



INSURANCE SOLUTIONS

The UK Run-Off Survey – Life Assurance

October 2006

ADVISORY

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Foreword

The 2006 *UK Run-Off Survey – Life Assurance*, has been commissioned by the Association of Run-Off Companies Limited¹ (ARC) and prepared by KPMG LLP (UK). It is an excellent source of reference data on the life run-off market in the UK and ARC is, as ever, grateful to KPMG LLP (UK) for its meticulous research and analysis.

The UK life assurance sector has been the subject of considerable activity in the last few years and the survey shows that the acquisition of closed books continues apace, as does the concentration of liabilities within the market.

Also of interest is that administration costs have shown a sharp reduction, which indicates that the efficiencies of scale upon which many of the acquisitions have been predicated, are indeed manifesting themselves. This corroboration of one of the key business model assumptions may help to maintain the acquisition momentum in the market.

We hope that you will find this survey as useful and interesting as its predecessors. As ever, if you have any comments or suggestions about the survey, please do let us know, as we are always looking to improve its coverage.

Philip Grant

Chairman, Association of Run-Off Companies Limited

October 2006

1 Executive Summary

1.1 Overview

There are now approximately 340 entities that are authorised by the Financial Services Authority (FSA) 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 now account for over 80 percent of the total value of long-term technical liabilities.

The survey is based on a study of the position at 31 December 2005 of over 130 UK life assurers and friendly societies (unless otherwise stated), which represent over 99 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 survey².



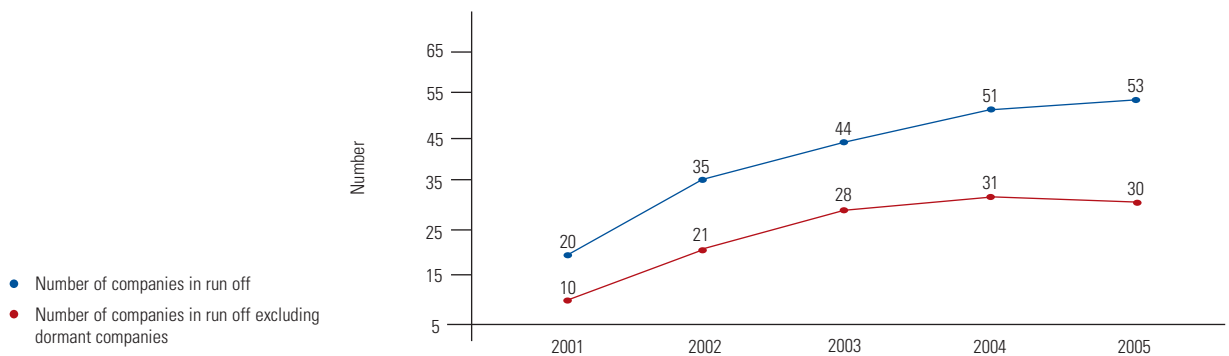
1.2 Findings

- Total policyholder liabilities of UK life assurers in run-off amount to over **£136 billion**, an increase of some £1 billion since 2004.
- Life assurers in run-off account for approximately **12 percent** of the policyholder liabilities of all UK life assurers. This is a decrease of two percent from 2004.
- Some **£14.5 billion** of capital is tied up in UK life run-off business, an increase of over £3.0 billion on 2004.
- The number of UK life assurers that have gone into run-off has increased to **53** from 51 in 2004.
- The life run-off market continues to consolidate with the five largest groups containing approximately **77 percent** of policyholder liabilities in run-off compared with 74 percent in 2004. The **53 companies** now in run-off are currently held within 18 corporate groups which is the same position as in 2004.
- The life run-off market spent over **£849 million** in administration costs in 2005. This represents a decrease of approximately 20 percent compared to 2004.

2 Current size of the UK life run-off market

In the UK 53 life assurers have gone into run-off³, meaning they write no new business. The business of 23 of these companies has, however, subsequently been transferred to other life assurers and the resultant shell companies have become dormant. Accordingly, of the 53 life assurers that have gone into run off, 30 still exist as companies in run-off in 2005, compared to 31 in 2004.

