



Finality Solutions for international reinsurance business accepted by Japanese insurers


Run-off business

“Legacy”, “Discontinued”, “Run-off”. However it is described, all insurers suffer from the problems of their past underwriting, the only issue being how significant those problems are and what tools are available to deal with them. In Japan, from the 1960’s onwards, the acceptance of reinsurance business from US and UK cedants was seen as an acceptable diversification of risk as well as an opportunity to earn significant overseas premium and ultimately profit. Regretfully, the emergence of asbestos related illnesses and the willingness of the US legal system to find in favour of claimants rather than insurers (often overriding explicit policy terms) have created significant long tail liabilities that would never have been anticipated at the time the business was originally accepted. Particularly for those insurers who aggressively sought to increase premium income from their overseas business, this has had devastating results as well as creating the need for additional resources to be tied to the administration of this business for many years and, potentially, for many more years to come.

These problems are certainly not unique to Japan. Indeed, exposure to APH (asbestos, pollution and health hazard) liabilities has had a far more devastating impact on insurers in the USA, UK and Europe and has led directly to countless insolvencies where the sheer volume of claims has overwhelmed a business. Japanese insurers can be thankful that their overseas reinsurance premium was a very small part of the company’s total premium income and the significant appreciation in the Yen over the subsequent period has mitigated the impact of these losses on the company balance sheet. Definitions of what run-off or discontinued business is vary. For the purpose of this article it is intended to refer to business underwritten in the past, where the policies underwritten have long since expired but where claims continue to develop and be reported.

Managing long tail claims

Handling these old year run-off liabilities in Japan poses two particular problems. Firstly, the specialist skills required to evaluate and explain to senior management the reasons behind these losses rarely exist. In part this is caused by the policy of rotating staff between different departments, but also because of the remoteness of Japan from the US, where most of these claims derive, or London which has a large pool of specialists (lawyers, consultants and actuaries) who focus for their entire careers on these legacy type issues and how best to




deal with them. Secondly, unlike most US and UK insurers, little if any reinsurance was purchased by Japanese insurers at the time which would otherwise have mitigate the impact of these losses. Indeed, it is very often the reinsurance purchased by Lloyd's and London market companies that has been retroceded to Japanese insurers. In truth, the Japanese market received minimal premiums for significant exposure and this exposure has since crystallised into reported losses. Losses that will continue to develop for a further 20 or 30 years.

We should not forget that run-off issues are not restricted to APH losses only. By way of example, the collapse of the US agency Fortress Re following the events of 9/11 and the fraud perpetrated on the pool members, led directly to the failure of Taisei Fire and Marine as well as having hugely significant financial consequences for the other two major pool participants. These aviation liabilities continue to require specialist handling today as disputes between the airlines and the property insurers in relation to who should pay and on what basis rumble on.

Managing run-off claims in Japan

Although small in the context of the size of Japanese insurers, the legacy reinsurance portfolios of international business are not insignificant and within most companies they are regularly reported on at Board level and have been for probably 20 years or more. Over this period, two key themes can be identified. Often staff rotation has been minimised, in particular at General Manager level. This has enabled a depth of experience to be gained of the unique characteristics of these discontinued portfolios and the techniques required to handle them. Secondly, commutation (described in more detail below) has been used as the primary tool of run-off administration.

In broad terms, a philosophy of either a passive or active claims management philosophy has been adopted. With a passive approach claims are settled as presented with little, if any, claims adjusting or assessment. Although such a strategy eliminates the need for specialist resources the claims still need to be processed regularly and the contracts exposed to APH liabilities are likely to remain active for 40 years plus. Alternatively, a more active approach has been utilised, particularly among the larger insurers or those with larger discontinued portfolios. More active claims management inevitably requires more resources and this has led to an increasing use of external consultants whose knowledge and experience has assisted in the development of specific strategies to identify and deal with the more volatile contracts and cedants found within these legacy portfolios. An active claims management



strategy seeks to close down these contracts at the earliest possible opportunity. This reduces the administration going forward as well as eliminating future deterioration. Commutations involve the negotiation of a full and final payment to the cedant who re-assumes the risk from the effective date of the commutation. Achieving commutations requires a willing cedant and, thereafter, a fair assessment of the future exposure. Understanding what an appropriate IBNR (incurred but not reported) is, valuing the known claims and applying any appropriate discounts (whether for the time value of money or for issues relating to the claims themselves) requires detailed knowledge and experience and this is where the use of external consultations can deliver real value. Disputes do arise when more questions are raised through a more stringent claims adjusting philosophy and at times this can lead to arbitration or litigation. These cases involve significant legal costs and considerable management time and should generally only be undertaken where the advice received is that the company has a very high chance of succeeding and where the values involved are significant. What is considered “significant” will, of course, vary from company to company.

