Schemes of **arrangement**

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a special supplement to

runoff business

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comment

There are fundamental changes in objectives when a company enters run-off, whether solvent or insolvent. In the confusion that regularly occurs during this transition, it is all too easy to lose sight of these changes, and for the company to carry on as before. The resulting misuse of company resources, loss of significant personnel, and diminishing morale can jeopardise the long term chances of achieving a favourable run-off. The challenge for companies entering run-off is to implement these significant changes as rapidly and painlessly as possible.

Given that most finality solutions for insolvent companies ultimately involve a scheme of arrangement, and that an increasing number of solvent run-offs are also looking towards solvent schemes of arrangement as a means of achieving finality, it is clearly important for the culture change accompanying a decision to allow the run-off to get to a position where a scheme is feasible within the shortest possible timeframe.

One of the main ideas to get over, to both management and staff, is that being in run-off isn't that bad. Providing new objectives are embraced on day one, enormous value can be provided to creditors in relation to an insolvent estate and to shareholders in relation to solvent run-offs. Not least among the advantages to shareholders is the release of capital that can accompany a successful finality solution such as a solvent scheme.

Neil Bruce, PwC

contents

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Gary Bray and Baljit Goraya explain what exactly s425 schemes are and how they are evolving in the solvent and insolvent markets

What is a scheme?

For a number of years now, schemes of arrangement (schemes) have been used extensively when dealing with the unique issues arising in connection with insolvent insurance or reinsurance companies. The emergence of schemes as the primary tool of insolvency practitioners in the insurance industry reflects their distinctive features and inherent flexibility, which have enabled the run-off of insolvent insurance businesses to be specifically tailored to the precise circumstances of each case. In particular, schemes are usually more beneficial to creditors compared to other insolvency procedures such as liquidation or company voluntary arrangements, typically resulting in earlier payments to creditors than might otherwise be the case.

In recent years, there have been an increasing number of solvent insurance and reinsurance companies entering run-off, or placing specific books of business into run-off, both in the UK and overseas. This trend has been accelerated by increasing commercial pressures arising from adverse claims development, poor investment returns and increased operating costs — particularly for long tail business — and the increasing need to focus on the optimum use of scarce capital. This is a combination of circumstances and pressures that seems set to remain a feature of the landscape for the foreseeable future.

In these conditions, solvent insurance companies have increasingly used schemes as a mechanism for effecting planned exits from the market or from specific sectors of it, enabling capital to be released and redeployed in pursuit of key, or at least more pressing, strategic objectives. Schemes have continuously evolved and been adapted to address the inevitable peculiarities and specific challenges or issues of each particular situation. This has frequently underlined the basic flexibility of schemes and their applicability in varied circumstances, as is demonstrated by the number and diversity of schemes that have been implemented in recent years (see pages 14 – 19 and 26).

What is a scheme of arrangement?
A scheme is a compromise or arrangement under English law (section 425 of the Companies Act, 1985) between a company and its creditors or any class of them, which becomes legally binding on all creditors or any class of them if the necessary majority of creditors or class of them vote in favour of the scheme and the English High Court approves it. In practical terms, a scheme is effectively a 'deal' between a company and its creditors. It is similar, in many respects, to a plan of reorganisation in the US.

There are few statutory requirements for a scheme and generally it can be written on any basis that will attract adequate support from policyholders and other creditors, providing great flexibility for insolvency practitioners, shareholders and directors seeking to devise and implement an exit strategy which is fair and commercially acceptable to all stakeholders involved.

Naturally, there are many parties with a legitimate interest in the terms of any scheme. Such stakeholders include shareholders, policyholders, service providers, employees, reinsurers and regulators – the flexibility of schemes allows a 'deal' to be formulated that strikes an acceptable balance between the needs of each. Accordingly, each stakeholder must be carefully considered and, where appropriate, consulted during the promotion and implementation of a scheme to ensure that all perspectives are considered and all parties satisfied with the final outcome (see page 12).

Schemes designed for insolvent insurance companies fall broadly into two types: those which carry out an orderly run-off, paying a proportion of claims as they are agreed ('run-off' schemes) and those which introduce a wholesale estimation of all present and future claims (effectively a 'mass commutation' with all policyholders) with a view to making a final payment to creditors and terminating the run-off ('estimation', 'crystallisation' or 'cut-off' schemes).

Schemes for solvent insurance companies obviously fall into the latter category and such wholesale estimation of claims is, in practice, implemented either on a claims submission or claims allocation basis. Under the latter approach, policyholders are provided with a value for their claims based on an actuarially determined estimation methodology. In contrast, under a claims submission approach creditors are invited to submit claims (including contingent or future claims), together with supporting evidence, which are agreed, possibly within a stated actuarial framework and possibly with the involvement, if agreement cannot be reached in the normal course, of an independent adjudicator.

In this way, schemes can provide a framework for an insurance company in run-off to accelerate the agreement and settlement of policyholders' and other creditors' claims and, ultimately, to achieve finality, the holy grail of run-off.

'The flexibility of schemes allows a 'deal' to be formulated that strikes an acceptable balance between the needs of each stakeholder'

What are the benefits of a scheme?
Although there are a number of alternative strategies available to an insurance company seeking to exit a market (see page nine), these do not necessarily provide the benefits afforded by schemes, the main advantages of which are typically:

- *Finality.* Any doubt a policyholder or creditor may have with regard to the solvency of a company, and whether its insurance protection will perform, can be removed by a scheme. Similarly, schemes can provide reinsurers with a means of achieving certainty and finality.
- *Flexibility.* A scheme can be designed to deal with the specific circumstances of each case and the particular needs of the stakeholders.
- *Early payment.* A scheme will provide a mechanism for estimating and agreeing all present and future claims against a company allowing creditors to receive payment earlier than would be likely if the company were to run-off its business in the normal course.
- *Run-off costs.* Some of the costs of the run-off, which may otherwise be incurred in the normal course for many years, and which can therefore be significant, can be avoided by a scheme. This saving can in turn provide financial benefits to stakeholders. ▷

● *Shareholder equity.* Residual shareholder value, if any, can be realised at the earliest opportunity through a scheme.

In addition to these generic benefits, individual schemes can be tailored to address specific issues. For example, some recent schemes have included a mechanism to safeguard against an unexpected influx of a high volume of unsupported claims. This mechanism allows a company to revert to a conventional run-off as the best course of action for dealing with such a scenario. A solvent scheme may also be designed so as more actively to involve or engage reinsurers by adopting a phased voting process. This provides policyholders and creditors with a greater level of direct influence and allows the needs of shareholders, creditors and reinsurers to be carefully balanced by, amongst other things, encouraging commercial negotiations and mutually acceptable commutation agreements.

'Some recent schemes have included a safeguard against an unexpected influx of a high volume of unsupported claims'

Do schemes have any disadvantages?

It would be disingenuous to suggest that schemes are perfect in all circumstances – they are not. However, the disadvantages are worth noting, not only for the sake of balance, but also to highlight that they can usually be managed without fundamentally undermining the basic appeal of schemes. In our experience, the main potential disadvantages encountered are:

● *Estimation.* It is an unavoidable fact that some policyholders or creditors may ultimately receive more or less than the amount they would have received had the company been run-off in the traditional manner. However, schemes are designed in such a way so as to ensure, so far as is practicably possible, that the estimation or claims agreement process is both reasonable and fair.

● *Finality.* In order to provide finality, a scheme introduces a bar date by which creditors must submit their claims. Any creditor failing to submit a claim by this date may not receive payment under the scheme. However, a company will seek to ensure that the scheme is brought to the attention of all creditors, indeed this is also supplemented by various legal safeguards, for example, the obligation to advertise the scheme widely and in appropriate publications.

● *Excluded policies.* For either legal, technical or commercial reasons, schemes may not be suitable for all types of business. For example, policies that provide protection for compulsory insurance, like employers' liability or third party motor liability, which could be eligible for compensation from the Financial Services Compensation Scheme in the event of an insurance company's default, are currently excluded from schemes.

● *Safety for policyholders.* In a run-off scheme for an insolvent insurance company, there might be risks for those creditors whose claims mature in the future, if too much cash were to be paid out early in the scheme. However, initial dividend levels are usually set cautiously in such schemes, so that no creditors should be prejudiced.

● *Loss of liquidators' remedies.* Under UK insolvency law, there are certain courses of action available to a liquidator if there has been any wrongful or fraudulent trading by a director, the company has given a preference or the company has been party to any transaction at an undervalue. These remedies are not available to an insolvent company subject to a scheme outside of a liquidation. However, the recent introduction of the administration process for insolvent insurance companies may change the position except in relation to wrongful or fraudulent trading, thereby reducing the extent of this potential disadvantage. In practice, before promoting a scheme, appropriate investigations would be undertaken to ensure that the loss of any such powers would not result in the loss of material recoveries.

