MILLIMAN WHITE PAPER

Insurance Business Transfers of Legacy UK Employers' Liability Policies

How the run-off market has enabled insurers to dispose of problematic long-tail liabilities

Christopher Clarke, FIA

On 13 June 2019, the UK High Court sanctioned the transfer of a large portfolio of predominantly UK Employers' Liability (EL) policies from RSA to an Enstar Group company. The sanctioning of this transfer is the latest example of a UK insurer disposing of its legacy EL liabilities via an insurance business transfer to a run-off specialist.

In this paper we consider the reasons why many insurers have sought exit solutions for their legacy EL liabilities and the approaches taken by the insurers of each of the five largest such portfolios.

Legacy EL Difficulties

EL policies have given rise to a number of very long-tailed liabilities, in particular claims from employees that have developed diseases following workplace exposure to asbestos. Asbestos-related diseases, including mesothelioma (an incurable cancer of the lining of internal organs, typically the lungs), normally only emerge many years after exposure. Insurers have already been dealing with asbestos-related compensation claims (which often run into six figures) for decades. Although the peak of claims may have already passed, due to the long latency period of the underlying diseases, insurers can expect to continue to be paying claims for years to come, perhaps for another 30 years or more.

In recent years, EL insurers have also seen very large volumes of noise-induced hearing loss claims. A spike in such claims over the last several years has been driven by the activities of claims management companies and claimant solicitors. Although these claims are usually of relatively low value, and many are ultimately repudiated, they are costly to handle and are a distraction from insurers' current business.

These types of claims are covered by policies that were in force at the time the exposure took place. This means that, in the case of asbestos claims, the claims are often covered by EL policies that were issued many years ago, often between the 1950s and 1980s.

Insurers with these sorts of legacy exposures often need to hold significant reserves to cover the expected future cost of settling the claims, on top of which they can also give rise to a significant capital charge, reflecting the considerable uncertainties in the ultimate run-off of the liabilities. Managing the run-off of legacy liabilities can be costly and a distraction for management, who want to focus on the ongoing business of the company, rather than on claims relating to policies that were written years ago, perhaps before many of their staff were even born!

Seeking an Exit from Legacy EL Exposures

Faced with such difficulties, it is quite understandable that many life insurers have sought an exit strategy from their legacy EL liabilities. One possible solution is a loss portfolio transfer (LPT), or reinsurance of the liabilities to a third party. This would likely remove a lot of the economic uncertainty from an insurer's balance sheet, but it does not achieve true finality in that the insurer remains on risk and, should the reinsurance prove inadequate or the reinsurer fail, the liabilities will revert to the insurer. To achieve true finality, a legal transfer of the underlying policies to a third party insurer is often the only option.

In the UK, a legal transfer of insurance business can be achieved via a court-sanctioned process known as a Part VII transfer (referring to Part VII of the Financial Services and Markets Act 2000 (FSMA), the legislation providing for such transfers). Similar legislation exists in Ireland, and insurance business transfers are also provided for by legislation in many other European countries, although elsewhere in Europe the process typically only requires the approval of the regulator, rather than a court.

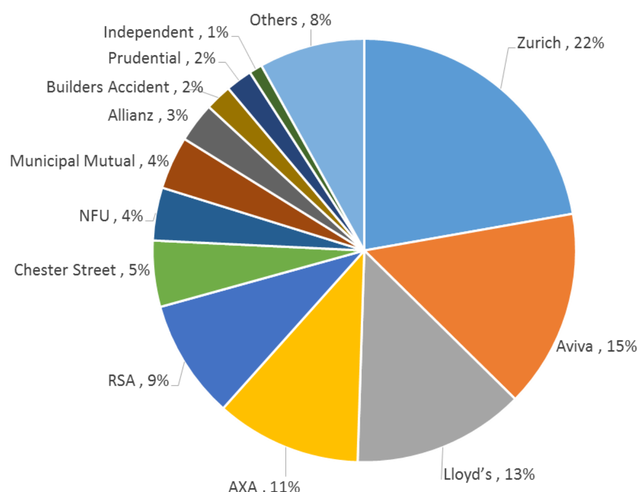
In recent years, a number of the major players in the EL market have sought exit solutions, with insurance business transfers being used in a number of cases.

