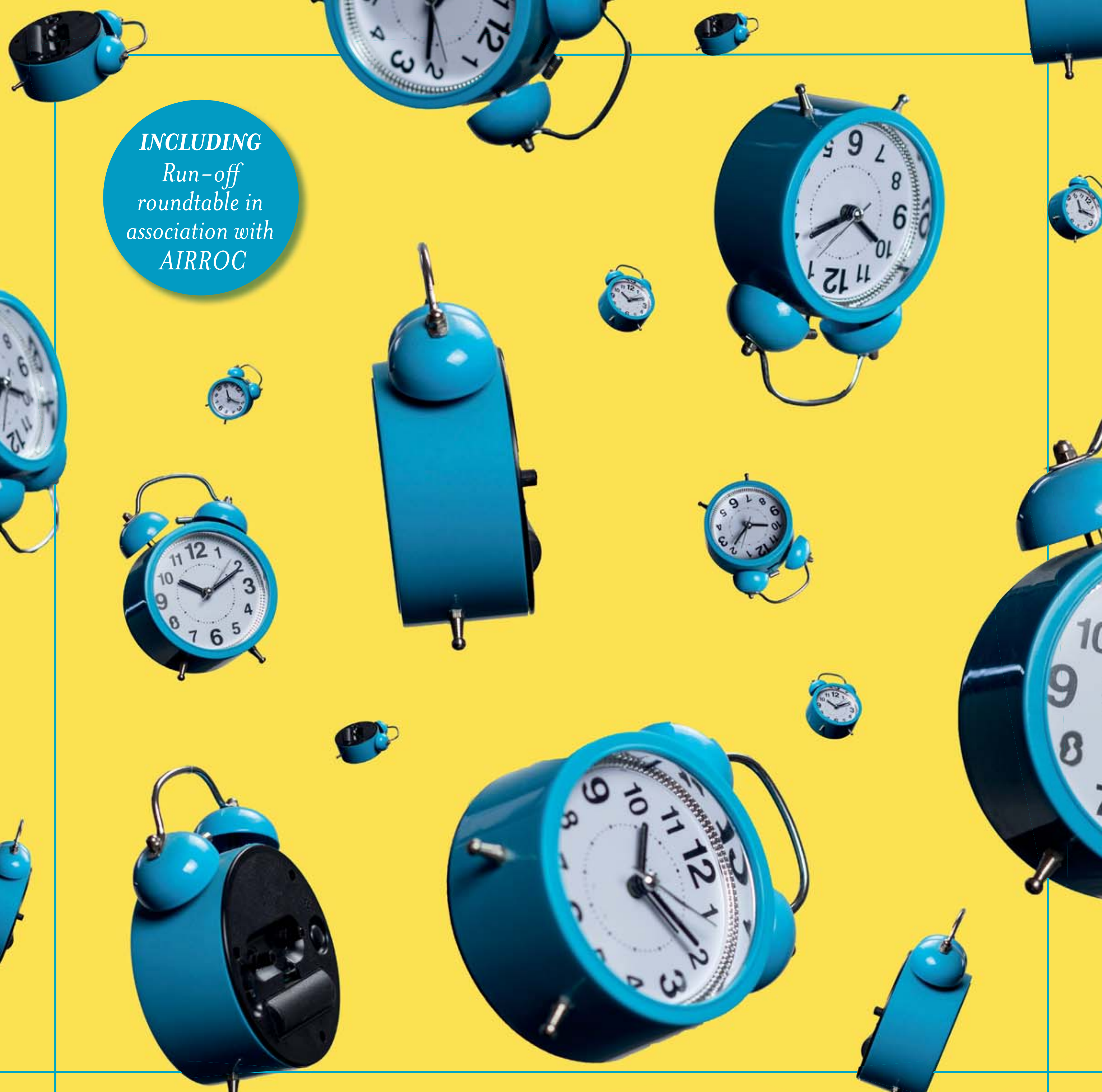

INCLUDING
Run-off roundtable in association with AIRROC

LEGACY SOLUTIONS 2019

STRATEGY
Advantages of a run-off solution

POTENTIAL
The legacy market boom

RETHINK
Releasing locked-up capital

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The run-off renaissance

Historically viewed as a 'last resort' move, the contributors to this *Captive Review* Legacy Solutions report show us that in 2019, the run-off space is in fact thriving as a strategic risk tool.