A constantly evolving tool

Schemes are continuing to evolve in response to the increasingly varied challenges and circumstances being encountered in the marketplace. This dynamic environment has resulted in the development of innovative, efficient and effective solutions for complex books of business, which address the unique difficulties or circumstances facing each company.

This is best illustrated by the following list of situations where schemes can be applied:

- *Portfolios.* Schemes are sufficiently flexible to allow them to be applied to discrete portfolios, such as discontinued business or third party business for captives.
- *Pools.* The application of schemes to portfolios rather than the whole of a company is particularly useful when dealing with involvements in underwriting pools. A scheme can bring finality to a pool and can also be designed in such a way so as to allow the pool members and their policyholders formally to agree ways of simplifying existing complex arrangements and relationships commonly observed in pools (see page 15).
- *Overseas companies.* Schemes can be applied to foreign companies with UK branches and any other company incorporated outside England provided that there is 'sufficient connection' with England. In addition, schemes can generally be implemented in countries where the legislation stems from UK law, such as Bermuda, Hong Kong, Singapore and Australia (see page 17).
- *Lloyd's.* The concept of schemes can be extended to Lloyd's syndicates and corporate capital vehicles. This is an area where there are potentially very significant development opportunities (see page 16).
- *Life companies.* Schemes can be applied to life companies in order to provide certainty in relation to the unknown element and longevity of certain types of life policies (see page 14).
- *Captives, P&I clubs and mutuals.* Schemes can be applied to captives and the concept can also be extended to P&I clubs and mutuals (see page 18).
- *US legislative changes.* An opportunity is now available for a solvent scheme solution in the US. In 2002, Rhode Island became the first state to enact a statute that allows a solvent company in run-off to reach a court supervised agreement with all of its creditors to accelerate the completion of a run-off.
- *Contingent schemes.* A company may face uncertainty regarding its ultimate solvency. A contingent scheme can provide an effective means of dealing with such a concern. A two part scheme can be effected where the company operates its normal run-off within a solvent scheme until such time as it is determined that there are insufficient assets to meet liabilities, including future liabilities. The scheme includes a trigger mechanism whereby the company will then pay a proportion of claims, thus providing scheme creditors with a seamless process from a solvent scheme to an insolvent scheme.
- *E-schemes.* In appropriate circumstances, a company can publish and promote a scheme via a secure website, which can also be utilised to receive and agree claims, offering the prospect of significant cost savings, operational efficiencies and flexible data collection. Given the typical size of scheme documents, particularly in larger cases with many thousands of policyholders and potential creditors, this can also provide significant environmental benefits!

As this demonstrates, schemes have proved to be flexible and adaptable in the myriad of circumstances that can be and are found in the insurance world — which is why more and more high profile companies are using schemes as a viable and effective means of achieving finality. Recent schemes have dealt with tens of millions of insurance liabilities and are progressively playing a part in dealing with the enormous amount of long tail liabilities emanating from all over the world, not least the US. With a carefully planned and managed exit, a scheme can be implemented early on in the life of a run-off, although the precise strategy and timing will be dependent on the particular circumstances of the business.

'Schemes have proved to be flexible and adaptable in the myriad of circumstances that can be and are found in the insurance world'

In assessing the potential of the scheme of arrangement route to finality it is important to be aware of the range of alternative options available. Kevin Gill and Emma Pugsley review the current choice of exit routes

Making an exit

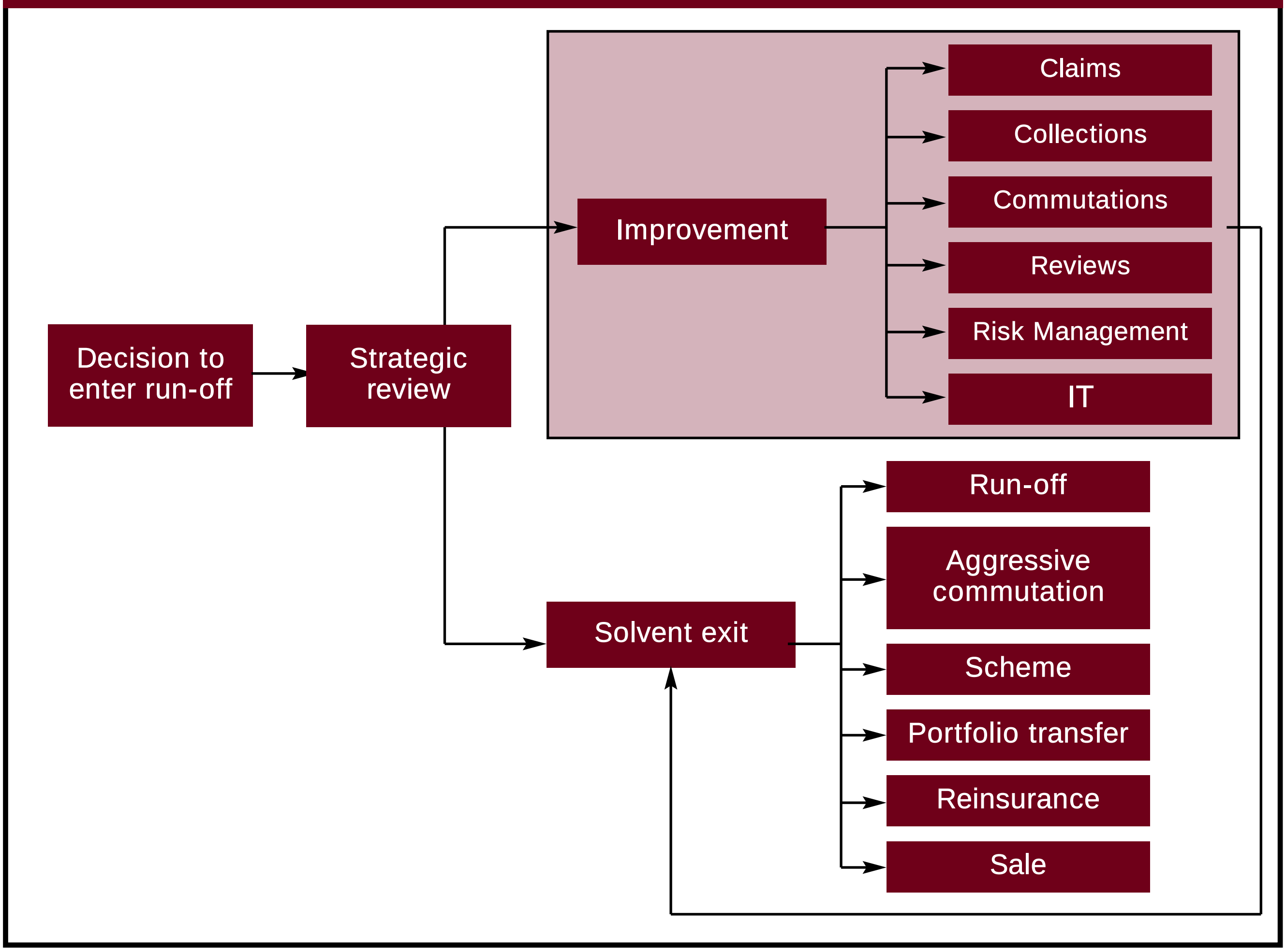
Research indicates that the worldwide total for liabilities in run-off is in excess of $300 billion, with more entities entering run-off each year. There are a number of exit strategies to choose from and the exit route chosen will often depend on the objectives of the key stakeholder, the shareholder. Those objectives may not be complimentary, for example, to maximise value and also to exit in a short time span and so the shareholder will need to prioritise the importance of each objective to reach an acceptable level of compromise.

There are six main available exit options (as shown in Figure 1) and a shareholder should consider carefully each option against its objectives.

a) Run-off to expiry
b) Aggressive commutation
c) Scheme of arrangement
d) Portfolio transfer

Figure 1

Exit options and ‘improvement’



e) Reinsurance
f) Sale

Each option is briefly described and considered below. Any company seeking to exit the market will need to explore and consider each option in detail. In particular each can have different tax implications, which may alter the merits of the solution (see page 23).

a) Run-off to expiry

The run-off of insurance business can take many years, especially in the case of asbestos losses which could take over 50 years to mature. Continuing a properly managed run-off to expiry means that only valid claims are settled to policyholders, ensuring that policyholders get the actual benefits of their policies. This also ensures that the reinsurance asset is fully and properly utilised reacting appropriately to each inward claim. Cash outflow can be managed on an orderly basis and techniques adopted to minimise outflow which may be necessary in some cases.