The Major Historical EL Insurers

As noted above, legacy EL claims often emerge on policies written many years ago. The EL insurance market has changed greatly over the past 50 years or so, with many of the participants now being part of other insurance groups as a result of mergers and acquisitions, and some historical insurers have since become insolvent. Figure 1 shows the approximate make-up of the EL insurance market during the 1980s (using the

current insurer name), based on figures compiled by an Institute and Faculty of Actuaries working party.[1] Although figures relating to earlier periods are not readily available, it is thought that this provides a good indication of the major insurers with legacy EL exposures (prior to transfer to a third party).

FIGURE 1: EL MARKET PARTICIPANTS IN THE 1980s



The five largest participants, between them making up around 70% of the market, were Zurich, Aviva, Lloyd's, AXA and RSA. Each of these insurers has now either disposed of its legacy EL liabilities, or has put in place a LPT. Four have transferred, or are seeking to transfer, their liabilities via an insurance business transfer. We discuss each of these below.

Exit Strategies Taken

LLOYD'S

The legacy EL policies written by Lloyd's of London were the first of the large EL portfolios to be subject to an insurance business transfer, although these were a relatively small part of a much larger set of transferred liabilities.

The 1992 and prior years' non-life liabilities of underwriters (known as Names) at Lloyd's of London were reinsured into Equitas in 1996. Equitas was established by Lloyd's as part of a project, known as Reconstruction and Renewal, which was intended to draw a line under huge prior year losses (driven in large part by asbestos-related claims) and to allow the market to restructure and focus on the future.

In 2006, Equitas entered into an agreement with National Indemnity Company (NICO), a member of the Berkshire Hathaway group of companies. The deal comprised an initial LPT of Equitas's liabilities into NICO, followed by a Part VII transfer of Equitas's policies into a new company in the Equitas group, at which time the limit under the LPT would be increased. The transfer was ultimately sanctioned by the UK High Court in June 2009, and, thus, gave legal finality to the Names. This followed a 2008 amendment to FSMA, which had, up until then, prevented former Names (who resigned before 24 December 1996) from transferring insurance business.

It should be noted that, while asbestos-related claims had been a major cause of the issues at Lloyd's that led to the formation of Equitas, these claims principally originated in the USA. In its report and accounts as at 31 December 2018, Equitas reported gross provisions for UK third party liability claims (likely to be predominantly EL) of £624 million. While a very significant portfolio, it is far smaller than Equitas's £3.6 billion of provisions held in respect of US exposures.

AVIVA

It was reported in 2015[2] that Aviva had entered into a LPT with Swiss Re in respect of its UK EL book. Although full details of the transaction have not been made public, it has been reported that Aviva ceded around £700 million of liabilities to Swiss Re, out of total gross UK EL liabilities amounting to around £1 billion.

It was reported[3] that Aviva (whose EL liabilities relate to a slew of predecessor companies that include Norwich Union, Commercial Union and General Accident) had considered a Part VII transfer. However, it ultimately concluded that, as a composite insurer with a large life insurance arm, latent liabilities sat better on its balance sheet, diversifying well with its existing life liabilities, than they would on the balance sheet of a run-off entity. If a transfer had taken place, it is likely that Aviva would have had to fund the extra capital costs a run-off company would incur from holding these liabilities on its balance sheet.

AXA

In April 2017, it was announced that AXA would seek to transfer those of its UK EL and public liability policies that were issued prior to 2002 to RiverStone (a Fairfax group company), and that a LPT would be put in place with RiverStone in respect of disease claims relating to policies issued between 2002 and 2014.[4] Reserves in respect of all of these policies were reported to amount to approximately £600 million.

Many of the policies subject to these transactions stem from AXA's acquisitions of Guardian Royal Exchange in 1999 and Provincial Insurance in 1996.

