



©iStockphoto.com / imagestock

HOW CROSS-BORDER PORTFOLIO TRANSFERS CAN REVITALISE OUTSOURCING

— **Dr. Hubertus Labes**, managing director, *Chiltington International GmbH*
Andrew Smith, marketing director, *Chiltington International Ltd.*

Dr. Hubertus Labes and Andrew Smith discuss the impact of the EU Reinsurance Directive on the outsourcing of reinsurance run-offs.

There are many sound business reasons why an organisation may choose to outsource the management of a re/insurance portfolio in run-off. For instance, it can allow the transferee to concentrate on other, more key areas of its operation, which it may not otherwise be able to do. It may simply be that the transferee no longer has the skills resident within its company to adequately perform an orderly and professional run-off. Indeed, it may never have had these skills in the first place. Also, large savings can frequently be achieved over the short, medium and long term, when an organisation transfers a portfolio in this manner.

Outsourcing

While some organisations will be looking for a purchaser to assume responsibility for the entire run, others will be looking for specialised service providers to simply take care of the administration. Whatever the reason for outsourcing the run-off, and however much of the work is to be outsourced, there are a large number of such service providers who are more than happy to take on the business in one way or another. Some will simply provide assistance with a specific function, but the major players, such as Chilington, will be happy to take over the run-off of the entire company.

Not surprisingly, most outsourcing companies are able to present a long list of reasons why calling them in will lead to improved handling of the run-off, not least of which is dealing with the delicate issue of staff. Run-off companies have difficulty in retaining and motivating key staff, and it can be difficult for a company to recruit someone with an essential skill into a small business. If the business is outsourced to a professional manager with a number of clients, then it can be handled in a proactive and professional manner, resulting in an improved service. In addition, many outsourcing service providers will take on the staff as part of the package. This can even be a legal obligation in some regions, such as the UK (TUPE Law) and Germany (§ 613a BGB).

Service providers usually do not claim that outsourcing will necessarily be the cheapest option; however, although it may look expensive once fees, administration costs and VAT have been added in, a more proactively managed book of business will ultimately lead to reduced claims costs. This is, in effect, the *quid pro quo*.

This is especially true if a company decides to go down the commutation route instead of just administering the run-off until its natural ending. Savings in run-off costs will be the fruits of commutation, since the reinsurer can dispense with the resources needed to service the discontinued treaties. Chiltington strongly believes in providing added value to its clients by downsizing liabilities through a proactive commutations programme, which results in outstanding obligations being wound up and—depending on the success of the commutation strategy—capital being released.

In spite of the above, in recent years, outsourcing the management of re/insurance portfolios has declined remarkably. This trend has been most marked in London, and a number of reasons have been put forward for this change. Perhaps the most compelling of all is the overwhelming desire for organisations to physically remove liabilities from their balance sheet, via a sale, rather than merely moving them in order that a specialist provider can then perform the run-off.

In addition, stakeholders of re/insurers that go into run-off realise that outsourcing a portfolio or selling a company is not necessarily the most economic solution. On occasion, it can be more profitable to run off a company or a portfolio of discontinued business in-house rather than sell it or outsource the administration. Clearly, a key factor in determining this will be the appetite of potential buyers and the value they place on the business. A dearth of buyers—although, certainly not the case in the current climate—will undoubtedly make the potential seller's decision that much easier.

Re/insurers have in the last few years noted a dramatic increase in the number of potential purchasers prepared to buy up discontinued books of business. Indeed, it is very much a sellers' market in this sense, and the prices of old books of liabilities for sale reflect this fact.

However, it seems that the shift away from outsourcing portfolios of run-off business may be reversed, albeit in a very different guise, as a result of EU countries implementing the EU Reinsurance Directive (Directive 205/68/EG of the European Parliament). This Directive represents the culmination of several years of discussion between the European Commission, the European Parliament, Member States and the re/insurance industry as to how reinsurance in the EU should be regulated. The Directive was finally approved by the EU Council of Ministers on November 16, 2005. It was published in the *Official Journal of the European Union* on December 9, 2005, and entered into force the following day. Member States were required to comply with its provisions by December 10, 2007.

Most European countries have or are in the process of implementing the Directive into national law, including Ireland, Germany, Spain, Austria, Netherlands, Hungary and Italy.

The main regulation of the EU Directive is the principle of home country control, which will also apply to the business activities of reinsurance companies in the European Union. The Directive requires that all reinsurance companies be authorised in their home Member State. Reinsurance companies admitted in Germany, for example, are therefore allowed to conduct reinsurance business throughout the European Union via branches or on the basis of the freedom to provide services within the region. Furthermore, the Directive provides facultative provisions on finite reinsurance, and makes it possible to transfer reinsurance portfolios completely or partly from one reinsurer to another without prior approval of the reinsured.