For many organisations, however, a long drawn out run-off is not attractive. There will be the continual risk of further claims deterioration, increased failure of reinsurers and the ongoing costs of the run-off, which will get proportionally higher as the claims liabilities tail off. Furthermore the shareholders will be restricted in how much capital they may remove from the business and will face the prospect of having much of their capital tied up for many years.

b) Aggressive commutation

An aggressive commutation strategy involves collapsing the run-off by undertaking a strategic programme of commutations to remove inward liabilities and exposures and to secure value from the outwards reinsurance programme. There will be heavy reliance on the efficiency and effectiveness of the commutations team to perform the commutations in an accelerated timeframe. In addition, the systems and reporting facilities will need to be able to support the requirements of an intense programme of commutations, for example with the availability of a principal based ledger.

Although this strategy can be effective in reducing the size of the run-off and reducing the risk of inwards deterioration and reinsurer failure, unless commutations are performed with each and every policyholder the timescale to finality will be the same as under option a), normal run-off to expiry. This strategy is likely to begin with a focus on the larger balances, and over time, as only the small balances remain, this approach will cease to be cost effective. Following an aggressive commutation strategy, it may be appropriate to implement an alternative exit strategy, such as a scheme, to bring about finality.

c) Scheme

A finality scheme is a global commutation with all creditors which uses section 425 of the Companies Act 1985 to effect a compromise with creditors. Essentially a scheme is a deal that is presented to all known and potential creditors for their approval through a meeting and vote of creditors. Once approved by the creditors and sanctioned by the court, a scheme becomes binding on all creditors. The purpose of a finality scheme is to offer a fair and transparent process to creditors to have their policies valued on a once and for all basis.

A scheme can be completed in a relatively short timescale, thereby avoiding some of the disadvantages of a long-term run off, realising any value for the shareholder at an earlier stage than might otherwise be possible. A key issue with schemes, however, is that they do not bind pure debtors, although this can be overcome by careful management of reinsurers.

Schemes can be especially attractive when used in combination with an accelerated commutation strategy.

d) Portfolio transfer

A portfolio transfer can be effected under Part VII of the Financial Services and Markets Act, which through a court driven process moves the liabilities, and attaching property (reinsurance asset) to another company.

This is a relatively quick process, subject to finding a company to take on the risks of the run-off at an agreeable price, and achieves finality for the transferor in respect of the liabilities transferred. However, the company accepting the portfolio will seek to price the transfer commensurate to the risk transferred to give it an opportunity of making a profit. This is likely to reduce any value that the transferor might have obtained from the run-off.

e) Reinsurance

Obtaining a stop loss reinsurance of run-off business is another relatively quick solution, following due diligence by the prospective carrier and negotiation and agreement over the terms of the contract.

Depending on the type of business written, the costs of this option may be prohibitive, as the market for certain business, eg. that containing asbestos, is very restricted. Whilst this exit is intended to provide finan-

‘Following an aggressive commutation strategy, it may be appropriate to implement an alternative exit strategy, such as a scheme, to bring about finality’

cial finality it does not give absolute finality because most reinsurance policies are not unlimited and the risk of reinsurer failure remains, however slight. In addition, although the ceding company typically gives up control of the run-off, it may retain an administrative burden as it monitors and accounts for the stop-loss arrangement.

f) Sale

The market for run-off sales has increased dramatically in recent years, a trend which is set to continue as both the supply of businesses in run-off and the number of specialist run-off business acquirers grows. The sale option can be very attractive, it can provide the vendor with certainty and true finality since it passes over a company in its entirety to the acquirer (subject to any warranties). Although there can be a significant amount of preparation work required for a sale, involving the marshalling of relevant documents, this exit can be a relatively quick process, subject to finding a buyer willing to acquire the company at an agreeable price and regulatory consent.

‘The sale option can be very attractive, it can provide the vendor with certainty and true finality since it passes over a company in its entirety to the acquirer’

As with a portfolio transfer the company taking on the run-off will want to ensure that it has adequately valued the risks inherent in the run-off to give itself a reasonable opportunity of profit from the acquisition. This valuation is likely to be at a heavy discount to the net assets shown in the balance sheet of the company being sold and the carrying value in the vendor’s balance sheet.

Managing the run-off: improvement

A number of the exit options detailed above will involve retaining the business for a period of time, depending on the strategy that is adopted and the time necessary to implement an exit solution. There are a number of ‘improvement’ strategies that can be used to minimise the costs of the operation, as per Figure 1.

The key areas for improvement and review will include:

a) Run-off management
b) Claims management
c) Collections and commutations
d) Third party relationships and outsourcing
e) IT

As indicated in Figure 1, an exit strategy may be selected as the appropriate strategy following a period of improvement.

a) Run-off management

Properly controlling discontinued business can minimise run-off operating expenses and mitigate the risk of underwriting deterioration. It will be important to ensure that any outsourcing contracts are properly worded and there are adequate controls, procedures and monitoring. Establishing an appropriate strategy for the run-off will be key to the success of the operation, and may include a decision regarding exit, its timings and method.

b) Claims management

Although claims represent around 80 per cent of the total expenses of an insurer, attention is often driven towards fixed and variable cost reduction exercises, rather than on re-engineering the claims department and processes. Improvement in this area could therefore have a material impact.

c) Collections and commutations

Two of the exit options detailed above, aggressive commutation and collection, for companies or portfolios with material amounts of reinsurance, will involve using the skills and strategies involved in this improvement area. As standalone strategies, however, they can be very effective in improving the results of an organisation, and with careful planning can realise significant rewards. In some instances, effective strategy in this area can prepare the run-off for exit via a scheme.

d) Third party relationships and outsourcing

Many insurers and reinsurers have taken advantage of an opportunity to outsource all or elements of their work to third parties. Where properly controlled these arrangements can be very beneficial, allowing the company to focus on its key strategic areas. In some cases, however, these relationships can be financially unsatisfying, and careful review and subsequent improvements in these areas can be beneficial to the company.

e) IT

An effective IT strategy and appropriate IT systems are important tools for the company, both for the period preceding exit and in some instances in assisting with the exit process. A good example of this is in the development and implementation of a principal based ledger. The availability of a system which can report on this basis will be useful for providing valuations for conducting ad hoc commutations during the run-off period. It will additionally be particularly important for an aggressive commutation strategy, and also for a scheme in determining key creditors and debtors for strategy purposes.

Each scheme will have many stakeholders. Clare Whitcombe explains who they are and how their interests should be addressed

Managing expectations

Throughout the life of a run-off, understanding stakeholder perspectives and managing stakeholder expectations is key to ensuring things run smoothly. These stakeholders include: shareholders, directors, run-off managers, creditors, reinsurers, regulators and staff to name but a few, and it is critical to understand the needs and motivations of each stakeholder when the exit strategy is being formulated.

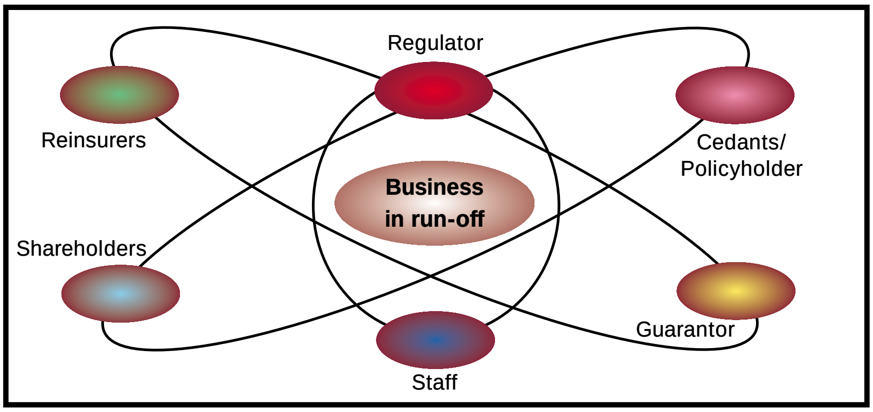
Each stakeholder should be considered during the planning, promotion and implementation phases of a scheme to ensure that all perspectives are considered. Where there are conflicting needs these must be carefully considered and managed to ensure that the deal presented balances the needs of each stakeholder and is a fair solution for everyone. Each scheme will generally involve the same types of stakeholders but the motivations will typically be different.

The process will start with discussions with the directors in order to understand the business issues and their expectations in relation to the scheme. Shareholders will obviously need to approve any exit strategy before it can be implemented and they must understand the process including the risks and rewards.

We would usually start with a blank sheet of paper and shape out what the deal looks like depending on the size, nature and complexity of the business.

Once we have a deal sketched out, soundings will be taken from key stakeholders to ensure that their concerns and needs are reflected and the scheme will be shaped to reflect these. The important thing to remember is that if any key stakeholder rejects the deal it will not work, so fairness to all is imperative.