The Part VII transfer of the pre-2002 policies was sanctioned in September 2018. This was the first of the three major EL-focused portfolios that have now been, or are soon expected to be, transferred by means of an insurance business transfer.

[1] https://www.actuaries.org.uk/documents/uk-asbestos-definitive-guide

[2] https://www.insuranceinsider.com/articles/94597/swiss-re-swoops-on-1bn-aviva-book

[3] http://myinsurancecloud.com/contribution/54579/

[4] https://www.axa.co.uk/newsroom/media-releases/2017/axa-insurance-begins-transfer-historical-liability-book-riverstone/

RSA

Royal and Sun Alliance (RSA) announced in February 2017 that it has reached an agreement to transfer £957 million of legacy liabilities to Enstar.[5] Around 75% of the liabilities were noted as relating to asbestos, the bulk of which being in respect of UK EL policies. The rest of the portfolio mainly comprised abuse, deafness, marine and aviation liabilities.

A LPT was initially effected with a Bermuda-based subsidiary of Enstar. Ultimately, a Part VII transfer, which was sanctioned in June 2019, transferred the policies to Mercantile Indemnity Company, a UK-based subsidiary of Enstar, with 75% of the portfolio continuing to be reinsured into the Bermudian company.

ZURICH

In December 2018, it was announced that Zurich had entered into an agreement with Catalina, under which it would transfer to Catalina circa $2 billion of UK EL liabilities, relating to policy years 2006 and prior.[6] The structure of the agreement had many similarities to that of RSA's deal with Enstar: an initial LPT into a Bermudian reinsurance subsidiary of Catalina, followed by a legal transfer of the liabilities from Zurich to a UK-based Catalina subsidiary.

Zurich's legacy EL exposures relate principally to business written by predecessor companies including Eagle Star and Midland that have been subsumed into Zurich's principal European operating entity domiciled in Ireland. Zurich is therefore currently pursuing a legal transfer under Irish legislation.

OTHERS

Other smaller portfolios of legacy EL business have also recently been disposed of. Examples include:

- In July 2016, it was reported that QBE had reinsured a legacy UK EL portfolio with reserves of £170 million into Armour.[7]
- In October 2016, Allianz completed the sale of subsidiary AGF to Catalina. AGF, which wrote predominantly direct employers' and public liability insurance in the UK, went into run-off in 1999. It had reserves of £185 million.[8]
- In December 2018, Generali received approval from the Italian regulator for the transfer of a portfolio of legacy business (including material UK EL liabilities) from its UK branch to Compre.[9] At the time that the deal was initially announced, the reserves for the portfolio were stated to be approximately €300 million, to date the largest portfolio acquired by Compre.[10]

Insurance Business Transfers and Issues Seen on EL Transfers

As we have seen, a number of the large portfolios of EL policies have been transferred using insurance business transfer mechanisms, in particular the Part VII legislation in the UK. Carrying out a Part VII transfer can be a costly and lengthy process, typically taking 12 months or more.

The Part VII process normally starts by consulting with the financial regulators (the PRA and FCA) and informing them of the intention to carry out a transfer. The firm(s) proposing the transfer will then need to appoint an independent expert who will prepare a report to the Court, giving their opinion on the likely effects of the transfer on various stakeholders. The report is presented to the High Court at an initial hearing, at which it will approve a policy for communicating with policyholders and other affected parties about the proposed transfer. Following the communication period, a final court hearing is held, for which the independent expert will prepare an additional report covering any issues emerging from the communication period and any other material changes since the time of writing the initial report. The regulators will also prepare reports to the Court stating whether they have any objections to the proposed transfer. Any interested parties may make representations at, or prior to, the hearing. Based on the information presented, the judge will decide whether or not to sanction the transfer.

The key factor in determining whether or not a transfer should proceed is whether any group of affected policyholders would be materially adversely affected by the transfer. This relates to both changes in financial security resulting from the transfer and to changes in policy servicing.