From the reinsurer’s point of view, commutation is an excellent tool to use when managing run-off business. However, the uncertainty as to what future exposure remains means cedants are generally very reluctant to enter into commutations either at all or, if they do, only where significant risk premiums are involved. Although London market and European cedants have broadly embraced commutations, US cedants remain the most reluctant and can be the most difficult to persuade where the reinsurer is well rated - as all Japanese companies invariably will be.

The extraordinary long tail nature of international run-off business, particularly compared to domestic business, is a headache for senior management. Questions will be raised as to why the results of business underwritten decades earlier continue to deteriorate and impact the company result. This has increased the pressure on reinsurance/overseas departments to find a solution that deals permanently with the international run-off liabilities.

Finality for international run-off business

It is generally accepted that the London market has developed as the centre of the run-off industry, with many specialist service providers offering their services and innovative solutions to the myriad of run-off problems. A number of providers have also created a niche market to acquire discontinued portfolios of business. Whereas in the past these


solutions were limited to stop loss or adverse development covers, they have since expanded into share sales of subsidiary entities or the carving-out of discontinued portfolios where a company is still underwriting new business. Within the UK (and indeed throughout the EU) legislation has been enacted to allow for a legal portfolio transfer known as a 'Part VII transfer'. The effect of this transfer is to remove a defined portfolio of business and all associated liabilities from one company balance sheet and to place it on another. The process requires regulatory and court approval but not individual policyholder approval. The table below identifies some of the larger transactions that have taken place to-date:

<u>Transferor</u>	<u>Transferee</u>	<u>Sanction date</u>
GE Re	Swiss Re UK	14-Mar-07
Munich Re America (UK branch)	Great Lakes Reinsurance (UK)	16-Mar-08
Samsung	Landmark	18-Nov-04
St Paul Re	Unionamerica	13-Dec-07
English & Scottish Maritime & General	Axa Global Risks (UK)	29-Nov-06
American Re	Munich Re	18-Dec-03
Tokio Marine Global	Tokio Marine Europe	28-Jul-05

In Japan, similar legislation to allow for the legal transfer of business in this way does not presently exist. Previously, it had been assumed therefore that solutions of this type were not available to Japanese insurers. However, the innovative nature of the London based service providers has resulted in a mechanism being developed whereby a Japanese insurer can achieve finality through the Part VII transfer mechanism and with it the permanent removal of their international reinsurance legacy liabilities from the company balance sheet. These solutions have a cost and therefore require the insurer's management to assess the merits of pursuing such a solution.

Finality for Japanese insurers run-off liabilities

For a Japanese insurer to achieve the 'sale' of their run-off portfolio using the Part VII transfer mechanism requires a number of steps to be completed. These are summarised

