A MARRIAGE MADE IN HEAVEN

About Equitas
Equitas is a group of companies set up by Lloyd’s of London in 1996, specifically to reinsure the non-life liabilities that had accumulated in the syndicates at Lloyd’s from the 1930s up to and including 1992. It is the world’s largest solvent run-off reinsurer, with gross outstanding claims of approximately $35 billion at its inception in 1996. These mainly comprised asbestos, pollution and health hazard liabilities (APH), which are extremely long term and expected to be paid out over a period in excess of forty years (as estimated by PwC, their independent accountants).

One important note: as Equitas is only the reinsurer for the “Names” of Lloyd’s, the legal liability to pay valid policyholder’s claims remains with the Names. Therefore in spite of the premiums that the Names have paid to fund Equitas, they are still liable to pay more should funds at Equitas run out. Sceptics have long believed that this will be the case, fuelled by the lack of clarity in Equitas’ financial reporting. However, all this could change pending the successful completion of Phase II of the deal between Berkshire and Equitas.

The amazing story of what some are calling ‘the deal of the century’. Geoff Atkins tells the story of the glorious union of the happy Bride (Equitas), the Bride’s Father (Lloyd’s of London), the extended family (the Names) and the happy Groom (Berkshire Hathaway) and how the congregation lived happily ever after too!

The Happy Bride — Equitas
Since its formation, the Trustees and Management of Equitas have had an unenviable task. They are trying to settle vast amounts of uncertain liabilities with the finite resources at their disposal — a fixed pool of money plus some old reinsurance protection of doubtful value.

Over the first ten years of the life of Equitas, they appear to have done a good job. The latest liability estimate is down to about 36 per cent of the original amount. The buffer between assets and liabilities, originally a fairly skinny six per cent, is still at 12 per cent — not exactly a comfortable situation, but ‘so far so good’.

Now, Phase 1 of the deal has already given them a much greater buffer of protection. Berkshire has promised an extra $A6.9 billion, which makes the buffer above current liability estimates a healthy 88 per cent before Equitas runs out of money.

The bride has married into money.

The Bride’s Father
Lloyd’s of London was on the verge of collapse under the weight of the emerging and unmanageable legacy liabilities before Equitas was established. While the efforts to separate Equitas and its lingering issues was reasonably successful, it has continued to be a potential problem for the long term viability of the Lloyd’s market and many of the businesses it supports.

Getting the infant daughter to leave home in 1996 was important, but the father has never been completely free of her.

Now, the financial security of Equitas seems to be assured, for the first time in its existence. Lloyd’s has contributed some money to the deal — $170 million in Phase 1 — but that amount is quite small in the context of Lloyd’s turnover and assets. It would appear to be extremely good value for Lloyd’s if it is to achieve the promised benefits.

Father has topped up the dowry, but it looks like a small amount to pay to be rid of her.

Phase 2 of the transaction will involve a further
payment of $43 million from Lloyd’s. Again, that seems to be a very modest financial price in order to achieve legal as well as financial separation of all the legacy liabilities that are in Equitas.

At present, the structure is one of reinsurance. The liability for the original claims still sits with the Lloyd’s syndicates (and the Names making them up). While it is one hundred per cent reinsured with Equitas, if the reinsurance fails, the liability falls straight back onto the original insurer (the Names).

Phase 2 is different in that it completely removes the Lloyd’s syndicates and Names from the picture. A scheme of arrangement is used to legally substitute Equitas as the insurer in all of the original transactions and the policyholders then have no claim against Lloyd’s at all.

**Phase 2 will sever the family relationship completely, and a further downy top-up from Father will be a small price to see the end of it.**

**The Extended Family — the Names**

Many thousands of individuals from around the world – most well-off but with no knowledge of the insurance business – joined the Lloyd’s family by signing up as part of one or more of the syndicates.

Syndicate membership was offered as a three-year fixed term investment, after which profits (or losses) would be cashed out, with the opportunity to ‘roll over’ the investment into a new syndicate year. However, as the legacy problems emerged it became more difficult to close out the syndicate year and by the time the legacy problems reached their peak there were hundreds of syndicates involving thousands of Names that remained on risk with no prospects of closure.

Equitas gave a nearly complete solution for the Names. Establishing Equitas was very difficult, but it provided by the Berkshire reinsurance changes the equation for the Names from a ‘fingers crossed’ situation to a remote possibility.

Phase 2 is where the real benefit arises for the Names. The legal transfer of their original insurance liabilities to Equitas gives them true finality for the first time. Once and for all, they can no longer be called upon to meet insurance claims from policies issued decades ago.

Of course by this time it is not just the Names themselves who are grateful, but for many of them it is their estates. The Names are real people and many have died since they signed up for their share of Lloyd’s business.

In any event, I can imagine a noticeable ‘blip’ in the sales of vintage champagne as the rebates are spent on small celebrations of freedom.