UK life assurers in run-off



Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2006

The survey reveals that as at the end of 2005, policyholder liabilities of the UK life run-off market totalled some £136 billion and represented approximately 12 percent of the total policyholder liabilities of all UK life assurers.

Table 1. Size of the UK life market

As at end 2005	Number of companies	Policyholder liabilities (£ billion)	%
Active market	287	980	88%
Run-off market	53	136	12%
Total UK life market	340	1,116	100%

Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2006

In addition to life assurers in run-off, there are active life assurers who have placed a significant part of their business (for example, their with-profits funds) 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, this survey underestimates the true size of the UK life run-off market.

In November 2005 the FSA, using publicly and privately available company information, reported that there are now 51 firms, out of a total of 99 firms, that manage closed with-profits funds. These firms have £85 billion of assets under management out of a total of £387 billion of with-profits funds assets under management. This is a different reporting basis from that used by the FSA in the past and so comparisons to prior years are difficult. In addition, comparison with these survey results is difficult because significant closed with-profits business is held by life assurers alongside other active business. This business is classified as in partial run-off and so included within the active market in these survey results. Nevertheless it does highlight the significance of with-profits business within the run-off sector.

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.

3 Change in size of the UK life run-off market

The number of life assurers in run-off has increased to 53 from 51 since 2004.

Table 2. Change in the UK life market

Policyholder liabilities (£ billion)	2001	2002	2003	2004	2005
Active market	804	717	769	837	980
Run-off market	75	107	124	135	136
Total UK life market	879	824	893	972	1,116

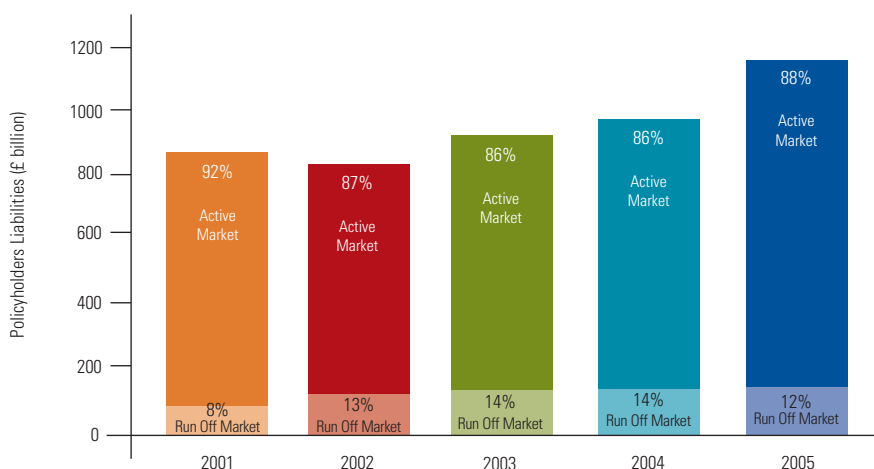
Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2006

Policyholder liabilities of the UK life run-off market increased from £135 billion to £136 billion in 2005. However, this understates the value of the UK life run-off market as it does not include £30.7 billion of policyholder liabilities that were transferred out of closed companies in 2005 and into other companies still writing new business. This £30.7 billion includes some £27 billion of policyholder liabilities from two life assurers that closed in 2005 that were transferred under a Zurich Group reorganisation to another active group company. It also includes over £3.7 billion of policyholder liabilities due under two annuity in-payment portfolios that were transferred out of the Resolution Group to other companies that still write new business.

This significant transfer activity coupled with an increase in the size of the active market has meant that although the UK life run-off market has increased in size, its share of the total policyholder liabilities of all UK life assurers has decreased from 14 percent to 12 percent, as identified in the graph below.

