in Düsseldorf, while Chilton International acted as run-off adviser to Deutsche Rück. Nigel Montgomery, of Sidley Austin LLP, advised on legal aspects of the transfer in both Germany and the UK.

Before the transfers, Deutsche Rück had for several years managed its discontinued lines of business separately from its ongoing and expanding reinsurance business. Having now centralised all its third-party run-off business in one entity, UK subsidiary Deutsche Rück UK Reinsurance Company Limited, the business has not only achieved its strategy of exiting from discontinued reinsurance business but has also fixed a maximum cost for its run-off liabilities. This, in turn, has insulated Deutsche Rück's balance sheet from any potential future adverse loss development from the transferred business. Deutsche Rück's post-transfer core business remains the reinsurance of the German public-law insurance sector, which comprises the German Provinzial insurance companies and also of other cedants from German-speaking countries.

Interestingly, however, while the UK's transfer process under Part VII of the Financial Services and Markets Act 2000 is seen as one of the elements in London's perceived lead in run-off techniques over continental European and US markets, the Deutsche Rück transaction is particularly notable for its first-time use of Germany's recently created transfer mechanism under Section 121f para 1 of the German Insurance Supervisory Act. Put in place with effect from June this year as part of its implementation of the European Union's (EU) Reinsurance Directive, previously Germany had no comparable legislation for the transfer of reinsurance portfolios to that of the UK's Part VII process.

Advantages over Part VII

Deutsche Rück's use of the German alternative was due to the fact that, in its specific set of circumstances, the process offered various advantages over the Part VII mechanism, which resulted in savings of both time and cost. In common with the Part VII legislation, the German transfer process enables a reinsurance portfolio to be transferred between authorised reinsurers without the need to secure agreement from policyholders. The trade-off in this transfer was a process firstly requiring consultation with the UK Financial Services Authority (FSA) and agreement for Deutsche Rück UK to assume the liabilities of Deutsche Rück. This involved submission of an individual capital assessment (ICA), which included an independent actuarial expert opinion on the reserves to demonstrate to the FSA that Deutsche Rück UK would have sufficient assets to cover the loss reserves, all expenses and the commercial risks of the company after the transfer.

Under Part VII, however, an independent expert report, policyholder notification and advertising and a court order would also have been required. Inevitably, this can be both time-consuming and costly. Deutsche Rück considered that the new German process would better suit its requirements, since fewer hurdles were involved with no need to appoint an independent expert or counsel for a court hearing.

The German procedure secondly required formal approval by the German insurance regulator (BaFin) and as a consequence the insureds were not notified before the transfer took place. BaFin did, however, insist it was provided with the identities of all policyholders to be transferred and the confirmation from the FSA that solvency requirements are met by Deutsche Rück UK after the transfer. Although there is no formal requirement to do so, Deutsche Rück UK is now carrying out an advertising and policyholder and broker notification process.

The transaction had a strong link to the London run-off market and its processes. The entity receiving the portfolio, Deutsche Rück UK, is regulated by the FSA. As outlined above, the FSA had an important role, which undoubtedly played a part in expediting the German procedure.

Second, the run-off of the transferred portfolios is being managed in London with the next stage being to develop a plan to finalise Deutsche Rück UK's run-off. This should bring some efficiencies to the management of Deutsche Rück's run-off business. Three previously separate blocks of business have now been combined into one larger block of business. With cedants common across the formerly separate portfolios, the management of principal-to-principal relationships is expected to be simplified. Deutsche Rück's own accounting for and management of the run-off business also becomes more streamlined. In fact, Deutsche Rück will no longer need to carry out any claims or accounting functions in respect of the run-off business and its management of this business can now be limited to the control of Deutsche Rück UK.

Solvent schemes common

Looking ahead, it is intriguing to reflect that, way back in 1997 and 1998, Chilton International was part of the development team for the first reinsurance solvent scheme in the UK, which also involved the UK subsidiary of a German reinsurer - in this

case, Hamburger Internationale Rückversicherung - and now, many years after that first German-related example, solvent schemes have become a common part of the run-off toolkit. As such, could it be the case that, led by another German example, portfolio transfers from continental Europe across to the UK are set to become a common and expected event?

If so, whatever the specific dynamics of the Deutsche Rück process, undoubtedly both the German and Part VII transfer mechanisms will be fundamental to such initiatives, with the choice of one over the other depending very much on the specific circumstances of each transaction. Accordingly, the advent of the German transfer mechanism is very much an enhancement of the toolkit for transfers from Germany to the UK, rather than a replacement.

With other European member states now implementing the EU Reinsurance Directive, the toolkit for cross-border transfers of reinsurance business can only become more extensive - a development bound to bring with it some interesting opportunities for the London market.

Ian Marshall is group head of consulting at Chilton International and Jürgen Rehmann is chief executive of Deutsche Rückversicherung AG