Portfolio transfers

Transfers of this nature between authorised reinsurers have always been permissible under Part VII of the Financial Services and Markets Act (FSMA). However, the trade-off is that these transfers involve a four-part process requiring: FSA consultation and agreement; an independent expert opinion on whether any policy groups are adversely affected; policyholder notification; and a court order. Inevitably, this can be a time-consuming and costly process.

The process provided by the new EU Law therefore offers advantages over the Part VII mechanism, especially when the transferred portfolio has no reinsurance protection. It allows for the transfer of a domestic reinsurance portfolio—completely or partially—into a single entity within the European Union, enabling a separation of active and discontinued business. This transfer is subject to approval by the national financial supervisory authority. A permit is granted if it can be proven that the accepting company will use the equity capital in such a way as to fulfil solvency margin requirements.

The transferring company's rights and liabilities from the reinsurance treaties are transferred to the accepting company together with the portfolio. Therefore, the new law creates the possibility to transfer reinsurance portfolios without the approval of reinsureds/cedants. The agreement on portfolio transfer is subject to written form, although the involvement of a notary public or Hague Apostille is not required.

The added ease to effect cross-border portfolio transfers within the EU will aid the consolidation processes and the restructuring of international re/insurance groups, and prove an alternative to complex merger, de-merger and spin-off procedures.

In run-off scenarios, this new law is of most importance in that portfolio transfers into the UK can then be subject to a Solvent Scheme of Arrangement procedure, thereby enabling the owners an accelerated exit strategy. This was the overriding consideration for the German reinsurer Deutsche Rückversicherung AG (Deutsche Rück), which decided to use the EU law rather than the Part VII procedure.

Deutsche Rück's strategy was to finalise its discontinued reinsurance business as soon as possible. Via a portfolio transfer to the UK, Deutsche Rück was able to accurately calculate the cost of running off its discontinued liabilities, and in doing so, insulate its balance sheet from potential future adverse loss development from the transferred business.

In anticipation of the legislative change, Deutsche Rück was able to complete the portfolio transfer just four months after the implementation of the EU Reinsurance Directive into the German Insurance Supervisory Act on June 2, 2007. As a result, the very first transfer of a reinsurance portfolio from Germany to London taking advantage of this legislation was achieved.

Chiltington International, from its offices in London and Hamburg, acted as run-off adviser to Deutsche Rück. This transaction reflects the desire of international insurance companies to move their business around the EU in order to achieve administrative efficiency and cost savings, and to open up options for closure, sale or capital markets transactions.

Depending on the class of business and the composition of the policyholders, finality will ideally be achieved in the form of a scheme of arrangement. With London's long-established run-off regulatory and management infrastructure, the ability to implement a scheme of arrangement is one of the key reasons why it is anticipated that an increasing number of European re/insurers will consider transferring their discontinued portfolios from the Continent to London.

However, transferring the portfolio is only one part of the exercise. It then needs to be carefully managed by whichever company the transferee has decided to move it to.

“Depending on the class of business and the composition of the policyholders, finality will ideally be achieved in the form of a scheme of arrangement.”

Conclusion

Managing outsourced run-off portfolios is an active and competitive market, with large full-service companies operating alongside specialist providers. The key question will be: from where can the market generate growth in the future? Run-off business undoubtedly continues to be a growth area. The volume of the reinsurance run-off business in Continental Europe was recently estimated at over €200 billion in liabilities, with annual increases of 10 percent forecast. This does not necessarily mean, however, that all existing providers will flourish. Indeed, many players are now acquisition targets, and some of these deals have already taken place over the past two years.

The growth in European run-off business, coupled with the ease with which portfolios can be transferred to the UK, will ensure that the outsourcing of run-off services continues to be in demand. The added, indeed overriding, attraction of Continental European companies then being able to place their transferred portfolios into a Solvent Scheme of Arrangement adds further credence to this claim. Such a procedure does not exist within the Continental European legislative framework—so far. This might indeed revitalise outsourcing, since once companies decide to go down this route, there will be a need for service providers in the UK to manage the transferred portfolios. Someone has to do the work!

Dr. Hubertus Labes is the managing director of Chiltington International GmbH. He can be contacted at: hlabes@chiltington.com. Andrew Smith is the marketing director of Chiltington International Ltd. He can be contacted at: asmith@chiltington.co.uk.