Gone are the days of the desperate captive manager looking to get old lines of business off of their books; run-off is nowadays more commonly deployed in strategic fashion – to free up trapped capital in order to write new lines of business or return to investors.

M&A activity, more firms entering the space, and more capital entering the space, too, are all factors serving to transform the run-off marketplace. Not only is the space and the practice of run-off becoming more well-known as a strategic option, it is also gaining general awareness now that its former reputation has begun to change.

Having read through this report, our readers are sure to get a strong sense of what the run-off market in 2019 looks like, and how they may themselves consider putting a run-off solution to sound strategic use.

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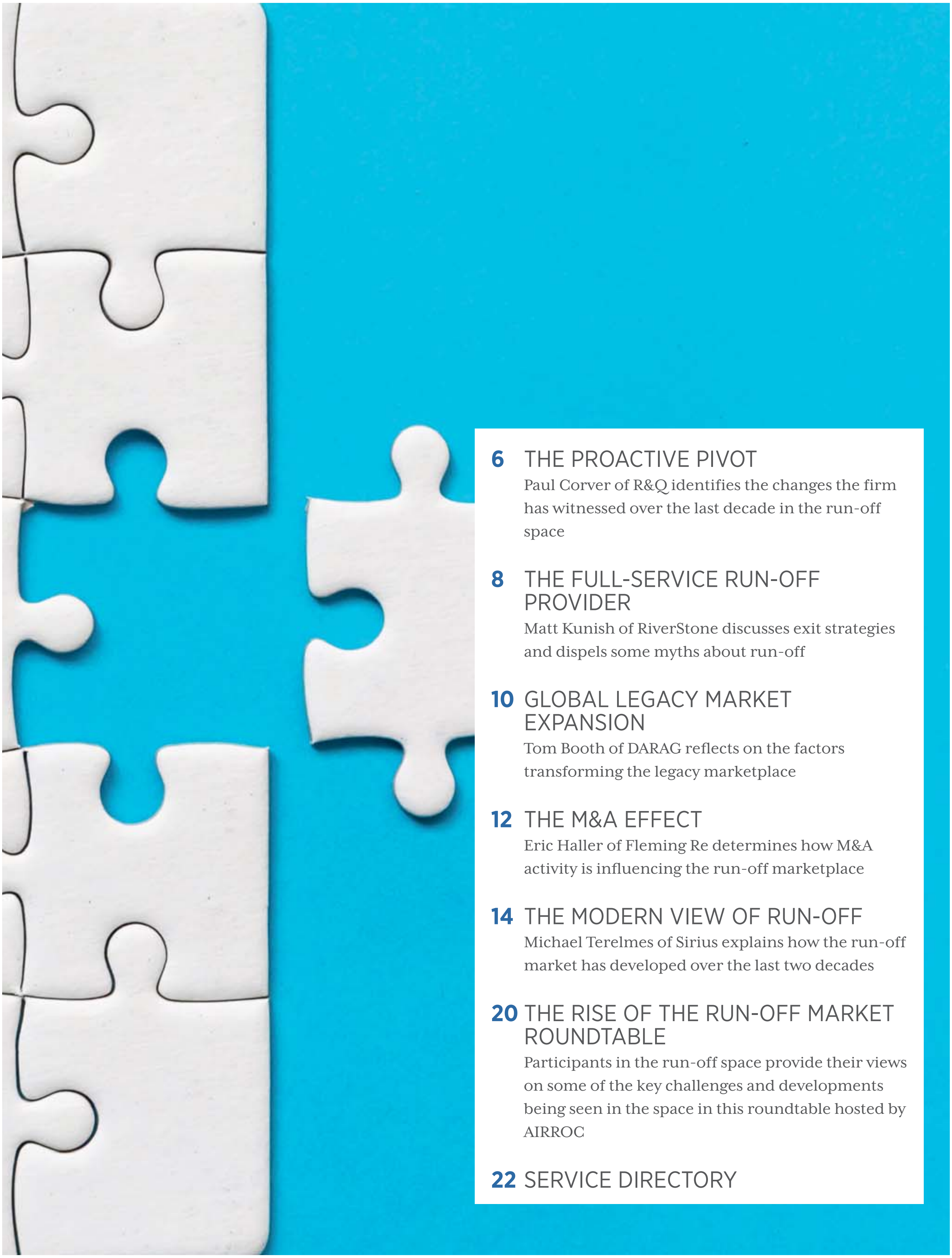
Published by Pageant Media,
One London Wall, London, EC2Y 5EA