A key stakeholder is the regulator. As long as a scheme satisfies the ultimate requirement of fairness, the Financial Services Authority (FSA, the UK regulator) will generally be supportive of a scheme. Even if the company falls outside its jurisdiction, the FSA will need to be satisfied that UK creditors are not adversely affected. Support from any relevant overseas regulator will, of course, also be vital.



Policyholders will want to know how much and when they can expect to receive payment under the scheme, and whether the claims agreement and adjudication processes are transparent and result in fairness. Taking early soundings from key creditors is vital to ensure they understand and support the scheme proposals.

A scheme benefits reinsurers in that it gives them certainty and finality, but if a company has a significant reinsurance programme it will need to embark on a carefully devised and executed strategy of pre-scheme commutations or discussions with the main reinsurers to ensure they understand the scheme and to obtain their buy-in.

Alternatively, a scheme can be structured so that they are able to participate. Reinsurers are asked to indicate what sums they are willing to pay and creditors can be given the opportunity to decide whether such offers are satisfactory or not. If sums pledged by reinsurers are insufficient, in the eyes of the creditors, they can vote to reject a scheme which seeks to crystallise all liabilities and choose instead to return to the run-off. In this way, creditors retain a degree of control.

Staff usually have vital experience and knowledge in relation to the business and will be key in the planning and implementation of a scheme. Staff retention and bonus programmes can be designed to ensure that the risk of loss of key staff is minimised and motivation is maintained. Given the increased popularity of schemes, staff have the added benefit of gaining valuable and practical first hand experience of implementing these exit strategies. ●

Neil Gayner examines the various factors involved in choosing when to initiate a scheme

When is the right time to scheme?

Early schemes were contemplated only for very old run-offs in order to release any surplus capital and bring finality and certainty. Market perception of schemes is now maturing. Schemes are now seen as the end phase of an integrated and focused strategy for discontinued business. As a result, shareholders are asking at what point in the implementation of the strategy should a scheme be developed?

Unfortunately, there is no simple answer to the question. In fact, it generates a number of further questions starting with the overall shareholder objectives. Are these to maximise return to the shareholder, preserve corporate reputation, minimise risk or possibly a host of other, sometimes conflicting, objectives?

Other factors to be taken into account on timing of the scheme include:

- The classes and type of business in the portfolio and the ability actuarially to estimate ultimate outcomes at a contract level. How mature is the book? Are there still in-force policies?
- The nature of the run-off to date. How aggressive has it been? Have some of the largest and most volatile exposures been commuted?
- The policyholder/cedant base – is it dominated by a small number or is it fairly evenly spread? If the former, what is their likely attitude to the scheme?
- Are there any ‘show-stoppers’ in the portfolio that need to be excluded from the scheme or dealt with first? For example, a scheme including employers’ liability on a losses occurring basis would probably meet resistance from the FSA, and personal lines business, whilst capable of estimating as a class, may not lend itself to a fair IBNR allocation at policyholder level.
- The reinsurance programme – how heavily reinsured is the portfolio, with what types of reinsurance, how much set-off is there, are there ‘difficult’ reinsurers and what is the quality of the security?
- What is the solvency and reputation of the company being schemed?
- Are shareholders prepared to pay a premium for certainty?
- How much current litigation is there?
- Are there major unresolved market issues? For example, it will currently be difficult to crystallise World Trade Center property losses until the number of losses issue has been finally resolved.

In our experience, having been involved in the majority of schemes to date, we have found:

- Most reinsurers will pay on the basis of crystallised liabilities if they believe the process to be fair.
- Reinsurers generally welcome finality and certainty. The key message is consult with key reinsurers in advance of implementing the scheme.
- Most cedants will be happy to achieve finality on fair terms, especially if the scheme includes payment of a premium, possibly in the form of reserves undiscounted for time value of money, or, if there is any doubt about the long term claims paying ability of the company being schemed. Again, the key message is to consult with key cedants and gain their support before the scheme meeting takes place.
- It is important to consult with, and consider attitudes and concerns of, other key stakeholders, including regulators and staff.
- Schemes can deal with active litigation or unresolved market issues through provision of a parking mechanism.

In conclusion, there is no single answer to the question of when is the right time to implement a scheme; the answer depends both on the key objectives of the shareholders and the characteristics of the portfolio. However, the single most important factor is probably the nature of the liabilities, and the answer is as soon as the portfolio is sufficiently mature for reasonable actuarial estimates to be developed at cedant level. ●

Andy Ward **explains the timescales involved in schemes**

How long do schemes take?

One of the major advantages of schemes of arrangement is their flexibility in that the provisions and timescales of a scheme may be drafted to suit the particular circumstances of the company in question. Consequently, because of the unique circumstances of each scheme company there is no set timeframe for the completion of a scheme, although there are fundamental stages common to each scheme.

In broad terms, the two main types of scheme are:

- An insolvent reserving scheme
- A crystallisation scheme for an insolvent or solvent company

Reserving schemes are generally used where there are long tail liabilities and/or considerable uncertainty within the company's data. The reserving scheme will make regular small value dividend payments to creditors with agreed claims, whilst reserving cash for payment of other creditors' claims which will not materialise until some time in the future.

Crystallisation or estimation schemes seek to establish the company's ultimate liabilities in early course – largely through the adoption of actuarial techniques – and hence accelerate the closure of the run-off. There are of course fundamental features which are common to all of the schemes and the key stages for an estimation scheme are shown in Table 1.

The the process of drafting the scheme and distributing the documents to creditors is common to both schemes and typically would take between three and six months, depending upon the legal complexities involved in the scheme drafting.

It is often stated that schemes today are essentially in a boilerplate format and can be produced very quickly. Whilst this is true to a certain extent, and the number and variety of schemes already produced assists in drafting, each new scheme company has its own idiosyncrasies which will need to be catered for within the drafting process.

Scheme drafting
Distribute scheme
Proxy form return
Scheme meeting
Court sanction
Scheme effective date
Bar date
Clause agreement and adjudication
Payment
Scheme termination

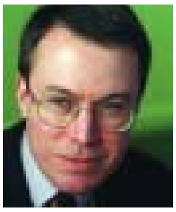
Once the scheme has been drafted and distributed to creditors, a timetable will be set for the remainder of the scheme and will initially provide a period for creditors to consider the merits of the scheme and to return proxy forms voting for or against the proposal. Once more, a typical timeframe for the return of proxy forms will be in the order of three months – a period which allows domestic and international creditors a reasonable amount of time to consider the position and cast their vote. The deadline for proxy form votes will be quickly followed – usually within one week – by a meeting of scheme creditors to vote on the proposal. Creditors may attend in person at the scheme meeting or proxy votes will be included in the voting process.

Assuming the scheme is voted for by the requisite majority of creditors attending the scheme meeting in person or by proxy, then the scheme will normally be ratified by the court in the relevant jurisdiction within one week. On receipt of court approval the scheme becomes effective and will follow the timetable set out in the document.

The next important timing issue for an estimation scheme the bar date for the filing of claims. This is a key date that will be determined by a number of factors:

- Where the scheme involves a sophisticated actuarial estimation of liabilities, then the bar date may be in the region of six to nine months to allow creditors to spend more time in evaluating their policies and reviewing the actuarial projections.
- Where data quality may be poor or where a company is small and has relatively few remaining creditors, then a submission style scheme may be used where creditors send in their claims for adjudication by the company and its scheme advisers. Typically the bar dates may be as short as three months.

Following the agreement of claims it is generally a short time – a month or two – before payments can be made to creditors. Once payments have cleared then the scheme may be terminated. ●



Schemes of arrangement can also be used in the restructuring of life assurers. Nigel Rackham considers the issues and potential solutions for troubled life companies and the implications of applying a scheme

Life restructuring

Many life companies are facing serious business issues, which are in some cases threatening the solvency of the company. Some examples of these are:

- Erosion of capital due to falling asset values which are not matched to policyholder obligations because of guaranteed benefit terms.
- Exposure to other guaranteed benefits (for example guaranteed annuity options) due to falls in interest rates and improved mortality.
- Continued threat to solvency through asset volatility on a weakened capital base.
- Pressure on margins from stakeholder type products, possibly sold by new entrants to the market with cheap and flexible product distribution and/or critical mass.
- Costs arising from mistakes of the past, in particular mis-selling.
- Because of capital strain marketwide it is difficult to find reinsurance at an acceptable price for mortality risk and it is also hard to find a purchaser for an ailing fund.

In turn the impact on policyholders has been significant:

- The fund may have closed to new business, lower (or no) bonuses declared, charges increased and penalties imposed on early surrender.
- An exit from volatile asset classes whilst protecting solvency gives policyholders little opportunity for upside, indeed they may be locked into values at what may prove to be the bottom of the market.
- Solvency concerns mean policyholders do not have the security they thought they were buying into.

