INSURANCE SOLUTIONS

# The UK Run-Off Survey - Life Assurance

September 2005

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# The UK Run-Off Survey - Life Assurance

**This is the third survey of the UK life run-off market that the Association of Run-Off Companies Ltd[1] (ARC) has commissioned. Prepared by KPMG LLP (UK), the survey sheds valuable light on an often overlooked industry sector and highlights how sizeable and important it has become.**

**We hope that you find this survey to be a valuable tool in your work. Should you have any comments or suggestions, please let us know, as we are always looking to extend and improve the accuracy and coverage of the survey[2].**
Philip Grant, ARC Director, September 2005

There are now approximately 330 entities that are authorised to carry on life assurance business in the UK, including composite assurers who write both life and non-life business, and friendly societies. Of these, approximately 10 percent by number account for over 75 percent of the total value of long-term technical liabilities.

The survey is based on a study of over 130 UK life assurers and friendly societies, which represent over 97 percent of the total value of UK long-term technical liabilities (hereinafter referred to as "policyholder liabilities"). UK life business of companies from other EU countries and from Lloyd's syndicates has not been included in this survey.

## Executive Summary

- Total policyholder liabilities of UK life assurers in run-off[3] are just over £135 billion, an increase of some £11 billion since 2003.

- Life assurers in run-off account for approximately 14 percent of the policyholder liabilities of all UK life assurers. This is the same as in 2003.

- Some £11.5 billion of capital is tied up in UK life run-off business, an increase of almost £3.0 billion on 2003.

- The number of UK life assurers that have gone into run-off has increased to 51 from 44 in 2003.

- The life run-off market continues to consolidate and the 51 companies in run-off are currently held within 18 corporate groups, with the two largest groups containing over £60 billion of policyholder liabilities in run-off.

- The life run-off market spent just under £1.1 billion in administration costs in 2004. This represents an increase of approximately 15 percent over 2003.

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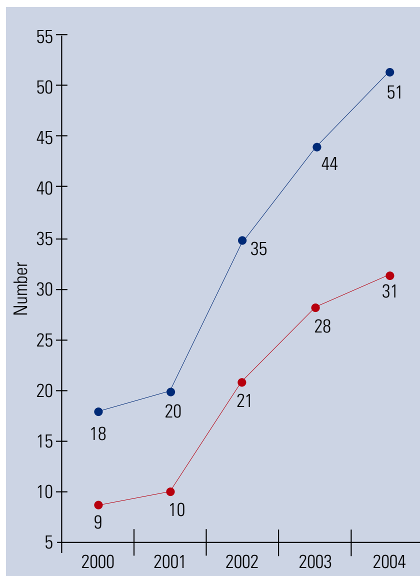
UK life assurers in run-off




Source: A.M. Best's Statement File - Life - UK,
S & P Thesys - SynThesys Life, KPMG LLP (UK) 2005

- Number of Companies in run off
- Number of Companies in run off excluding companies that are now dormant

## Current size of the UK Life Run-Off Market

There are 51 UK life assurers that have gone into run-off and write no new business. The business of 20 of these companies has, however, subsequently been transferred to other life assurers and the resultant shell companies have become dormant. Accordingly of the 51 life assurers that have gone into run off, 31 still exist as companies in run-off in 2004, which is a net increase of three over the position in 2003.

Our survey reveals that as at the end of 2004 policyholder liabilities of the UK life run-off market totalled some £135 billion and represented approximately 14 percent of the total policyholder liabilities of all UK life assurers.

Table 1. Size of the UK Life Run-Off Market

| As at end 2004 | Number of companies | Policyholder liabilities (£ billion) | % |
|---|---|---|---|
| Active Market | 279 | 837 | 86% |
| Run-Off Market | 51 | 135 | 14% |
| **Total UK Life Market** | **330** | **972** | **100%** |

Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2005

In addition to the life assurers in run-off, there are active life assurers that have placed a significant part of their business (for example, their with-profits fund) into run-off. We have identified 24 such UK life assurers in "partial run-off" but information on the value of the run-off portfolios within these assurers is not publicly available. As a result, our survey is likely to underestimate the true size of the UK life run-off market.

In September 2004 the Financial Services Authority (FSA), using publicly and privately available company information, reported that 66 of the total 110 with-profits funds are closed to new business and that these closed funds have £191 billion of assets under management. When considered in conjunction with this survey, this shows that significant closed with-profits business is held by life assurers with other active business. These would be classified as active in our survey.