ISSN: 1757-1251 Printed by The Manson Group



THE PROACTIVE PIVOT

Paul Corver of R&Q identifies the changes the firm has witnessed over the last decade in the run-off space

Captive Review (CR): R&Q has been actively providing solutions to captives for their discontinued business for over 10 years. What has changed in that time?

Paul Cover (PC): R&Q has been actively acquiring liabilities from insurers and reinsurers for almost 30 years and has been the lead run-off acquirer in the captive space for the past 10 years. Early captive deals were generally acquisitions or transfers of business from captives that were no longer utilised. However, over time and as the captive sector has become more aware of the benefits of proactive run-off management, we are undertaking more deals with captives and other self-insurance structures that are actively underwriting: clearing out the 'dead wood' of old years, discontinued classes or perhaps disposed operations and recycling capital to be used for fresh underwriting.

While we still see opportunities to acquire captives that are no longer utilised, there is a clear move to a more proactive state, which mirrors what has been happening in the wider insurance and reinsurance commercial market.

CR: How many transactions has R&Q completed in the past 10 years?

PC: R&Q has completed 95 transactions in all since 2009, 40 of these were with captives and 26 with other self-insurance structures such as RRGs or workers compensation self-insurance trusts. The captive and self-insurance sector is a key market for R&Q.

These transactions have been across 34 different legal or regulatory jurisdictions covering the US, Bermuda & the Caribbean, the UK & Europe as depicted in the charts on page 7.

Paul Corver

Paul Corver is the group head of Legacy M&A at R&Q and has been active in the run-off space for almost 30 years. Aside from managing both solvent and insolvent run-off companies, for the past 10 years he has been actively acquiring portfolios of legacy liabilities for R&Q. These have included acquisitions, LPT's, Part VII and business transfers, novations, mergers and assumptions. Transactions have been concluded in numerous territories and with companies such as Unilever, John Laing, Virgin Atlantic, Clariant, Astra Zeneca, Chubb and Axa LM.

CR: How important is execution risk and reputation of the counterparty for captives disposing of run-off liabilities?

PC: Execution risk and reputation are as important as price in our experience. A track record of closing deals in the relevant jurisdiction in a timely basis and having access to financing are important to sellers. A great price does not mean much if the funding is not there.

For disposals, a seller must be confident that the regulator of their captive will approve a change of control to a buyer. It may be the case that a seller wants a transaction completed within a certain time frame and does not have confidence that a buyer can meet the deadline.

Another key consideration is having the licensing and platforms required for novations, transfers and reinsurance deals.

Reputation and demonstrating a knowledge and operational capability to handle the liabilities being disposed of is important. The liabilities can often relate to the seller's past or present employees or customers and the seller must be confident that the liabilities will be managed appropriately.

CR: R&Q has rated carriers in the US and EU. How important are these for providing the appropriate solution?

PC: R&Q has two A-rated, fully licensed carriers in the EU and US and we have found the ratings to be very impactful to our legacy solutions offerings. There are very few legacy consolidators with rated paper and many corporates and insurers security committees need rated paper in order to transact (re)insurance transactions. We have found that our ratings open up markets that were not previously available to us.

The rating provides an additional market standard that gives potential counterparties greater comfort around the financial strength, leverage, growth, transparency and capital management than unrated consolidators. R&Q have seen that having rated entities can reduce collateral requirements and benefits the cedant with reinsurance credit that comes from transacting with a rated run-off partner.