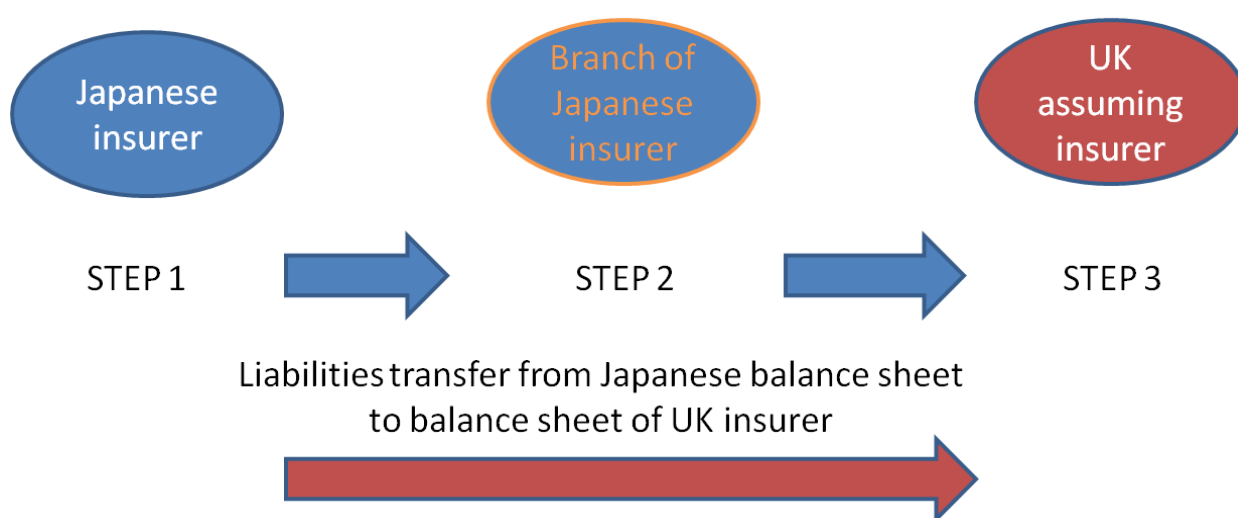


below, although it should be recognised there will be unique characteristics and issues that need to be addressed in each specific situation.

1. Identify the portfolio of business. The first step is to define the business as precisely as possible that is to be the subject of the transfer. It would, for example, be usual to cut off at a particular underwriting year i.e. all business underwritten up to 31 December 2001.
2. Relocate the business to a UK branch of the Japanese company. This does not involve any legal transfer between entities and the liabilities at this stage remain on the insurer's balance sheet. The company must apply for and obtain a licence to open the branch and, having relocated the business in this way, the portfolio is brought within the jurisdiction of the UK court.
3. Transfer the business from the UK branch of the company to a third party transferee company following the procedure under Part VII Financial Services and Markets Act 2000. This process requires a number of steps including; obtaining a report on the proposed transfer by an independent actuarial expert; discussions in relation to the proposed transfer with the UK FSA to secure their approval; publicising the transfer through a mailing to policyholders and advertising in newspapers and on a website; applications to court including approval for the proposed publicity and for the transfer itself.

These steps are illustrated in the following diagram:


Illustration of transfer steps



Where the UK FSA and independent expert are satisfied that policyholder's interests are protected and that the assuming company is sufficiently robust, the court is likely to sanction the transfer. As a consequence there is a legal transfer of the business from the Japanese company to the transferee company and all future obligations will thereafter be met by the transferee company. This provides the insurer with finality for their legacy business. In future, all policyholders will be required to submit claims to the new assuming company, leaving the Japanese insurer free to concentrate on their on-going business.

Track record of transfers involving Japanese insurers

Although an innovative approach to the finalisation of a company's run-off liabilities, transactions of this type are now tried and tested. The first of these transfers involving a Japanese insurance company was completed in January 2007 and involved the transfer of claims reserves for business with significant APH exposure. The liabilities and assets were transferred to a newly created UK licensed insurer. This company purchased an adverse development cover from an international reinsurance company as part of the process to




satisfy the UK FSA, independent expert and the court that sufficient assets were available within the insurer to meet future policyholder's claims.

In May 2010 a second Japanese insurance company was granted court approval to transfer a portfolio of claims to a newly established and licensed UK insurer. In this case, a Bermuda cell was used to reinsure the UK insurer assuming the portfolio and a significant proportion of the assets assumed by the insurer were immediately transferred out to the Bermuda cell. A third transfer of a Japanese company's liability is presently underway and expected to be court approved in the near future.

UK Court considerations prior to transfer sanction

What each of these transfers demonstrates is that finality can be achieved for these legacy portfolios as long as the insurer is willing to pay a premium above the best estimate reserves. What this premium should be will depend on the portfolio and the transaction partner as well as the UK FSA and Independent Expert being satisfied that the structure of the acquiring vehicle provides sufficient protection to policyholders. This will usually involve demonstrating available assets at the 97.5 percentile confidence level, a very high threshold and very much a worst case assessment of the remaining liabilities. It is because this threshold is so high that there are unlikely to be many objections to transfer, at least on the grounds of available assets to pay claims. The Independent Expert and the UK FSA focus on the impact of a pending transfer on policyholders both in the entity left behind as well as the transferring policyholders and their protection in the assuming company. Only if they are satisfied that the interests of both sets of policyholders are fully protected will they recommend the court sanction any transfer. In other words, the transfer must not only involve total reserves on a worst case basis being placed in the new entity, but also whatever reserves are released by the existing entity must also not weaken, in any material way, their balance sheet. If it did, the Independent Expert would be forced to point out that the loss of these assets could be detrimental for the remaining policyholders and court approval would almost certainly be denied.