## Change in size of the UK Life Run-Off Market

The survey shows that the number of life assurers that have gone into run-off has increased to 51, from 44 at the end of 2003.

Over the same period, the policyholder liabilities of the UK life run-off market increased from £124 billion to £135 billion. This increase of £11 billion is however a net figure and includes both increases due to several life assurers becoming closed and decreases due to certain group reorganisations where the business of a closed company has been transferred to another group company that still writes new business.

Table 2. Change in the UK Life Run-Off Market

| Policyholder Liabilities (£ billion) | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| Active Market | 815 | 804 | 717 | 769 | 837 |
| Run-Off Market | 71 | 75 | 107 | 124 | 135 |
| **Total UK Life Market** | **886** | **879** | **824** | **893** | **972** |

Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2005

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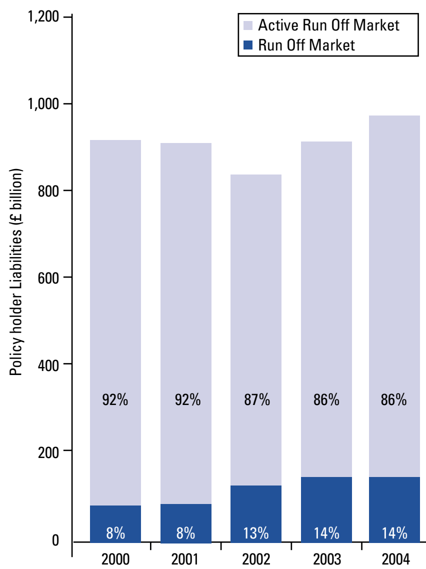
Change in size of the UK Life Run-Off Market




Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2005

This survey reaffirms that the UK life run-off market has grown continuously and significantly since 2000:

- The number of life assurers in run-off increased by a factor of almost three between 2000 and 2004;
- Policyholder liabilities of UK life assurers in run-off have increased by nearly £64 billion, or almost 90 percent over the same period;
- The annual increase in policyholder liabilities of UK life assurers in run-off peaked at a 43 percent increase in 2002 (following significant equity market falls), reducing to a nine percent increase in 2004;
- Policyholder liabilities in run-off have increased from eight percent of the total life market in 2000 to 14 percent in 2004.

Key factors in these increases have been the move of several large well known ex-mutuals and with-profit companies into run-off following the impact on profitability and solvency during the past 10 years of sustained low interest rates, the identification of mis-selling liabilities and stock market falls.

## Other features of the UK Life Run-Off Market

The survey demonstrates that the UK life run-off market has continued to successfully manage its expenses in 2004. Non-commission expenses of the UK life run-off market increased by 15 percent to £1.1 billion. This is comparable to the increase in policyholder liabilities and the number of assurers in run-off.

By contrast the remainder of the UK life market increased its non-commission expenses by a quarter in 2004, while the value of policyholder liabilities increased by nine percent. Market commentary indicates that a significant element of this expense increase reflects the high degree of regulatory change implemented during 2004.

This suggests that either regulatory change had a lesser effect on the expenses of the UK life run-off market than the active market, or that the cost has been offset by other savings made in the run-off market. One of the contributors to expense savings in the run-off market may be the widespread use of specialist outsourcing, where closed life assurers often use outsourcing to control expenses and generate savings through scale efficiencies. However the continued cost benefits of outsourcing may be impacted by a recent court judgment, which held that VAT will in future be chargeable on certain outsourcing services.

Some other features remain characteristic of the UK life run-off market:

- Assurers in run-off have a smaller proportion of their assets invested in equities (2004: run-off 14 percent, active 30 percent) and this proportion reduced for both run-off assurers and active companies in 2004 (2003: run-off 16 percent, active 33 percent). This reflects a more prudent equity investment strategy, but restricts the potential of life assurers in run-off to participate in equity market increases.

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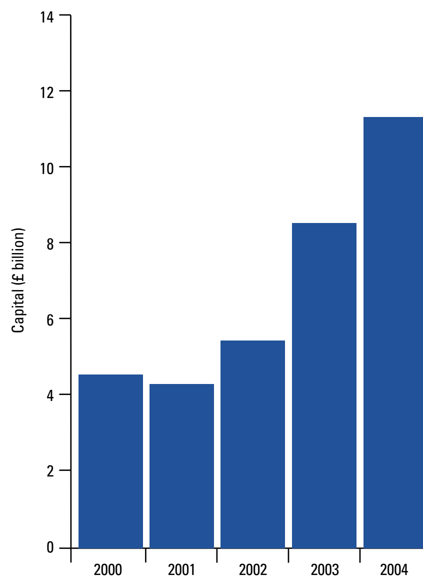
- Although the reported strength of the UK life run-off market has improved on 2003 and is now closer to that of the active market, the solvency strength of life assurers in run-off remains on average below that of active life assurers. It should be noted, however, that the basis for determining regulatory solvency was revised in 2004 (to reflect the "twin peaks" regime).

