



Discontinued Business Group

Crystal Ball for 2009

Traditional reinsurance buyers are likely to dominate the market going forward as recent interest from alternative finance sources – which pushed up prices to unprecedented levels – is likely to disappear.

The total size of the run-off market is now 25% smaller than it was three years ago. Service providers who don't have the ability to handle large volumes of business, or without a niche specialism, will be looking at partnering with other firms.

Reinsurers will ride again

If you go back five years, the primary acquirers of run-off portfolios were reinsurance companies such as Berkshire Hathaway and Swiss Re. Since then there has been stiff competition from newcomers to the market who have been attracted by the potentially high returns in an entirely new investment area.

The number of these potential buyers has been driving the prices up sharply. Enstar's recent acquisition of Unionamerica was struck at a price some 115 per cent over the net present value of the assets, leaving very little room for claims volatility.

In fact it could be argued that the space had become rather overpopulated, with sometimes more than 15 interested parties bidding for any one transaction. However, recent financial turmoil could result in the specialist acquisition vehicles, investment houses and hedge funds withdrawing from the sector – and finance all but disappearing. This may mean that the market redefines itself, leaving run-offs to be traded amongst the experienced specialists, and the more traditional reinsurance buyers.

Service providers seeking new partners

2008 saw Randall & Quilter Investment Holdings plc acquire the KMS Group and it is likely that a number of other outsource service providers will be acquired in the coming 12 months.

There are three primary drivers behind this trend. The first is that the big run-off accounts are steadily disappearing – the total size of the run-off market is now 25% smaller than it was at the end of 2005, requiring less manpower to service it – headcount employed has fallen from 2350 in 2006 to 2260 in 2007.

The second is the sheer number of providers in the sector and the fact that strategically they need either to be able to handle a large volume of business at competitive rates, or to be providing short term solutions to specific issues. Those who fall uncomfortably between the two will be looking for partners.

The third is that one of the key areas highlighted for growth in run-off is Europe. However, these (re)insurers are much more likely to want to keep their run-off with a local service provider – who is culturally sympathetic to their claims handling philosophy and employment issues.

Pressure on capital ratios is likely to see a drive among insurers to get legacy portfolios off their balance sheets – especially in Europe and increasingly in Asia which has large volumes of discontinued business.

Tougher economic conditions are likely to cause more litigation. Having paid top dollar for recent acquisitions, any slow down in the rate of reinsurance receivables could spell trouble for the future.

Further information

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Legacy running off to Asia

There is no doubt that the focus for business development in 2009 for the run-off sector is outside the UK – with Continental Europe seen as a prime target, but with opportunities existing as far afield as Asia.

All across Europe potential injections of capital brought about by the forthcoming Solvency II, combined with poorly performing investments, means that businesses can no longer ignore the impact on their balance sheets of legacy portfolios – management and directors will no longer be able to leave these issues in the back office. In particular Germany is seen to have the greatest potential in Continental Europe, where there is no doubt that mindsets are broadening and consideration is being given to potential solutions for legacy business.

Asia has large volumes of discontinued business which is currently being managed reactively, despite the fact that markets like Hong Kong do have the legislation in place to put proactive solutions in place. While the concept of making money from this business is largely alien in the big Asian markets, it is highly likely that the sheer potential combined with the onset of the credit crisis will hasten market development.

A red light for receivables

The process of managing run-off has often been likened to a manufacturing operation – doing the simple things well: collecting reinsurances, paying claims, monitoring assets, getting the accounting right and watching the cash. Recent pricing of mergers and acquisitions may not have left much room for error if any of these activities goes unexpectedly wrong.

In the recent past deals have ended up being expensive and have often been highly leveraged. If claims deteriorate and reinsurance receivables become harder to collect – often the case in a harder economic climate – then any drop in income could have quite a serious impact.

In addition, all insurers are now facing serious challenges managing the asset side of their balance sheet, with current volatility in the financial markets having an obvious impact on return on investment.

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