Desperately seeking solutions

As old estates wind down, competition is hotting up in the service provider arena, especially in London. Consequently, companies are diversifying, developing new services and targeting new markets.

John Sanders **reports**

As 2005 drew to a close, it lacked the hallmarks of an outstanding year for run-off service providers. Fierce competition and a shortage of traditional business have squeezed margins, the BAIC scheme ruling took many by surprise and a change in VAT threatens business models in the UK.

Nonetheless, some view 2005 as a time of positive change. Potentially significant new players – Quest, Citadel and Global Re – launched in the UK, the US and Germany respectively (see box). And the US was battered by the most active hurricane season on record; misery for millions along the Gulf Coast, but a possible ▷

New entrants in 2005

Citadel Risk Management, USA

Founders formerly with CNA's Global Resource Managers.

Started August 2005 with offices in Connecticut, New Jersey and Pennsylvania.

www.citadelriskmanagement.com

Global Re, Germany

Set up by Global Re Group (formerly Gerling)

Started September 2005, based in Cologne, with access to 350 staff and worldwide office network.

www.globalre.com

Quest Group, UK

Founding directors from Chiltington International and Ernst & Young

Started August 2005 with 16 people and $1 billion dollars of liabilities under management.

www.quest-group.co.uk

silver lining for a run-off market eager for business.

Continental Europe, widely regarded as lagging behind London in its approach to run-off, has seen interesting developments too. Apart from Global Re's arrival, Germany is hosting its first major run off event – the Cologne Commutations Rendez Vous. France meanwhile has formed its own run-off association, SEGS, and former PartnerRe executive Jean-Marie Nessi is set to start up a reinsurance run-off company.

Sean McDermott, Quest: The future lies in buying run-off as well as offering outsourced services

So, while some talk of a lack of work in the super-competitive London market, others are optimistic about prospects, especially those willing to adapt. These multi-dimensional companies, including Omni Whittington and PRO, are moving away from the model of relying on commutations and claims adjustments to take advantage of new opportunities.

Mike Walker, partner at KPMG in the UK, says this trend has been particularly noticeable since mid 2004, adding that service providers in this category 'can perform services ranging from buying and running a company to buying debt as well as providing the traditional, more routine services.'

And for those setting up new businesses in this mould, Quest director Sean McDermott believes conditions are promising. 'Times like these when you've had Hurricane Katrina and Rita are times of big change when a lot of opportunities will emerge. So, I expect the next 12 months to be quite interesting.'

Art Coleman, president of US start-up Citadel Risk Management, agrees that new opportunities are constantly emerging for service providers willing to clear up the industry's past mistakes. 'Underwriters keep on writing the same kind of risk. So every cycle ends up generating its own new huge thing that we can generate revenue from.'

New beginnings

Interestingly, the three big new players all have their roots in existing run-off operations. The principals behind Quest hail from Chiltington and Ernst & Young, while Citadel sprang out of CNA in the US and Global Re's service unit is built on the run-off of Gerling Global Reinsurance.

Quest is a company which believes the future lies in buying run-off as well as offering outsourced services. Between them, its founding directors combine the skills needed for M&A transactions, restructuring, insolvency, operational management, run-off management and the associated consulting skills.

As McDermott says: 'Increasingly people are looking to sell run-off or to pursue finality solutions which are much broader than just outsourcing.' He acknowledges that several service providers have already converted to this model, but believes that Quest has an advantage by being able to provide transaction and restructuring skills as well as run-off experience.

Although the number of deals so far is small, he is confident that it will grow. Because of regulatory and business pressures, insurers are looking at removing a broad range of liabilities from their balance sheets, not just old long tail liabilities as in the past. The main reasons for the limited transaction activity to date are complexity and 'the difficulty in finding purchasers who have an understanding of these complexities and vendors who are prepared to commit the time that is involved,' he says.