A Part VII transfer, from establishing a new UK Branch through to court approval of the transferring business to a new entity, can be expected to take from 18 to 24 months. It will require a representative of the company to act as the head of the branch with authority, independent of Head Office, to manage the business during the period of operation of the branch. Significant advisory costs should be anticipated to assist with dealing with the FSA, the independent expert and the court. This, in conjunction with the premium required over




and above the best estimate reserves, means the solution is unlikely to be cost effective for portfolios of business under, say, USD 50million.

Frequently asked questions about Part VII transfers

Inevitably, concerns have been expressed on a number of levels about transactions of this type, how successful they will prove to be and what possible challenges they may face. Some of the more frequently raised questions include the following;

1. Is it possible to transfer business from a highly rated reinsurer to an unrated special purpose vehicle? The answer is yes. No rating is required to be held by the company assuring the portfolio. Both transactions that have taken place to date have been to newly created, licensed but unrated companies.
2. Can a transfer operate where the liabilities arise from policyholders outside the UK? Again the answer is yes. The transferor must demonstrate “sufficient connection” to the UK legislation. In both the transfers that have taken place involving Japanese insurers the number of UK policyholders was less than 30% of the whole portfolio. Nevertheless, the court was satisfied that this was still a sufficient connection with the UK.
3. What happens if policyholders, particularly US policyholders, object? During the transfer process, there is only a limited opportunity for policyholders to object as the court will place significant reliance on the report of the Independent Expert. Policyholders are not entitled to seek to go behind the work of the Independent Expert or to challenge the information on which their conclusions are based. The court will listen to any objections raised but unless there are large numbers of policyholders with valid objections they are unlikely to influence the court decision to approve the transfer. In most cases, the transferee and transferor will work together to identify and deal with any potential objectors well before the court hearing.

The Part VII transfer process is now being used extensively in the UK and Europe as a means of reorganising and restructuring a business. Until recently, solvent schemes of arrangement (another court sanctioned process, involving a mass commutation of a portfolio, but one in which a majority of policyholders must vote on and approve) had been the more popular tool. These schemes have been the subject of much contention and objection, particularly from US policyholders and are now less widely used. The Part VII transfer process, on the other hand, does not extinguish policyholders coverage or right to claim in the future but rather transfers the obligations from one legal entity to another. Because of this, it tends not to be subject to the same level of criticism as solvent schemes and the nature of the approval



process in any event limits the ability of policyholders to object to such transfers. The successful use of the Part VII transfer process with regard to Japanese portfolios will, the author believes, result in the same approach being taken with portfolios in other jurisdictions that do not have their own portfolio transfer procedures. Insurers in Korea and Taiwan, for example, who like the Japanese insurers underwrote international business decades earlier and are suffering from the very same long term run-off liabilities may also avail themselves of this proven finality solution.


Developing finality solutions in Japan

The use of the Part VII transfer mechanism is one example of the innovative approach of the London market to run-off related issues. It does however raise an interesting question as to what could be developed within Japan to deal directly with legacy issues rather than the need to find a novel way to bring business underwritten in Japan under the UK court rules and regulations. Would it not be possible, for example, for insurers within Japan to lobby for legislation that allowed for the legal transfer of business in Japan such that legacy business, whether consisting of domestic or foreign policyholders, could be solved locally? If so, this would provide entrepreneurial opportunities within the country as well as demonstrating to those wanting to enter the Japanese market that Japan offers a flexible and innovative environment to enable an orderly exit from the business as well. The insurance environment must be properly regulated and the interests of policyholders fully protected but, as this UK solution demonstrates, such needs can be satisfied as long as the legislation proposed keeps the interest of policyholders above those of the stakeholders. Until such time, Japanese insurers looking to finally solve their legacy issues are restricted to the use of the branch/Part VII transfer concept for those portfolios that qualify.

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