Although the UK life run-off market has increased in size, its share of total policyholder liabilities has decreased

Change in the size of the UK life market



Source: A.M. Best's Statement File - Life - UK, S & P Thesys - SynThesys Life, KPMG LLP (UK) 2006



This survey reaffirms that the UK life run-off market has grown significantly since 2001:

- The number of life assurers in run-off increased by a factor of nearly three between 2001 and 2005 (20 to 53)
- Policyholder liabilities of UK life assurers in run-off have increased by over £61 billion, or approximately 81 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 one percent increase in 2005
- As a proportion of the total life market, policyholder liabilities in run-off increased from 2001 to 2002 and have remained fairly constant over the last four years, although the true impact is not visible as increases are hidden within the partial run-off market.

Increases in prior years were substantially due to a number of large assurers moving into run-off following the adverse impact on their profitability and solvency of sustained low interest rates, the identification of mis-selling liabilities and stock market falls. Increases in 2005 have largely been the result of increases in the value of invested assets, although this has been offset by an increase in the level of transfer activity through which policyholder liabilities in closed life assurers have been transferred to active insurers as referred to on page 4.

4 Other features of the UK life run-off market

The UK life run-off market continued to successfully manage its expenses in 2005. Non-commission expenses of the UK life run-off market decreased by 20 percent to £849 million compared to a one percent increase in the total value of policyholder liabilities in run-off.

The remainder of the UK life market increased its non-commission expenses by five percent in 2005, while the value of policyholder liabilities increased by 17 percent. The improved cost savings by assurers in run-off has arisen through a number of factors including the increased efficiencies brought through market consolidations and the expense savings that have been achieved through outsourcing arrangements.

The widespread and increasing use of specialist outsourcing, where closed life assurers use outsourcing to control expenses and generate savings through scale efficiencies, is also likely to continue to be a contributor to expense savings in the run-off market.

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 (2005: run-off 19 percent, active 34 percent) and this proportion increased slightly for both run-off assurers and active companies in 2005 (2004: run-off 14 percent, active 30 percent). The increase from the previous year reflects the strength of the equity markets in general. However, the ability of assurers in run-off to participate in equity market increases remains limited by their more prudent equity investment strategy.
- The FSA has reported that the capital strength of large with-profits life assurers has improved overall. In addition, although the capital strength of life assurers in run-off has improved compared to 2004, it continues to be on average below that of active life assurers.
- Life assurers in run-off received over £3.2 billion of net premium in 2005. However, this is prior to the deduction of the £3.7 billion purchase of reinsurance by two closed assurers in the Resolution Group relating to the transfer of a substantial part of their pensions annuity business to active assurers. Comparisons with the prior year are difficult to make as the 2004 figures were also affected by the purchase of significant reinsurance by certain closed life assurers. Overall, the premium figures are still substantial, although individually most closed life assurers show a general downwards trend in net premium.