In the meantime, Quest is working on three multi-year outsource contracts and several small projects, although director Graham Combes emphasises that it does not intend to grow dramatically into a full service back office third party service provider. 'That is not what we're about. Our model is to move towards acquiring portfolios, to accelerate those portfolios to finality and along the way do some third party work as well.'

In the US, Citadel has a broadly similar philosophy. 'We had an opportunity with a potential run-off client to set ourselves up to provide services to the external market, which is what we wanted to focus on for a number of years,' explains Coleman. Like Quest, it does not plan to compete with traditional service providers. 'My ultimate goal is to find situations where we can purchase the liability,' he says, adding that his preferred route is to work with a company, understand the book, then possibly acquire the liabilities and run them off.

Unlike many companies, Citadel is interested in life and accident &

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Graham Coombes, Quest Group

health insurers, not just Property and casualty. 'If you look at the new wave of run-off, it's not the P&C companies who are going into run-off. The majority of them have already done that,' observes Coleman. Accordingly, Citadel's first client, which he prefers not to name, was an accident and health insurer.

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Art Coleman, Citadel Risk Management

Despite the challenges posed by different state regulatory systems and the fragmented US market, Coleman expects others to follow his example and branch out on their own. 'There's a lot of talent in the market place and there could be more opportunities where people say the time is right for me to set up.'

Back in Europe, Global Re's new service provider concept follows in the steps of several in the UK and the US which grew out of businesses in run-off. As such, Global Re probably has the potential to become the largest service provider in Germany, where Chiltington is the only well established player, although CMGL and others have a presence.

Certainly, Global Re believes it can build a thriving business in continental Europe, especially in countries where it has offices. Its key advantages, says director Thomas Willkowei, are experienced staff, proximity to continental European markets and – crucially – a greater cultural affinity with continental attitudes than London market competitors.

Diversification

Elsewhere, existing players too are responding to evolving market conditions and reducing their reliance on the declining volume of traditional outsourced run-off processing. As a result, companies are going into different areas, whether expanding geographically, by product lines or migrating to other businesses.

PRO for example has moved towards providing solutions. 'We see our skills in taking books of business, helping to devise a strategy for an appropriate exit and preparing the company for that process,' says CEO Lee Brandon. That often means a sale or solvent scheme. PRO – because it is owned by Swiss Re – will not become a principal itself, but instead works with partners who can buy run-off portfolios or businesses.

PRO is also looking outside the UK and during 2005 acquired several books of international business from continental Europe, where Brandon, whose responsibilities include associated companies in Spain and Italy, sees more opportunities emerging over time. 'There is still an institutional problem about really actively managing run-off business on the Continent. It is changing, but it is a slow process. In some markets, run-off is still closely associated with the stigma of insolvency.'

Like others such as Axiom and CMGL, PRO also provides support services to live insurers. 'The skills we've honed in the run-off market, such as asset collection, commutations and inspections, are now in demand in the live market,' says Brandon, adding that he expects more service providers to follow this example.

CMGL too is positive about the future following a change in ownership from Zurich to Sovereign Capital. Under Sovereign, managing director Jerry McArthur says its core competencies will remain the provision of claims and insurance management services, but the company will have more scope for growth.

Firstly, being outside the Zurich Group removes potential conflicts of interest. Secondly, Sovereign has pledged to invest in CMGL, primarily by buying other service companies in London and continental Europe. However, in contrast to newcomers Quest and Citadel, McArthur adds that: 'buying risk portfolios is not really our core market.'

He also denies that CMGL's strategy represents market consolidation, emphasising that acquisitions will be limited to small, specialist operations to extend existing services. The six offices in continental Europe therefore have a remit to look for 'any compatible competitors which would help us to accelerate our growth.'

Like PRO, CMGL too is developing its non run-off operations, which account for around 35 per cent of fee income, mainly from claims handling for FTSE companies. 'Companies that can develop their services beyond the London market are the ones which will be around in the longer term. And that is what we are doing,' says McArthur.