In the context of EL policies, the ultimate beneficiaries of the policies are the current and future claimants, rather than the policyholders themselves (sometimes long defunct enterprises). However, in its recently published guidance on Part VII transfers, the FCA stated that it takes a liberal interpretation of the term 'policyholder' and expects independent experts to do likewise. The interests of these claimants, both in terms of the security of the transferee firm and its ability to pay future claims, and in its ability to handle claims efficiently, have therefore come to the fore in recent transfers.

[5] https://www.rsagroup.com/news/press-releases/2017/rsa-announces-disposal-of-uk-legacy-liabilities/

[6] https://www.zurich.com/en/media/news-releases/2018/2018-1217-01

[7] https://www.insuranceinsider.com/articles/97372/armour-takes-on-170mn-qbe-uk-el-book

[8] https://www.insurancejournal.com/news/international/2016/10/11/428996.htm

[9] http://compre-group.com/press/compre-receives-regulatory-approval-for-generali-legacy-transaction/

[10] https://www.generali.com/media/press-releases/all/2017/Generali-agrees-to-sell-Non-Life-run-off-portfolio-of-its-UK-branch

Handling large volumes of EL claims requires specialist skills as well as bespoke claims administration systems to deal with the nuances of EL claims. In recent EL transfers, claims handling staff have often also moved to the transferee, not least because the transferee does not have sufficient claims handling staff or expertise of its own. The transferee firms have also often needed to implement new IT platforms, if their existing platforms do not have the capacity or functionality to absorb the transferring business and the transferors' platforms cannot readily be migrated. Implementing new IT platforms is not straightforward and there have been cases where claims handling and administration have been outsourced back to the transferor for a period of time following the transfer until such time as the transferee can guarantee continuity of service.

An interesting feature of the RSA and Zurich transfers is that both involve Bermuda-based reinsurers supporting a UK-based transferee. As Bermuda-based groups, for reasons of capital efficiency, it might have suited Enstar and Catalina better had the business transfers been into Bermuda-based entities; however, the Part VII (and Irish equivalent) legislation does not allow for transfers of business outside of the EEA. The structure adopted in the RSA transfer has a quota share cession of 75% from the transferee to the Bermudian reinsurer, leaving a material portion of the risk with the UK-based transferee entity. It is important to note that structures with very high cessions that leave the transferee as little more than a fronting insurer are unlikely to find favour with the regulators.

It is also worth noting that on 16 August 2019 the High Court declined to sanction a proposed transfer of annuity business from Prudential Assurance to Rothesay Life. In his judgement following the hearing, the judge noted that policyholders chose Prudential based on its age, reputation and financial strength, and, given the descriptions in documentation provided to them, the policyholders could have reasonably assumed that Prudential would not transfer their policies to another provider. The implications of this judgement (if upheld on appeal) are still uncertain, and may not relate directly to transfers of non-life business (particularly those involving only commercial lines policies), but, nevertheless, may need considering before embarking on future transfers.

Conclusion

The experience with UK EL business is evidence of both the usefulness of insurance business transfers as a tool for insurers looking to dispose of problematic legacy business, and of an active run-off market with the appetite to take on uncertain long-tail risks. It is notable that each of the five major EL portfolios was transferred to, or reinsured by, a different group, and all of the major players in the run-off market have taken on UK EL portfolios in recent years.

While the largest EL portfolios have now been subject to a LPT or insurance business transfer, further smaller portfolios may well continue to be brought to market.

How Milliman Can Help

Milliman is a leading provider of independent experts for Part VII transfers, its consultants having been the independent expert for more completed transfers over the last four years than any other actuarial firm. Milliman's experience includes fulfilling the role of independent expert in the recently sanctioned transfer of business from RSA to Enstar.

Milliman has extensive experience with EL business and, in particular, with asbestos and other latent claims, gained both through work on insurance business transfers and on numerous reserving assignments. Milliman has also assisted companies on the sale and acquisition of businesses with asbestos and other latent liabilities.

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

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CONTACT

Christopher Clarke
christopher.clarke@milliman.com

Derek Newton
derek.newton@milliman.com

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