Depending upon the circumstances there are a number of measures which can be taken to stabilise or strengthen a fund. Some involve a capital injection (or pseudo-capital such as a contingent loan or financial reinsurance). Some element of risk reduction can be achieved by true risk transferring reinsurance but this is likely to be costly due to the lack of appetite for some life risks in the market. It is also possible to use derivative contracts to hedge some market risks, albeit again at a cost.

There are also restructuring solutions amending policy terms which improve the position of the fund whilst policyholders are not just dealt with fairly but can share in the benefits. For example:

- Removing certain future guaranteed benefits and providing suitable compensation. This may find favour with policyholders whilst removing the reserving and capital requirements on the fund. This is the solution achieved by Equitable Life.
- Ring-fencing existing policy terms but offering more flexible alternatives for future premiums.
- A wholesale conversion from with-profits to unit-linked funds.

The latter two options more closely align risk and reward. Policyholders can choose a more flexible investment vehicle, offering upside opportunity, whilst also accepting the market risk. The fund has reduced risk and hence reduced capital requirement and can share this benefit with policyholders. Reducing widely differing policy terms within a group may make the business administratively easier to manage as well.

There are a number of issues which have to be addressed which can be complex. For example tax, both for the company and for policyholders, can be a particular sticking point (see page 23). The regulator would also need to be involved.

Pros and cons of a scheme

It is possible to achieve some level of restructuring of policy terms through a portfolio transfer providing the court is satisfied that the restructuring is necessary. Although a transfer to a third party may not be possible some intra-group restructuring may be possible. This does not need policyholder consent although policyholders still need to be circularised and can be heard at the court hearing necessary to sanction the transfer.

An apparently easy solution is to seek individual agreement from policyholders to a change in terms. In practice, agreeing the documentation and dealing with policyholder queries may make the process as complex as a scheme solution. The major drawback is that inertia and a lack of policyholder understanding may make the take-up rate of any option low. A solution through a scheme of arrangement offers the beauty of binding all the affected policyholders once the requisite majority is obtained. ●

The flexibility of schemes means they can be applied to discrete portfolios of business. They are also useful when confronting the complexities of pools, say

Diana Gardner-Brown and Emma Pugsley

A rescue from the pool

One aspect of a scheme's flexibility is that only the defined liabilities of the portfolios are dealt with. For example, some liabilities might be valued through a cut-off scheme, whilst other liabilities are left to run-off normally. In addition, a scheme can define which assets support the scheme liabilities, providing a company with the ability to ringfence liabilities of discontinued business.

The ability to limit a scheme to a defined portion of a company's liabilities is particularly useful for dealing with business written through underwriter or broker pools, providing participants with a facility for exiting one of the most problematic areas of run-off. Pools were regularly used for many decades to provide insurers and reinsurers with the chance to become involved in writing books of business in geographies and/or classes of business that would otherwise not have been available to them. A further attraction of pool arrangements was the opportunity to share in overhead costs, a prospect that was particularly inviting when entering new areas of business.

As pools evolved they became more complicated: for example, underwriting participants came and went over time, underwriting years were 'closed' by reinsuring into other underwriting years and fronting on behalf of other participants became commonplace. The popularity of pools and underwriting agencies has now declined and a great number are now in run-off. Furthermore, a number of pools now contain one or more members that are insolvent, compounding the complications of pools and bringing its own difficulties.

A scheme can be tailored to deal with the particular circumstances and issues facing the participants of a pool and is particularly useful for simplifying and streamlining the legal construction of the pool to the benefit of the pool participants and pool creditors.

Whilst an individual pool member can implement a scheme for its own portfolio in a pool, it can be much more powerful and straightforward if all pool members seek a scheme exit. This is what the surviving members of the Dunedin underwriting pool chose to do, with each effecting a scheme for their participation in that pool, resulting in the first solvent scheme for a whole pool in the UK.

This scheme also demonstrated the flexibility of schemes as it allowed the pool members and creditors formally to agree ways of simplifying the complex arrangements and relationships that had built up during the life of the pool. The pool originally consisted of five companies, but one was subsequently dissolved with the four remaining participants agreeing between themselves to share that member's pool liabilities. The scheme formalised this sharing arrangement with the pool creditors, enabling all of the pool liabilities to be dealt with in one scheme.

An important issue for the members of the Dunedin pool was for each member to retain the several liability that each enjoyed in relation to their original participations, so that each did not become responsible for another member's liabilities. The scheme provided that each member was severally liable for its 'scheme defined' participation and was not jointly liable for other members' liabilities.

Schemes can be drafted to bring further benefits to the participants and creditors by catering for the impact of any of the pool members becoming insolvent, thereby avoiding some of the problems and the hiatus surrounding the onset of insolvency of a pool member. ●

Schemes may also be applied within the Lloyd's market to hasten finality, explains Kevin Gill

Exiting Lime St

The Lloyd's of London market is faced with the same run-off issues as the company market. It has to face and manage the prospect of deteriorating losses, the risk of reinsurance security failure and the ongoing overhead costs of performing the run-off. Traditionally, the Lloyd's market has dealt with its run-offs and open-year exposures through a mixture of reinsurance to close (RITC), commutations and run-off to expiry. More recently it has been able to take advantage of the portfolio transfer options provided by Part VII of the FSMA 2000 to transfer run-off business out of the Lloyd's market.

Nevertheless, there are approximately 70 syndicates in run-off, and it would seem that the current exit routes are not providing the capital providers at Lloyd's with the desired exit and finality that could benefit the market. Many regard the traditional closure route of RITC as being too expensive, giving away profits to a reinsurer that could be retained for the current capital providers. Is there now an opportunity for a scheme of arrangement to provide finality and certainty to Lloyd's run-offs?

A solvent scheme is no more than a deal whereby an underwriter seeks to arrive at a fair value with its creditors (policyholders) for its current and future liabilities and to settle those liabilities in full at an earlier stage than would be possible in a run-off. The benefits that a scheme provides to the underwriter and policyholder are no different than those derived from schemes in the company market.

Distinguishing features

There are two distinguishable features between the Lloyd's market and the company market.

The first is its capital providers. The Lloyd's market is characterised by part of its capital being provided by individuals, rather than companies.

The second is the Lloyd's franchise. The capital providers and managing agents work under the name of Lloyd's and their actions affect not only their own fortunes, but also that of the Lloyd's market. How do these two features affect the ability to implement a scheme?

Since a scheme is a Companies Act mechanism that allows companies to come to an arrangement or compromise with its creditors, where a corporate vehicle provides the capital on a syndicate then technically it will be able to use a scheme to come to a compromise with its creditors (ie. the policyholders). However, part of Lloyd's capital is provided by natural names and schemes are not available for individuals. To deal with this, natural names' liabilities need to be transferred from the natural names into a corporate body. That company can then implement a scheme. One way to move the names' liabilities would be by way of a business transfer under Part VII of the FSMA 2000, although there are other ways of achieving a similar result.

With the Lloyd's brand being a franchise, any company promoting a scheme in the Lloyd's market will need to be mindful of the other stakeholders benefiting from Lloyd's' reputation. It will be important to demonstrate that solvent schemes at least uphold the reputation of Lloyd's, given the fundamental importance of Lloyd's never having failed to pay a claim in full. A solvent scheme can provide clear financial benefits to the market and in addition it also preserves and indeed can enhance By ensuring that the fair value of present and future claims are paid in full, Lloyd's can demonstrate positive steps to bring finality to its run-off business. A scheme allows policyholders to be paid in full at an earlier stage than would otherwise be normal, providing policyholders with certainty and value from their policies in an expeditious fashion.

With run-off managers now seeking proactively to manage their run-offs to provide value and benefit to their clients, the shareholders of an underwriter, they are exploring and implementing schemes to bring closure to run-offs. This enthusiasm has extended to the Lloyd's market, with a number now showing interest in whether a scheme can be used to bring finality and certainty to a run-off within Lloyd's. ●

Although solvent schemes in the UK are governed by UK legislation it is not only UK-domiciled companies that can benefit from them. Mark Jones and Andy Rothseid examine the wider geographic applications of section 425 of the Companies Act

Global schemes

Many commonwealth and ex-commonwealth countries originally built their own corporate legislative structure around that of England. This means that corporate legislation in countries such as Bermuda, Hong Kong, Singapore, Gibraltar and Australia include provisions that are very similar to that of section 425, and therefore schemes, both solvent and insolvent, can be implemented in these commonwealth and ex-commonwealth countries.