The ratings are particularly favourable for reinsurance transactions where removing discontinued books, old years or corporate deductibles will give an immediate capital benefit to sellers in addition to removing the cost and associated administrative burden associated with retaining these liabilities.

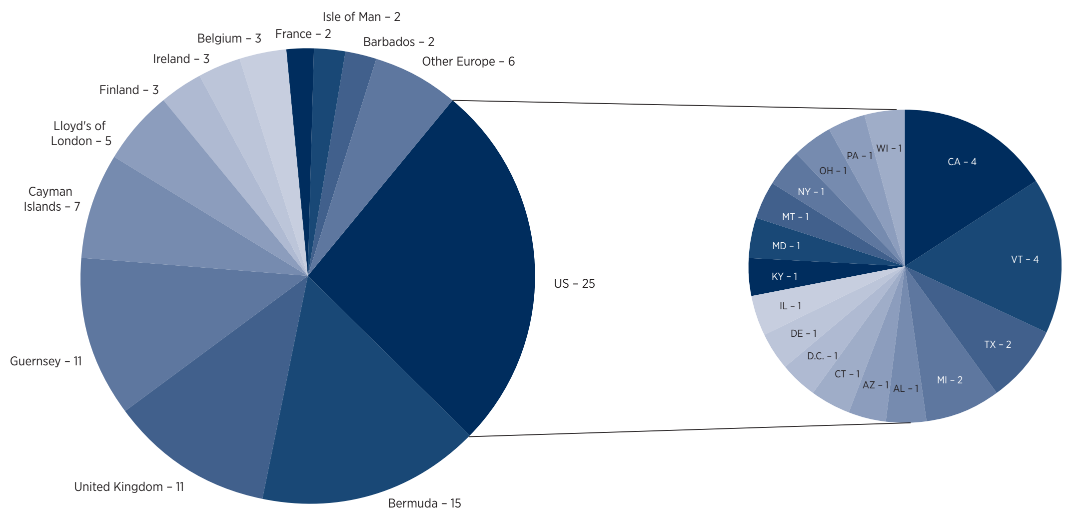
CR: What type of structures does R&Q now utilise?

PC: A wide variety of structures are utilised to provide the contracting party with the most suitable solution for their requirements. Outright acquisition has been the

CLOSED DEALS BY JURISDICTION, 2009 TO SEPT 30, 2019

Other Europe

Cyprus	1
Denmark	1
Gibraltar	1
Liechtenstein	1
Malta	1
Norway	1



most prevalent and that gives full finality to the captive owner. However, we are now seeing an increase in novations, LPTs and other transfers especially where the contracting party is an active and ongoing entity.

More bespoke structures have been used where rated paper is needed, such as assumption agreements for workers compensation liabilities from a self-insurance trust.

Whether discontinued liabilities are on licensed balance sheets or corporates, R&Q has the breadth of licensing and expertise to deliver legacy solutions that fit its clients' needs, as summarised in the chart below.

CR: Is effective use of run-off restructuring widely recognised in the captive space? If not what are the barriers?

PC: R&Q have completed 66 run-off restructuring transactions with captive insurance companies or other self-insurance vehicles in the past 10 years. The captive sector is becoming far more aware of the benefits of proactive run-off management and disposal.

Captives can be used to retain risk from the corporate parent enabling the group to retain premiums and underwriting profits, receive enhanced insurance terms and gain better access to the global reinsurance markets.

If there are changes in the market conditions and corporate structure or management, this can result in captives seeking run-off solutions as the demand or need for the captive reduces. Additionally, high claims volatility and long-term exposures can also drive desire for run-off solutions.