Jerry McArthur, CMGL: change of ownership gives more scope for growth

For some companies, such as the LCL Group, acquisition by a larger player with capital muscle and international geographic presence can give a boost to their service offering. LCL's announcement in November 2005 that it was being acquired by Charles Taylor Consulting plc (CTC) represents, according to group ▷

director Philip Holden, the chance to expand its business globally through both extended service provision as well as acquisition: 'It provides us with global access to a comprehensive range of technical support and

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Lee Brandon, PRO

expertise within CTC and additionally provides access to capital markets for our future growth and acquisition strategy.'

European perspective

Both PRO and CMGL have recruited managers – from competitors and the broader insurance market – to support their expansion. As part of its strategy to raise standards and demonstrate professionalism to regulators, CMGL has appointed Cees Schrauwers, former managing director of Aviva International and CGU UK, as chairman. The appointment of a Dutch national also underlines CMGL's commitment to continental Europe.

However, McArthur argues that it is still important within Europe to highlight the benefits of outsourcing run-off. Like Brandon, he talks of a cultural block in France and Germany where insurers remain reluctant to outsource and 'therefore declare that they do not have run-off issues on their balance sheet.'

Philip Holden, LCL: Looking forward to increased global access

KPMG's Walker is more optimistic, claiming that continental European companies are gradually beginning to recognise that they may have run off issues, that 'it's not always best to manage it in-house and that there is a body of expertise that could help them make their run-off more efficient.'

Nonetheless, Graham Tomaszko of Turnstone (and chairman of the Association of Insurance and Reinsurance Service Providers), says that many European insurers are slow to use London. 'When we go to Hanover and Munich and see the size of these companies compared with how much work they farm out to us, it is minuscule.'

US horizons

Consequently, several UK service providers see better prospects in the US. Tomaszko, for instance, saw more potential in attending the AIRROC meeting in New Jersey, than the Cologne Rendez Vous: 'We don't get enough US people into London. So going over there offers us an opportunity to speak to the Americans.'

That will please Coleman, one of the organisers of AIRROC, where solvent schemes as well as commutations were on the agenda. However, he is aware of the difficulties facing domestic and overseas service providers in the US. 'The US insurance market hasn't had the development to bring it together to take advantage of the types of services that could make things easier for us.' He is, though, confident that change will happen simply because of the billions of dollars tied up in run-off.

Walker agrees that the US service provider industry is much less well developed than in the UK. Although this presents opportunities, he suggests that progress toward the UK model of service provider may be ▷

hampered by the different state regulatory regimes.

Innovation is certainly on the agenda in the US, including ideas such as pooling resources Equitas style to handle large scale run-off. However, it is anybody's guess if and when these concepts will come to fruition. Coleman for one is sceptical about getting the level of co-operation necessary to make the Equitas concept fly.

Citadel, his own company, is proposing stop loss reinsurance to bridge the gap between companies seeking to commute, but bogged down in IBNR disputes. 'Each side would put in a portion of the premium for the stop loss,' explains Coleman. 'Basically we would take the liabilities away from the two companies, allowing them to conclude their business, yet give the ceding company a new reinsurer to cover the difference.'

Coleman also has a word of advice for UK service providers looking to set up shop in the US. Waiting for the phone to ring with a request to submit a tender won't get them far, he says. In the US the emphasis is on

Thomas Willkowei, Global Re: a start-up service provider drawing on the expertise gained from Global's own run-off

knocking on doors and identifying portfolios: 'It's a totally different marketing approach.'

PRO, however, appears to be faring better than some in the US. Brandon says the company is 'getting increased demand for our services in the US and we are increasing our activities there.' Much of the $2.5 billion London market business it manages originated in the US and PRO regularly has people in the US where it offers a wide range of services.