There are several precedents for schemes for insurance companies domiciled in these countries. Two of the very early solvent schemes, namely for Scottish and Commonwealth Insurance Company Limited (now dissolved) and Trent Insurance Company Limited, were based on section 99 of the Companies Act in Bermuda. The solvent scheme for Ramus Insurance Company Limited was also based on the same law in Bermuda. The level of insurance operations in run-off in Bermuda would suggest that additional Bermudian solvent schemes are likely to follow. As far as other countries are concerned, a scheme for three Hong Kong subsidiaries of the insolvent HIH Insurance Group was implemented last year based on section 166 of the Hong Kong Companies Ordinance (the first scheme for an insurance business based in Hong Kong).

Foreign companies

PricewaterhouseCoopers recently advised on a particularly innovative application of UK legislation in order to implement solvent schemes for five subsidiaries of the ING Group. This application involved, surprisingly for a solvent scheme, the Insolvency Act in England.

Under section 221 of the Insolvency Act, any company incorporated and domiciled outside England may be wound up in England, provided that there is 'sufficient connection' with England.

A most important legislative link is then made. If there is jurisdiction for a foreign company to be wound up in England, then there is jurisdiction for the court in England to allow for a section 425 scheme to be implemented in England for that foreign company.

What is considered to be sufficient connection with England for the purposes of winding up a foreign company has become more settled over time. It has always been considered as 'sufficient' if the company has carried on business in England, whether it is based in England or carried on the business through a branch in England. Therefore the most obvious application here would be for a foreign company wishing to implement a solvent scheme for its UK branch that operated in the London market.

However, the solvent schemes implemented for the five subsidiaries of the ING Group mentioned above further clarified the position. Four of the ING companies were Dutch and one Australian, and all wrote business in the London market in the period from the 1950s to 1984, in one case into the 1990s. As a result, the policyholders, cedants and reinsurers of all five companies included parties that were based in England. For each of the five companies the proportions that these parties based in England bore to those elsewhere were not insignificant, and therefore all five companies could potentially be wound up in England under section 221 of the Insolvency Act. Therefore all had sufficient connection with England, and hence solvent schemes under section 425 were possible. Furthermore, three of the companies had continuing business that they wished to be excluded from the schemes. The schemes for these companies were successfully implemented on 20 December 2002.

A section 425 scheme will bind all creditors of a company who are subject to the jurisdiction of the English courts. It should be noted, however, that a scheme will not be enforceable against a creditor outside England, except to the extent that such creditor takes part and receives dividends under the scheme.

This means that a section 425 scheme will not on its own be sufficient to prevent a non-English creditor from obtaining judgement in any proper non-English jurisdiction and then enforcing such judgement against the assets of the company anywhere in the world outside England. However, this can be mitigated by the company obtaining further protection from the courts of other countries where creditors and/or assets are based. This involves applying to the courts of the relevant countries to seek their recognition of the scheme.

Many of the schemes that have been implemented to date have involved the company obtaining a permanent injunction in the US under section 304 of the US Bankruptcy Code. This has provided protection from parties potentially seeking to take action that are either subject to US jurisdiction or are seeking to take action in the US.

Therefore where a foreign company has sold its insurance and/or reinsurance products into England, for example through the London market, whether or not it has a branch based in England, provided that the proportion of its policyholders, cedants and reinsurers based in England compared to those based elsewhere are significant, and therefore that company is capable of being wound up in England, then a section 425 scheme could be implemented in England for that company. Additional protection in other jurisdictions can also be sought if deemed necessary.

Closure for captives

The last few years has seen a steady growth in captive insurance company formations of around five per cent per annum, with the four most popular domiciles being Bermuda, Cayman, Guernsey and Vermont. Surprisingly, despite numerous new captives being licensed each year, the total number of captives has remained around 4500 over the last few years, due to an equivalent number entering run-off or, worse still, liquidation.

The ever changing corporate environment has fuelled the captive run-off market: mergers, acquisitions, sale of companies with captives, change of domicile or a change in business strategy can result in captives no longer being needed to support the new venture or its strategic direction. The consolidation of risk management programmes of numerous captives within a group of companies can also result in redundant captives.

The tax benefits available to captives are also reducing (with the US Congress considering actions to close the ‘Bermuda tax loophole’). UK parent companies with overseas captives are affected by the controlled foreign company rules attributing income from subsidiaries in low tax jurisdictions to UK taxable profits.

This myriad of changes has created a new and growing run-off market, but little headway has been made to address this issue.

Achieving finality

Despite the increase in popularity of schemes within the run-off insurance market, until very recently this exit mechanism has not been mirrored in the captive market as a tool for achieving finality. In 2003, Ford became the first company to successfully promote and complete a scheme for third party business written by its captive Transcon, further demonstrating the wide application of schemes and paving the way for increased recognition and acceptance of schemes in this market.

The diverse and flexible nature of schemes allows companies to achieve finality for the company as a whole or for a portfolio of the company’s business, making this a highly attractive exit option for captives with run-off business.

The numerous advantages resulting from use of a scheme also extend to captives. Substantial savings in run-off costs, which would otherwise be incurred in the normal course for many years, can be made. Finality is also achieved, therefore removing any doubt regarding the solvency of the captive. A scheme provides a mechanism for crystallising present and future claims against the captive, creating certainty and facilitating earlier payments to creditors, thus resulting in the earliest possible release to a parent company of any residual value from a captive’s business in run-off.

Baljit Goraya

Rhode Island

In 2002, Rhode Island became the first US state to enact legislation to allow a solvent insurance or reinsurance company in run-off to reach a court-supervised agreement, known as a 'commutation plan', with all of its creditors in order to bring finality and certainty to its run-off.

'Redomestication in order to take advantage of scheme-like legislation, such as that found in the UK, commonwealth and ex-commonwealth countries and the US, is likely to become more popular'

The legislation itself is very similar to section 425 in the UK. In fact, it would appear that the legislators modelled the legislation on section 425 in the UK and section 99 in Bermuda in their drafting.

In order to implement a Rhode Island court-supervised commutation plan, a company must :

- Have property and casualty liabilities.
- Be domiciled in Rhode Island.
- Have ceased underwriting new business.
- Be renewing business only as required by law or contract.

If a company meets all four of these requirements then it may apply to the Superior Court for an order implementing a commutation plan. Before making such an application to the court, the company would review the plan with the Rhode Island Department of Business Regulation (the Department), and its compliance with regulations issued by the Department, in order to ensure its support.

As with UK solvent schemes, a commutation plan does not impose any obligation on the company's reinsurers. Therefore, the company proposing a commutation plan would be wise to seek to reach agreements with its reinsurers prior to proposing such a plan.

If the company meets all the conditions imposed on it, and obtains approval from the Superior Court then notice will be sent to all interested parties and, as with UK schemes, all creditors will be given the opportunity to vote on the plan at a creditors' meeting.

Creditors, policyholders, reinsurers and guarantee associations may file comments or objections with the court. Therefore, it is important that the company has taken soundings from all the key parties and reacted accordingly in drafting the plan. In order to be implemented, the plan must first obtain the approval of 50 per cent in number representing 75 per cent in value of liabilities of all creditors or class thereof voting. Once this is achieved the court will then enter an implementation order, subject to the comments and objections made to it by creditors and policyholders, making the commutation plan effective.

'This statute certainly represents a new level of innovation in the US insurance market'

Once payments have been made to all creditors under the plan, application will be made to the court for it to enter an order of dissolution, releasing the company from any further liabilities, and allowing the company to release its capital to its shareholders.

A foreign company (foreign to Rhode Island that is) wishing to implement a commutation plan would have to redomesticate to Rhode Island. Depending on the particular state (or country) involved, the company would have to obtain approval from both its current state (or country) of domicile and Rhode Island. In order to accomplish this it would need to satisfy the Department, and possibly its current domestic regulator, that it, among other things, had sufficient reserves to meet its liabilities.

This statute certainly represents a new level of innovation in the US insurance run-off market, and is an innovative and proactive measure to address the problems posed by an insurance business in run-off. At the time of writing, two companies in run-off have applied for redomestication to Rhode Island. When the redomestication has been effected, those companies will be the first eligible to take advantage of the new statute. It is likely that a number of other companies are also now considering the Rhode Island statutory process.

Conclusion

Redomestication in order to take advantage of scheme-like legislation, such as that found in the UK, commonwealth and ex-commonwealth countries and the US, is likely to become more popular. In fact countries like Gibraltar, which also has scheme legislation similar to that of England, and states like Rhode Island positively encourage it.

It would appear that as more and more companies take advantage of scheme legislation, their advisers come up with innovative ways of doing so, and the benefits of schemes become more apparent to the insurance industry, it is likely that schemes or commutation plans will take off within the next few years. ●

Neil Bruce stresses the importance of taking a completely different approach to the reserving function in setting up schemes and the value added benefits that can be reaped

Change of focus

The reserving function will normally be part of the finance function or a separate actuarial function providing all kinds of statistical, planning, reserving and underwriting support. The change in objectives faced by the reserving function following the decision to enter run-off is profound and represents a major change in culture for those involved. The difference of emphasis required is made clear in the accompanying table.