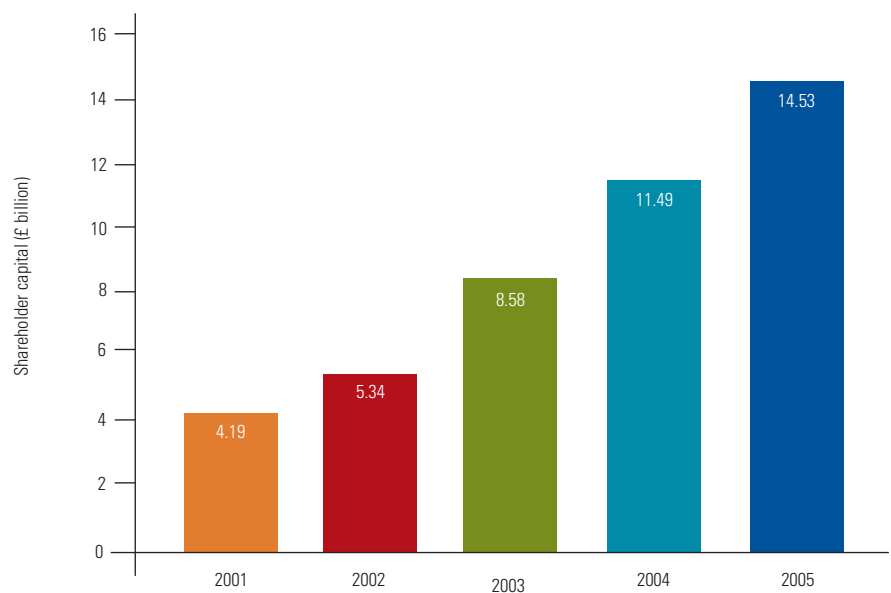
5 Capital tied up in run-off

Some £14.5 billion of capital was tied up in life run-off businesses in the UK by the end of 2005. This is a 27 percent increase over 2004 and significantly exceeds the one percent increase in policyholder liabilities in 2005. General increases in investments are likely to have contributed to this movement, although it has not been possible to identify the effects of regulatory or accounting changes.

Life assurers need to hold capital to meet their reported solvency requirements and this level may need to be increased in order to meet Individual Capital Assessments (ICAs) which are a firm's own calculation as to the realistic amount of capital they require. This may be increased by the FSA by the issuance of Individual Capital Guidance (ICG). Whilst the agreed ICA / ICG may increase the required capital, it is also possible that the ICA / ICG could be lower than the solvency capital already held. Further, if the firm is using a market consistent approach to calculating an embedded value, there may be little effect on shareholder funds as any additional capital will be discounted at the same market consistent rate and hence there may be little distortion.

Capital may be tied up in UK life run-off assurers for many years as it can take up to 25 years to run-off a closed book of business in the normal course. Therefore there are potentially high levels of capital that are tied up in closed life assurers and that may be unavailable for distribution to shareholders. The true level of corporate capital tied up in UK life run-off assurers is not known as ICAs are not made public but it is significant and it is shareholders who are primarily exposed to any risks.

Shareholder 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) 2006

6 Recent developments in the UK life run-off market

6.1 M&A activity

There has been further significant merger and acquisition activity within the UK life run-off market in the period to September 2006.

This activity reflects not only consolidation within the run-off sector as in previous years but also a development which has impacted both the run-off and active markets. The development involves the transfer of annuity business either from one insurer to another or from pension funds to insurers, both of which have shown substantial increases in the last year. In the former case, the transfers have often been from insurers in run-off, where the annuity in payment business does not fit in with the business model of the run-off insurer either because of its disproportionate size and/or its risk profile. Two of the larger transactions in this category are the transfer of annuity policies with a liability value of some £4.6 billion by Equitable Life to Canada Life and the transfer by Resolution Life of two annuity in payment portfolios with an aggregate liability value of some £3.7 billion to Canada Life and Prudential.



The transfer of pension fund liabilities relating to closed company defined benefit plans (often referred to as bulk annuity business) to assurers has increased dramatically over the last year as companies have sought to reduce their exposure or potential exposure to these plans, which has become more visible following the implementation of Financial Reporting Standard (FRS) 17. FRS 17 requires that any plan deficiencies are recognised on the company's balance sheet. This development has led to the emergence of a number of newly created specialist annuity insurers, including Paternoster and Synesis Life, to target this expanding market. In addition, a number of existing assurers have also recently entered or announced their intention to enter this market including Scottish Equitable (part of Aegon), AIG Life UK, Aviva, and Wesleyan. These companies will join Prudential and Legal & General who are the established market leaders. This growth in the bulk annuity business will not only increase the value of liabilities held by the insurance market overall but, to the extent that they are held by specialist annuity assurers, will increase the size of the run-off market.

Consolidation in the run-off market has continued and the large run-off consolidators argue that combining run-off businesses through consolidation provides scale and synergy efficiencies, diversification benefits and enables businesses to be managed in a focused and effective manner by life run-off specialists. The overall reduction in expenses indicates that economies of scale are being achieved. In addition, market consolidation provides sellers of insurers in run-off with an exit, often from non-core business, which can result in releases of capital that can be utilised more efficiently elsewhere.