**Phase 2 will release a large Extended Family from their ongoing responsibilities, and the Groom might even buy them a drink to celebrate.**

**The Happy Groom — Berkshire Hathaway**

Berkshire is an organisation that exists to make money for its shareholders. The largest shareholder is the world’s most famous investor and one of its richest men – Warren Buffett.

Buffett explains that the ‘float’ of policyholders’ premiums between payment of premium and settling of claims provides a very nice extra pool of investment funds. The ‘cost of funds’ is the underwriting loss on the insurance business (if any). Berkshire is not afraid of an underwriting loss so long as it is small relative to the return it can make on the investment of funds. Of course in the years when there is an underwriting profit, the cost of funds to Berkshire is actually negative.

---

**About Berkshire Hathaway**

Berkshire Hathaway is a large holding company that owns a diverse range of businesses, with insurance being its core business. Originally a textile company, it was taken over in 1965 by its current CEO and Chairman (and also its largest shareholder) Warren Buffett, and has since grown into the large multinational organisation that it is today. Berkshire is one of the world’s most successful companies, averaging a 21 per cent+ annual return to shareholders over the last thirty years. Much of this return is generated by using the ‘float’ provided by Berkshire Hathaway’s insurance operations (that is, the premiums from insurance policies which it holds temporarily until claims are paid out) to finance its investments in a diverse range of companies. This strategy is only possible for Berkshire because of the substantial amount of assets at its disposal.

NIC and all of Berkshire’s major insurance subsidiaries maintain an exceptionally high level of capital strength and are currently rated A++ (Superior) by A.M. Best and AAA by Standard & Poor’s for their financial condition and operating performance.

General Re, generate substantial ‘leveraged’ investment funds for Berkshire.

The best description of Berkshire’s business is that it is an investment company – it invests the funds of shareholders in order to generate profits. Berkshire has never paid a dividend, so if a shareholder wants to spend any of the profits they sell some shares, and the consequence for Berkshire is that its investment funds have grown very rapidly.

Buffett explains that the ‘float’ of policyholders’ premiums provides a very nice extra pool of investment funds. The ‘cost of funds’ is the underwriting loss on the insurance business (if any). Berkshire is not afraid of an underwriting loss so long as it is small relative to the return it can make on the investment of funds. Of course in the years when there is an underwriting profit, the cost of funds to Berkshire is actually negative.
Most insurers would be very wary of using the policyholder premium float for investment other than in low risk fixed interest securities, and rightly so. The difference with Berkshire is that the net assets of the company are so enormous that if part of the investments were to go bad, there will still be plenty of money to meet claims. Berkshire is not afraid of taking calculated risks with its shareholders money, and the way it runs its insurance business is no exception.

For Berkshire, the deal provides:
- a big lump of funds for investment ($10 billion)
- a long time horizon for the investment, because the liabilities stretch over a long period of time
- the claim risk, i.e. how the eventual cost of all the insurance claims compares with the current estimates of that cost
- a key position of influence in how the future cost of the claims actually emerges.

The investment aspect of the deal is what makes it a winner for Berkshire, and why no other insurer in the world could do the deal.

The value of more investments for Berkshire

The deal brings investment funds of $10 billion to Berkshire. The liabilities are valued using a discount rate of 4.3 per cent, meaning that an investment return at that rate is needed to supplement the claim reserves each year. Any return above 4.3 per cent contributes to profit for Berkshire.

Based on the quoted average period of 11 years for payment of the claim liabilities, the table below shows the (very approximate) extra profit to Berkshire from higher investment returns:

<table>
<thead>
<tr>
<th>Investment Return p.a.</th>
<th>Extra Profit $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>460</td>
</tr>
<tr>
<td>6%</td>
<td>1,040</td>
</tr>
<tr>
<td>8%</td>
<td>2,000</td>
</tr>
<tr>
<td>10%</td>
<td>2,700</td>
</tr>
<tr>
<td>12%</td>
<td>3,300</td>
</tr>
<tr>
<td>15%</td>
<td>4,000</td>
</tr>
</tbody>
</table>

We can only speculate as to whether Berkshire’s sums on the deal factor in an extra two, three or four billion dollars for the higher investment return they are likely to achieve.

This marriage brings the Groom a nice big chunk of what he really loves.

Claim risk

The claim risk will no doubt have been carefully weighed up, but only to the point of ‘sufficient comfort’. It is reported that Berkshire had looked at this deal previously, but at the time could not be comfortable with the risk involved with asbestos claims. It is probable that the apparent success of Equitas over the last decade, perhaps allied with the passage of time, has now made the difference in Berkshire being comfortable with the risk.

Berkshire may well think there is a good chance of making an underwriting profit (i.e. the liabilities eventually running off less than the reserves), but they will also be conscious of the downside risk, and will have a level of comfort that such a risk is manageable and within the parameters of what they can afford from investment profits and their large capital base.

It appears that the Groom knows enough about the Bride’s problems and is not afraid of them.