Ongoing company	Run-off
• Reserving at the class of business level • Shareholder return • Underwriting support • Brokers ensure relationships with company • Absolute level of reserves • Best estimate reserves (mean) • Market perception of the security of the company	• Reserving at the policy level • Policyholder security and equity between creditors • Claims management and commutation activity • Company must ensure relationships with brokers, insureds and reinsurers • Relative level of reserves (insolvent) but also absolute level of reserves (solvent) • Best estimate and worst plausible reserves (mean and volatility) • Market desire to commute with the company

The types of action within the reserving function that will prepare a company for finality include the following:

The reserving process in run-off will change its focus from a class of business or overall level to a focus on reserving at a policy or creditor level. This has advantages in terms of being ready for major commutations as well as preparing the way for different types of finality option. It also helps identify commutation areas where quick wins can be made, such as where large offsetting balances could be dealt with to reduce underlying uncertainty.

Commutations become one of the most important operations within the company. They can be used to create inwards cashflow, which is very important, as premium income can no longer be relied upon. Effective commutation of outwards reinsurance can also prepare the way for an efficient scheme process in that it can eliminate the major net debtors who are not bound by a scheme (solvent or insolvent). It can also ease the mechanics of the crystallisation process if a significant analysis of outwards reinsurance and then set-off is made redundant.

The identification of accurate payment patterns becomes increasingly important, given that forced realisations of investments may have a profound effect on the ability of the company to meet its eventual liabilities. Payment patterns are also one of the key assumptions in identifying an acceptable range of commutation values for any transaction.

As well as identifying best estimates of future liabilities, the reserving function needs to be able to produce high or 'worst plausible' estimates of reserves in order to aid in commutation discussions and ultimately be able to make a proposal to policyholders that will reward them adequately for taking liabilities back on to their balance sheets. This can involve detailed analyses of risk versus reward and can lead to strains or releases from company balance sheets according to different external conditions (such as the prevailing level of interest rates).

In summary, the reserving function has to completely change its focus as a result of entering run-off. It does, however, have a one-off opportunity to add more value to the company than ever before by being involved in practical commercial valuations and negotiations and, particularly, to prepare a company for a finality option such as a solvent scheme. Actuaries seldom have so much opportunity to create value. ●

One of the key decisions to be made when organising a scheme of arrangement is how claims liabilities are to be valued. Nick Watford compares and discusses two of the main approaches

Value judgement

There are two main methods of valuing ultimate claims liabilities in a crystallisation scheme. The first approach is 'claims allocation', whereby creditors agree data with the scheme administrators which is then passed to the scheme actuary to apply an actuarial methodology that has been pre-approved by scheme creditors as part of the resolution to close the scheme. This is often referred to as a 'we tell you' approach, as the scheme actuary sets the final claim amount, although the creditor does have the opportunity to agree the data to be used.

The second approach is 'claims submission', in which each scheme creditor is asked to estimate their own claim amount and submit this for review by the scheme actuary, together with sufficient support in the form of policy level analysis and actuarial analysis to permit assessment of their claim. In contrast to the 'we tell you' design of the claims allocation approach, claims submission is often described as a 'you tell us' approach.

Claims allocation

The main advantage of a claims allocation process for an insolvent estate is that it can deal effectively with large volumes of claims in a manner that provides at least rough justice to all concerned. Whilst it is appreciated that actuarial techniques do not always produce a fair solution to every individual creditor, the advantage of applying uniform actuarial approaches to all creditors gives some comfort that creditors will be treated objectively and fairly, or at least that the overall process will not be subject to bias.

The allocation approach can deal equally well with 100,000 creditors or 1000 creditors and, in consequence, is less likely to be subject to delays as a result of unforeseen problems. It also places the burden of estimation and allocation on the scheme actuary with little burden on creditors themselves, other than agreeing that the data used by the scheme actuary is correct.

This, however, is in itself one of the main criticisms of the allocation approach, namely that creditors' views on IBNR are not considered directly by the scheme actuary, who is entitled to disregard their views. There is a difficult balance to draw in this respect, which also needs to recognise the size and complexity of the scheme itself and whether a submission approach is a viable alternative.

A further common criticism of the allocation approach is that it may give money to potential creditors who are uninterested in the crystallisation process and who have played no part in supporting the orderly wind-up of the business. This criticism is less valid in that it is possible

Claims allocation	Claims submission
Advantages • Objective and fair • Efficient, effective and timely • Less onerous from creditors' standpoint • Deals effectively with large volumes of claims	**Advantages** • Only option where data is poor • Deals with creditors who want to participate • Creditor views on IBNR are taken into account
Disadvantages • Creditor views on IBNR not taken into account • Perception that amounts are agreed with disinterested creditors	**Disadvantages** • Can be a problem for unsophisticated creditors • Can be confrontational • Process may be longer, especially if large numbers of claims submissions received

to operate an allocation scheme that only allocates liabilities to creditors who have previously signed up to the process and positively declared that they want to receive a dividend. It is also possible to run an allocation approach that ignores minimal allocations of, for example, less than $50 and puts these allocated amounts back into the overall pot.

Claims submission

The claims submission approach is very different to the allocation approach in that the initial onus is all on the creditor to produce a claims submission, including allowances for IBNR. This needs to be done according to agreed estimation approaches but, in practice, it is still common for some creditors to ignore the general principles laid down and, in some cases, to come up with ludicrous claims — for example, claiming for full policy limits on non-APH policies where there is virtually no possibility of future claims arising.

The scheme actuary can usually deal with these types of claims easily but there is still a significant amount of work to do in agreeing all claims with individual creditors. This process may become confrontational and can lead to a further actuarial or claims adjudicator being involved in the process as a whole. There is also the potential for contentious legal issues to arise that will require the scheme actuary to seek legal advice to help resolve each case. In an allocation situation these issues will usually be dealt with up front and appropriate legal judgments will be factored into the scheme actuary's assumptions, rather than being dealt with on a claim-by-claim basis.

This difficulty in agreeing claims on an individual submission basis can lead to significant delays in the process. A crucial factor in deciding whether a claims submission approach is appropriate is the number of claims submissions that are expected and the number where disagreement in the amounts claimed is likely to result in a prolonged process of agreement. More than any other factor, this can dictate whether or not a claims submission process is likely to be a practical solution. There is therefore an inherent 'gamble' taken in deciding upon a submission scheme in that the creditor response may be significantly greater than anticipated.

There are, of course, some instances where a claims submission approach is the only alternative, notwithstanding the delays that can occur. Where the insolvent company has little or no historical information of its own, it can be almost impossible for the scheme actuary to follow a claims allocation approach and claims submission may be the only practical alternative.

A claims submission approach can also be very effective where the in-house claims department has a very good understanding of the insured population and their expected future claim amounts, for example where IBNR is small or where the substantial IBNRs that will arise are relatively easy to estimate, such as for some asbestos assureds where policy limits are very likely to be exhausted.

Summary

In deciding which is the right approach to take, the key issue must be which approach is most appropriate in reaching a fair and equitable answer for creditors and, of course, in minimising expenses so as to improve overall dividends. It is no good coming up with a sophisticated method that is equitable to all creditors if the actuarial fees necessary to reach this position eat up a large slice of the remaining distributable assets!

In some situations it is conceivable that a combination of elements from the two approaches may be used to the overall benefit of the scheme creditors.

Application to solvent schemes

The rapid increase in the popularity of schemes of arrangement for solvent companies begs the question as to how liabilities are divided up between policyholders in a solvent scheme. In this respect, the main drivers described above are equally applicable to a solvent scheme as to an insolvent scheme. There are, however, some very important differences as follows:

The same emphasis is not so relevant to a solvent scheme. Here, it is important that the overall estimation is reasonably correct in the first place as, if it is not, then one or other of the company's shareholders or the policyholders may be severely disadvantaged in the crystallisation process.

It is also important that risk comes into the equation. For a creditor in a solvent scheme, they are bringing uncertain liabilities back on to their balance sheet and would normally expect to receive more than a discounted best estimate of their liabilities (otherwise why else would they agree to it?). There is therefore a reward that often needs to be paid by the parent company to the creditors in a solvent scheme to recognise this transfer of risk. In some situations, however, such as where creditors may perceive there to be a significant risk of future insolvency, the equation may change to also reflect credit risk.