- Life assurers in run-off continue to receive significant net premium (in excess of £2.7 billion). This is a 40 percent decrease on 2003 and principally reflects a reduction in single premium business and the purchase of significant reinsurance by certain existing closed life assurers.

## Capital tied up in run-off

Our survey demonstrates that by the end of 2004 some £11.5 billion of capital (measured on the revised regulatory solvency basis adopted during 2004) was tied up in life run-off businesses in the UK. This is a 35 percent increase over 2003 and significantly exceeds the 9 percent increase in policyholder liabilities in 2004. A proportion of this movement is likely to have been driven by the recent changes in regulatory capital requirements, although it is not possible to identify the relevant amounts from publicly available data.

Capital tied up in UK Life Run-off




Source: A.M. Best's Statement File - Life - UK,
S & P Thesys - SynThesys Life, KPMG LLP (UK) 2005

Our survey does show that under the new "twin peaks" solvency regime many UK life assurers in run off are required to determine their solvency on a "regulatory" basis. This means that they have a higher "regulatory" than "realistic" solvency requirement and suggests (due to the different way that the two requirements treat certain liabilities) that the with-profits funds of these UK life assurers in run off are weaker than their active counterparts.

In addition to their reported solvency requirement, all assurers are required to hold further capital to meet Individual Capital Assessments (ICA) agreed between them and the FSA. While ICA's are not made public, they are likely to further increase the actual solvency requirement for UK life run-off business and tie up further shareholder capital.

With closed funds likely to take in excess of 25 years to run-off in the normal course, it is clear that there remains significant corporate capital tied up for the foreseeable future. This capital is significantly exposed to risks and has restricted scope for enhancement of shareholder value, particularly in the presence of guarantees where the downside investment risk is largely borne by the shareholder.

## Recent developments in the UK Life Run-Off Market

*M&A activity*

There has been a further increase in significant merger and acquisition activity within the UK life run-off market in the year to July 2005. This activity is again dominated by a few large life run-off consolidators who have been established, or have developed their strategy to take advantage of opportunities arising in the UK life run-off market as it has grown in size and become more mature.

It is considered that combining run-off businesses through consolidation provides scale efficiencies, diversification benefits and enables the business to be managed in a focused and effective manner by life run-off specialists.

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Following the five significant M&A transactions reported in our 2003 survey, major M&A transactions in the past year include those shown in Table 3.

Table 3. Major M&A transactions in 2004/ 2005

| Acquirer | Target | Acquisition value (£million) | Acquisition Method | Date |
|---|---|---|---|---|
| Reliance Mutual | British Life Office | 473[a] | Part VII transfer | June 2004 |
| Reliance Mutual | Family Assurance Friendly Society | 254[a] | Part VII transfer | September 2004 |
| TDR Capital and Sun Capital Partners | Life companies (Pearl, NPI and London Life) of HHG plc | 1,070[b] | Joint direct acquisition | April 2005 |
| Britannic Group | UK life unit of Allianz Cornhill | 110[b] | Management agreement and Reinsurance | December 2004 |
| Resolution Life Group | UK life operations of Swiss Life Group | 205[b] | Direct acquisition | March 2005 |
| Chesnara plc | City of Westminster Assurance | 48[b] | Direct acquisition | June 2005 |

(a) - Liabilities acquired: (b) - Purchase consideration

Source: KPMG LLP (UK), market analysis from June 2004 to June 2005

In addition, following its acquisition of the Royal & SunAlliance life businesses in 2004, Resolution Life Group recently entered into portfolio transfer reinsurances of two annuity in-payment portfolios to Canada Life and Prudential Assurance. These transfers represent liabilities of nearly £3.7 billion and significantly reduce Resolution's longevity risk exposure. It is planned that the portfolios will be legally transferred to the reinsurers using Part VII transfers in due course.

Also, in July 2005 Resolution Life Group and Britannic Group announced their proposed merger.