Debt and consolidation

Like Citadel, PRO is developing new products. One Brandon highlights is its ability to purchase insurance debt. Again, this fits in with the trend towards service providers taking away and solving a problem rather than just managing it.

Walker too believes that debt purchase is a growth area, with people buying companies' difficult to collect reinsurance programmes and 'also looking at buying the liabilities of insolvent insurance companies to try to make a book on the ultimate payment percentage.'

The appetite for debt is a sign, Walker adds, of the amount of capital available in the market, which may also indicate that conditions are theoretically in place for consolidation. However, many continue to question the rationale of the big players merging, arguing that this may simply bring more processing capacity under one roof.

Instead, they talk in terms of focusing on or moving into higher value added services or niche markets. That is certainly the path that PRO intends to follow, but Brandon believes others may not be so fortunate and could succumb to consolidation. 'If you have a shrinking market place, not everyone will be in the same position. I think some entities are going to struggle, or are struggling. But just merging with a competitor is not of particular interest to us.'

Among the smaller players, Turnstone has recently signed a co-operation agreement with ISG, but Tomaszko denies that this is conventional consolidation. 'We're looking to consolidate resources, not companies. When something needs to be done we have access to the resource that we don't have and they have access to expertise we give them.'

Tax and schemes

Looking at developments which caused a stir during 2005, two spring to mind – VAT and BAIC. The industry is fighting plans to extend VAT (Value Added Tax) in the UK to run-off service providers, but the out-

Lee Brandon, PRO: moving into the insurance debt purchase market

come may not be clear for some time. If the tax change goes ahead, Walker cautions that traditional outsourcing could be affected, but on the other hand, the outright sale of businesses or portfolios in run-off may become more attractive.

Brandon is more sanguine, pointing out that few companies base outsourcing decisions on cost alone. 'They outsource because they want to achieve a strategic objective. So it may have an impact, but I'm not sure it will be a huge impact.'

McArthur shares the view that VAT will put pressure on outsource companies to become more efficient, but says it will not worry CMGL which already charges VAT to its corporate customers. In other areas of its business, he believes that 'companies the size of ours and others in the market have the ability to build in the efficiencies required to neutralise the VAT impact.'

Similarly, the rejection of the BAIC scheme of arrangement in July has not caused the upset initially feared, as UK courts have since sanctioned other schemes. McDermott argues that if anything the BAIC ruling will create more work for specialist scheme advisors, be it lawyers, accounting firms or service providers such as Quest, as BAIC demonstrated that schemes are not as easy to implement as some thought and need to be thoroughly and professionally prepared.

'Until BAIC there was an emerging feeling that almost all solvent schemes were a sausage factory type solution. Companies were saying why outsource or sell a portfolio, why not just do the scheme in-house? Well, BAIC has changed that.' McDermott also notes that the schemes implemented so far have tended to be small or the more straightforward ones, strengthening his argument that opportunities will increase as companies attempt to deal with their more complex run-off problems.

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>
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Evolving solutions

One area which has been a disappointment for service providers is the Lloyd's market. Initial hopes of a steady flow of work – especially after Lloyd's set up a panel of approved suppliers – have vanished. Brandon is not alone when he says of Lloyd's: 'there is a dearth of the actual pure run-off management at the moment.'

However, the Lloyd's situation simply mirrors that elsewhere and underlines the fact that service providers will have to continue to think laterally if they are to maintain business volumes, especially as old insolvent estates, such as KWELM, gradually close down. 'How they replace that will be a significant challenge for them over the next few years,' says Walker.

Fortunately for those employed by service providers, most are already taking steps to adapt to the changing environment, meet the challenges and prepare for the new opportunities they see ahead. As Brandon points out: 'The London market for run-off has matured and has an increasing range of products. As the solutions continue to evolve, I think more business, which is in-house at the moment, will gradually be outsourced. But it will be outsourced to obtain a solution, rather than just to be managed.' ●