In recent times, the simple use of an undiscounted liability (to be paid now) has sometimes been considered to be sufficient recompense for the risk being accepted by creditors in this situation. This approach may now be out of date with investment income levels being low and insurance companies in run-off normally being bought for a discount to net assets. This leads to a conclusion that some premium over undiscounted reserves may be appropriate, the size of this premium naturally being dependent on the parent's desire for finality and the creditors' own capacity to bear risk and their attitude towards any credit risk. ●

Rewards can be reaped by considering the tax implications of a scheme of arrangement sooner rather than later, advises Simon de Young

The tax implications

There are four rules which any wise insurance business or scheme administrator should attend to: maximise tax assets (attributes) before entering into a scheme; set up/preserve the most tax efficient structure for the scheme; maximise tax benefits of being in a scheme; minimise tax costs of exit.

The same rules apply to both solvent and insolvent schemes, though the details may diverge.

Rule 1 – Maximise the scheme's tax assets

As the purpose of a crystallisation scheme is to release balance sheet liabilities, if the liabilities released exceed tax losses brought forward, scheme profits may be subject to tax (but see Rule 3 for the exception).

The same conclusion can also apply to insolvent schemes if the balance sheet residual liabilities are to be released in order to ensure members voluntary liquidation (MVL) exit and the tax losses brought forward are not sufficient to cover the liabilities released.

The tax losses entering into a scheme may be less than the net liabilities on the scheme's books for a variety of reasons:

- In surrendering its losses as group relief to another member of the group, a company may already have given up some of its historic tax losses.
- As the run-off was never expected to turn to profit there may have been an agreement with the Revenue to disallow some historic losses to achieve simplification of the company's tax affairs.
- A poor trail of correspondence means tax losses may be forgone.
- Losses have been previously disallowed by means of the discounting legislation

Therefore, before entering into a scheme a company should assess the level of its tax losses (including a due diligence of the loss trail) and consider opportunities for enhancing the scheme pool by:

- Acquiring losses through s107 FA 2000 planning (either from a company or a portfolio transfer).
- Taking advantage of proposed changes to the discounting legislation (which mean that companies subject to solvent schemes may be able to disclaim tax losses in the future).
- Obtaining value for losses which are surplus, by group relief or disposal.
- Seeking to reduce the level of tax profits arising in the scheme (see Rule 3).

Rule 2 – Tax efficient structure

The best tax structure very much depends on the specific circumstances of the scheme. However, careful drafting of the scheme documents is required to ensure a scheme does not involve putting the scheme assets in trust, giving rise to such tax complications as: forfeiture of all brought forward tax losses; capital gains liabilities; inheritance tax issues.

For a solvent scheme, the best structure will be the one that gives rise to the least tax on exit. Where a company is purchased at a net discount there may be significant profits/capital gains on exit. However, the inherent uncertainty in insurance accounting can be used to the advantage of shareholder tax planning. For this reason the time to set up tax efficient share structures is before the scheme is implemented.

Rule 3 – Tax benefits of scheme

This is where the exception to the maxim 'tax follows the accounts' can make a real difference. FA 1994 introduced new legislation (amending s94 TA 1988) to assist with business recovery, whereby profits resulting from releases of debts with creditors that take place within a scheme of arrangement (CA 1985) or voluntary arrangement (IA 1986) are exempt from tax. This law applies equally to insolvent and solvent schemes and can generate considerable tax savings.

Rule 4 – Exits

As noted above, for insolvent schemes it may be that the MVL route is considered the preferable exit strategy. However, to do this you need to be satisfied that the balance of unpaid liabilities can be released without suffering further tax. In addition, unclaimed dividends may be held on trust suffering tax at 34 per cent. These issues will need to be resolved on the scheme's closure.

For solvent schemes the tax saving opportunities can be more immediate: if all has gone well the company could be sitting on a pool of cash to distribute to shareholders. The hybrid nature of a scheme may not apply on capital exits. It is therefore important to give due attention to tax opportunities at Rule 2 and a tax efficient structure to minimise tax leakage. ●

Paul Duffin assesses the importance of implementing effective IT systems and processes when running a scheme

The impact of IT

As with any process affecting a run-off, the more flexible the IT systems are the quicker and less painful the scheme process will be. In essence, a scheme is a global commutation and the same basic rules apply to this commutation as to any other. If you have good quality information to back-up your numbers and flexible IT systems that enable you to present the information in a variety of formats, then you are in a stronger position to drive through the process quickly and efficiently.

One of the main advantages of a scheme is the flexibility that you can build into the process. This flexibility means that deficiencies in data or systems can be catered for and dealt with in an appropriate manner. However, if both the systems and data are good then more options are left open and the scheme is less restricted in its design.

There are a number of key questions that will need to be answered and the flexibility inherent in the IT systems will, to some extent, determine the best route forward in any given circumstance:

- Who are you going to circularise?
- What information are you going to circularise?
- How are you going to circularise the information?
- What responses are you expecting from the recipients?
- How will you deal with the returns when they come?

The remainder of this article will focus on two of these areas: the information that is to be circularised and how that information is to be circularised.

Information to be circularised

Typically, the scheme process is about agreeing a claim figure at a fixed point in time, often at policy level, with each of the principals that did business with the company. This claim figure is made up of three distinct elements:

- Unsettled claims and premiums
- Outstanding losses
- IBNRs

The timing of when this information is shared with the principal will vary from scheme to scheme. The agreement of the unsettled element of the claim should be a matter of factual discussion between the scheme company and principal.

The other two elements are a little more subjective. In order to assist the evaluation of future claims, policy information held on the company's computer system will be circulated for verification by the principal. Typically, this will confirm information about the type of business that the policy covered and the extent of the financial exposure on the policy.

One method that can be used to evaluate the future claims is to allocate a proportion of the actuarially evaluated IBNR to each policy or policy/loss based on factors that are thought to be significant for the type of business written. The advantages of this approach include:

- It is equitable to all creditors whether they are large or small.
- The allocation is based on a methodology that has been agreed as fair as part of the scheme and therefore cannot be disputed if this is the line that the scheme administrators want to take.
- It handles high volumes of policies at relatively low cost, as policies do not need to be dealt with and analysed individually.

Once the IBNR has been allocated to policy level then a very valuable piece of information has become available to the run-off. If the systems are flexible enough then it should now be possible to view the company's ultimate debtors and creditors. This enables credit control departments to focus on companies that will be the target debtors of the company with some very powerful information to back up any commutation discussions. The split of the balances between inwards and outwards business, the split between paids, outstandings and IBNR, as well as the split of these figures by types of business, all provide potentially invaluable negotiation tools.

With ultimate level debtor creditor information available to the run-off it also becomes more practical to begin to model various run-off scenarios. Which companies should be approached first for commutations? Based on a given collections and commutations strategy, what are the cash flows for the company going to be for the next few years? When is the optimum time to consider a scheme as a closure mechanism? How and when will maximum value be extracted from the run-off? If IBNR estimates change as a result of external influences or a further data cleansing exercise then what is the impact of this new information on the run-off strategy?

By having the ultimate balances available at principal level sooner rather than later, the managers of the run-off are better placed to make informed decisions about the future strategy for the run-off and the appropriate exit strategy, scheme or otherwise.

How to circularise the information?

Historically, paper has been sent out as the main means of communicating with principals. With the increasing use of the internet as a serious business tool in recent years it has now become a more acceptable means of inter-company communication and some recent schemes have taken advantage of this. There are a number of factors that need to be considered before deciding on the most appropriate means of communicating in a given scenario:

'A cost benefit exercise should demonstrate whether it would be cheaper to process the returns via a more automated route'

- How many principals are going to be contacted?
- What is the mix of principals between individuals, non-insurance companies and insurance companies?
- What is the expected level of response?
- What are the skills and experience of the team that will deal with the returns? How easy will it be to increase staff numbers, if required, to deal with peak periods?

If the number of creditors to be circularised is very small then a paper circularisation may well be the most effective means of communication. As the numbers increase, all other factors being equal, the advantages of an electronic solution begin to add up.

Once the returned data is available in an electronic format then it is easier to analyse the returns via an automated or partially automated process. For large circularisations the savings here can be great, as the number of staff required to deal with the returns can be significant. If the changes that are being made to the data are below the level deemed to be material then an automated system could allow them to be processed with little or no further checking, allowing staff to concentrate on the higher value items.

In many instances there may be a large number of staff available to process returns. The mindset of many organisations is that the cost of using these staff to process returns is nil, as they are there anyway. While potentially in the interests of the staff, this may not be in the best interests of all of the other stakeholders. A cost benefit exercise should demonstrate whether it would be cheaper to process the returns via a more automated route and use fewer staff, freeing up people to perform more valuable tasks.

Knowing the full range of circularisation options available to a particular scheme, their relative strengths and weaknesses and the typical cost of each of the options, allows the team to be in the best position to make the right decision for any given scheme. ●

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