Following the six significant M&A transactions reported in the *UK Run-Off Survey – Life Assurance September 2005*, significant M&A transactions in the past year include those shown in Table 3.

Table 3. Major M&A transactions in 2005 / 2006

Acquirer	Target	Acquisition value (£million)	Acquisition Method	Date
Canada Life	Resolution - annuity business	2,178	Part VII transfer	July 2005
Resolution	Allianz Cornhill	860	Part VII transfer	September 2005
Canada Life	Equitable Life - annuity business	4,600	Reinsurance / Part VII transfer	May 2006
Prudential	Resolution - annuity business	1,500	Part VII transfer	June 2006
Resolution	Abbey National plc's entire life business	3,600	Direct acquisition	September 2006

Source: KPMG LLP (UK), market analysis from June 2005 to September 2006

All of the UK life insurers in run-off remain contained within 18 groups

Although the number of insurers in run-off has increased by two to 53, all of the UK life insurers in run-off remain contained within 18 groups. This is due to the M&A activity discussed above. The increased concentration within the run-off market is further evidenced by the fact that the five largest run-off groups in 2005 contain just over £105 billion of policyholder liabilities, compared to just over £100 billion in the five largest run-off groups in 2004.

6.2 Group reorganisations

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

Table 4. Group reorganisations via Part VII transfers in 2005 / 2006

Group	Transferee	Liabilities transferred (£million)	Date
Swiss Re	Scottish Widows	295	December 2005
Resolution	Phoenix Life Limited	2,956	December 2005
Chesnara	Countrywide Assurance	832	June 2006

Source: KPMG LLP (UK), market analysis from June 2005 to September 2006

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

7 Conclusion

This survey shows that while the UK life run-off market grew in 2005, the pace of increase has slowed especially in comparison to the active market. The increase may, however, have been significantly larger had it not been for a number of large transactions in 2005 which had the effect of moving portfolios of business previously included in closed life assurers to active life assurers. The increase is otherwise substantially a reflection of the general increase in investment values which has impacted the market as a whole. In the period 2001 to 2005, liabilities in run-off increased from £75 billion to £136 billion, some 81 percent. In the same period, capital tied up increased by a much greater degree, nearly three and a half times from £4.2 billion to £14.5 billion. The bulk of this increase is due to the number of assurers entering run-off in this period, but a proportion also represents potentially higher returns to shareholders as a result of increased investment returns and cost efficiencies.

The surveys have shown that the activity of a few major consolidators has led to an increased degree of concentration and a greater number of acquisitions in the UK life run-off market. Despite this increased activity, there appears to be no reduction in the consolidators' desire to make further acquisitions, although the market consolidation means there are less opportunities. Future activity will most likely take place as Part VII transfers of run-off portfolios contained within otherwise active assurers.

Further changes are likely to be the result of rationalisation, transfers of specific portfolios or acquisitions of bulk annuity business

The UK life run-off market has continued to embed recent acquisitions and deal with day-to-day business challenges. Embedding acquisitions has and may continue to result in further disposals and reinsurance (or securitisation) of portfolios, such as annuity in payment business, that acquirers do not wish to retain. We noted last year that expenses had increased by 15 percent to £1.1 billion, broadly in line with the increase in policyholder liabilities. This year's survey shows a remarkable decrease in costs to £849 million, approximately 20 percent. A great deal of this may be attributable to economies of scale following consolidation and outsourcing to lower cost centres. 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 stabilised and is now experiencing progressive consolidation and this consolidation activity is likely to continue to concentrate the UK life run-off market. The large consolidators are now of sufficient scale to be major players within the UK insurance market as a whole with one consolidator already in the top 100 of UK companies measured by market valuation. Nevertheless major challenges still exist in managing a market with policyholder liabilities of over £136 billion and with capital tied up in long-term funds of over £14.5 billion.



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