Position of influence

One of the most fascinating things to observe in the next few years will be how Berkshire exercises its new position of influence in the progression of legacy claims. The majority of the claims are from asbestos and pollution in the US where Berkshire has its home. Equitas was one of the few insurance organisations with enough involvement to make it really worthwhile to try to influence ‘the system’ for asbestos claims. Equitas has recently begun to do this, with strong efforts to raise the standards of proof necessary to establish compensable disability from exposure to asbestos.

Equitas has also supported the still-unsuccessful bid for sweeping law reform in the US, with the FAIR plan still stalled.

The deal

The agreement

National Indemnity (NIC), a member of the Berkshire Hathaway group of insurance companies, will:
- reinsure all Equitas’ liabilities
- provide up to a further $8.4 billion of reinsurance cover to Equitas
- take on the staff & operations of Equitas and conduct the run-off of Equitas liabilities.

The Implementation

**Phase I**

NIC will provide reinsurance cover to Equitas of $6.9 billion over and above the 31 March reserves ($10.5 billion) less adjustment for payments and recoveries since that date.

Premium payable to NIC will be:
- all of Equitas’ assets less $410 million
- contribution of $171 million from Lloyd’s.

Staff and operations of Equitas and the management of the run-off will all pass to an English subsidiary of Berkshire Hathaway.

It is expected that upon completion of Phase I a small premium will be paid to Reinsured Names (distributed pro rata to their Equitas premium).

**Phase II**

Equitas will seek approval of the High Court to transfer all the liabilities of the Reinsured Names into Equitas or a subsidiary of Berkshire Hathaway. Prior to this approval, the Equitas Trust will continue to provide a measure of oversight of the management of the run-off of liabilities.

If this transfer occurs before the end of 2009, NIC will provide up to $1.5 billion of additional reinsurance cover for a further premium of up to $95 million.

At the time of this transfer, or on 31 December 2009 if this transfer has not occurred, Lloyd’s will provide a further contribution of $43 million.

Note: the premium payable for the Phase II reinsurance, the future costs of the Equitas Trust, other costs of running Equitas and any payments to Reinsured Names will be paid out of the assets remaining with Equitas.

**Current status**

Completion of Phase 1 occurred prior to 31 March 2007 (as scheduled) following approvals from the FSA, regulatory authorities in the US & Equitas Trustees.
I can imagine Berkshire continuing to support the efforts of Equitas to tighten the evidentiary requirements for asbestos claims. Berkshire can have a lot of influence if its management so chooses, so this is one to watch.

I wonder, though, if Berkshire would support the FAIR plan? Execution of this plan would mean each defendant (and Berkshire will be one of the biggest) paying a negotiated lump sum to a huge trust fund. Would Berkshire be willing to give up the funds it has just acquired? One can imagine it being very difficult for Berkshire to negotiate its contribution downwards, since it has the ultimate ‘deep pocket’.

Equitas appears to have been successful in negotiating commutations with insureds. Will Berkshire continue this approach, and will it be as successful? Berkshire may have less enthusiasm for commutations, because it would pay out funds sooner and remove assets from the investment pool. Also, it may be harder for Berkshire to convince insured parties to accept a discounted ‘bird in the hand’ amount when the future security of Equitas looks to be assured. It is probable that part of the success of Equitas in commutations is due to the insured parties recognising that if they don’t take the cash now, it just might not be there in future.

How will the Groom throw his (substantial) weight around in the life of the Bride?

Great news for the congregation too — reason to celebrate

This deal of the century is not only good news for those directly involved – Equitas, Lloyd’s of London, the Lloyd’s Names and Berkshire. Around the world there is a very large population of insurers and other corporations who still have insurance with Equitas, and in turn the claimants against those insurers and corporations who are relying at least in part on Equitas meeting its claim liabilities.

With Berkshire, these people all now enjoy the best security there is in the insurance business, at least in the private sector. (In fact the Berkshire security would probably be regarded as better than a lot of governments!)

Not only is their confidence in being paid greatly increased, for insurers who have risk-based capital regimes applying to them there is an immediate financial benefit. This arises because the capital charges applying to reinsurance recoveries vary with the credit rating of the reinsurer.

In Australia, for example, reinsurance recoveries from Equitas attract a capital charge of four per cent (meaning that the Minimum Capital Requirement for the insurer includes an amount equal to four per cent of the expected recovery from Equitas). After Phase 2, the re-rating of Equitas should mean that the capital charge will be the lowest available, or two per cent.

Similar regimes apply in other parts of the world, and are likely to spread further as regulatory standards evolve. Thus every insurer with remaining coverage from Equitas gets a direct financial benefit in terms of improved capital adequacy.

There is a very large congregation who have an interest in the future of this Bride — and the financial strength of the Groom makes them all winners from the marriage.

Truly, a marriage made in heaven.

1 All money amounts are shown in $A at current exchange rate.