Although the number of assurers in run-off has increased by seven to 51, all of the UK life assurers in run-off remain contained within 18 groups. This is due principally to the M&A activity outlined above. The increased concentration within the run-off market is further evidenced by the fact that the two largest run-off groups in 2004 contain just over £60 billion of run-off policyholder liabilities, compared to £50 billion in the two largest run-off groups in 2003.

*Group reorganisations*

As noted above, and in addition to M&A activity that has involved Part VII transfers, there have recently been a number of group reorganisations involving business in run-off and partial run-off that have utilised Part VII transfers. These include the major transfers detailed in Table 4.

Table 4. Group reorganisations via Part VII transfers in 2004/ 2005

| Group | Transferee | Liabilities transferred (£million) | Date |
|---|---|---|---|
| Zurich Group | Zurich Assurance (formerly Eagle Star) | 25,000 | January 2005 |
| Aviva Group | principally Norwich Union Life & Pensions | 20,000 | January 2005 |
| Lloyds TSB Group | Scottish Widows | 7,000 | December 2004 |

Source: KPMG LLP (UK), market analysis from June 2004 to June 2005

These transfers demonstrate the availability of the Part VII mechanism to move life business together with related reinsurance between assurers. This allows groups to consolidate previously acquired and legacy business in one place, thus enabling them to deauthorise and liquidate unneeded closed companies.

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## Conclusions

This survey shows that while the UK life run-off market grew by a sizeable amount in 2004, the pace of increase has slowed. We consider that this reflects the stabilisation of mis-selling, guarantee and investment issues affecting the UK life assurance market in recent years. Few market commentators are now anticipating a significant downturn in investment markets, or the identification of major new “mis-selling” issues in the UK life market in the near future. It therefore appears likely that the number and value of closed funds will stabilise, with future changes arising from assurers making strategic decisions to close specific books of business.

Over the past two years our surveys have shown that the number of acquisitions and degree of concentration in the UK life run-off market has increased, largely as a result of activity by a few major consolidators. Since many of the large, independent, closed life assurers have now been acquired by consolidators, there are reduced opportunities for further closed company acquisitions. However, there is no indication that the consolidators’ appetite for closed funds has been satisfied, with most of them expressing a desire for more acquisitions. As a result further acquisitions are likely to be dominated by Part VII transfers of run-off portfolios contained within otherwise active assurers. Whether these transfers actually occur will ultimately depend on the price an acquirer is willing to pay and the cost of capital supporting these closed funds.

Going forward, the UK life run-off market needs to fully embed recent acquisitions and continue to deal with day-to-day business challenges. Embedding acquisitions is likely to result in further disposals and reinsurance (or securitisation) of portfolios that acquirers do not wish to retain, and further restructuring of expense bases, including the continued use of outsourcing. At the same time, current industry leaders are driving the pursuit of “market best practice” management for closed funds and the FSA has stated that it will continue to work with the sector on “Treating Customers Fairly” and other recent regulatory developments.

Overall, this survey suggests that the UK life run-off market has progressed from a “growth phase” to a more mature “consolidation phase”. While consolidation activity is likely to continue to concentrate the UK life run-off market, the sector now has sufficient scale and maturity to make significant strides in meeting the underlying challenges presented by over £135 billion of policyholder liabilities and over £11.5 billion of shareholder capital tied up in closed funds.

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1 Association of Run-off Companies Ltd is the UK run-off insurance industry’s trade association. It is a limited company with its members as shareholders. The association has been in existence since 1998 and has in excess of 200 members.

2 The survey is based on an analysis of publicly available financial information, including regulatory returns submitted to the Financial Services Authority (FSA), utilising ‘A.M. Best’s Statement File - Life – UK’, S & P Thesys - “SynThesys Life” and from audited statutory accounts filed at Companies House. This information has not, however, been verified or validated in any way by KPMG LLP (UK).

3 In this survey life assurers classified as "in run-off" comprise only those companies that have ceased to actively underwrite new life assurance contracts. Companies that have closed a substantial, identifiable element of their business (e.g. with-profit business, pension business, etc.) as well as UK life assurers that have ceased writing certain products, or relatively small product lines have been defined as "active" because an analysis between active and run-off business is not readily obtainable.

Due to the long-term nature of life assurance contracts, an assurer that has ceased to actively underwrite new life assurance contracts may continue to receive regular premiums, accept increments to existing policies, accept new members under existing group contracts and issue new contracts in accordance with existing contractual commitments for many years. Thus, depending on the maturity profile, funds can continue to grow for a number of years after they have been closed to new business.

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