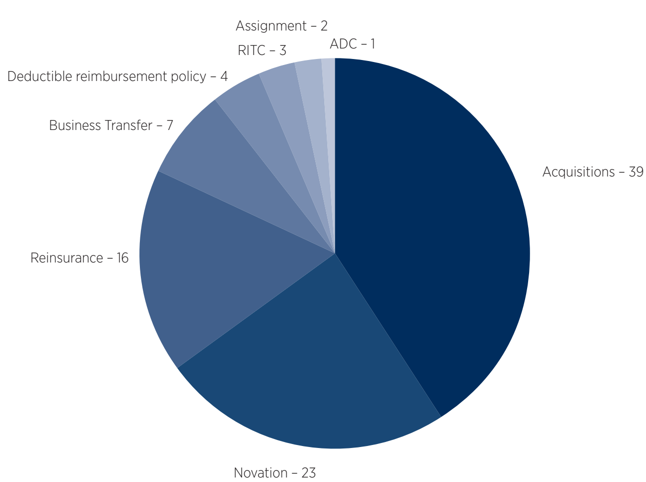
However, there are challenges in some jurisdictions due to regulatory or market conditions, for example in Luxembourg, captives with large equalisation reserves can be hard to restructure using traditional run-off solutions due to the high levels of tax applied should they be released. This is often an unattractive option for captive owners.

However, the run-off sector has always been innovative, and solutions will be found to address most challenging situations.

CR: With a reported hardening of insurance rates, what can captives do to expand their portfolios?

PC: As rates harden for certain classes, or rates for new exposures such as cyber risk are deemed expensive, there will be attractions for companies to put more of the risk in their captive, especially if they feel they have far stronger risk controls than the sector's average. In order to help finance the addition of new exposures, the captive should review its legacy as disposal of older, maybe long-tail liabilities should free up capital that can be used to support the new generation of underwriting activity. There is little benefit for a captive carrying trapped capital supporting old liabilities when it can use that capital to place more risk into the captive.

CLOSED DEALS BY TYPE, 2009 TO SEPT 30, 2019



THE FULL-SERVICE RUN-OFF PROVIDER

Matt Kunish of RiverStone discusses exit strategies and dispels some myths about run-off

Captive Review (CR): What are the most common reasons a captive may look to an exit strategy?

Matt Kunish (MK): Captive owners may look to an exit for a variety of reasons. We've seen situations where it could be the sale of the whole company or the merger of two companies; both have a captive and the acquiring parent company no longer wants or needs the smaller company's captive.

In the case of a group captive, there may be participants who want to utilise the capital that is tied into the captive for other strategic purposes. Those individuals can exit the captive while the remaining participants can maintain the ongoing captive.

There are also situations where the experience may not have been what the owner of the captive expected, and they simply want to return to the commercial market removing the need for the captive.

CR: What forms does this process take?

MK: There are three main forms that it can take. The first and simplest being an outright sale of the captive - a stock transfer where a party such as ourselves literally acquires the legal entity and all of the insurance policies that come with the entity, along with its balance sheet.

A second transaction is a novation which could also be done of certain insurance policies – a move that is easier if the captive is a single parent, and ergo the only insured. In this situation, an owner may only want to dispose of a certain line of business or a number of policy years.

The third scenario is a reinsurance arrangement. The captive buys a reinsurance contract that could take the form of a loss portfolio transfer where all of the reserves get transferred and/or as an adverse development cover, such that it protects the downside for the captive.

The reinsurance agreement is typically the easiest and most efficient method to effect. The novation and sale of the captive typically require another layer of approvals from the regulator.

No matter what type of transaction it is, the key to being able to effect it quickly is the ability to access the relevant information. It helps to have a motivated seller so that we receive timely answers to important questions. Without it, there can be significant delays. Overall, and if everything works smoothly, the process tends to take around 3-4 months to complete for whichever exit strategy is chosen.

Matt Kunish

Matt Kunish is the chief business development officer at RiverStone, a run-off and legacy solutions provider. With over 25 years of insurance industry experience, he leads the actuarial and business development groups in the US. Kunish began his career as a consulting actuary for Deloitte (formerly Bacon & Woodrow) in London. He earned a BSc with honors, in mathematics and economics from the University of Bristol.

CR: Do a lot of clients who come to you have a developed understanding of what they can expect when they look to an exit strategy?

MK: Typically, no. We've found that captive owners don't necessarily have the insurance expertise. This means an upfront education is required; we like to meet with clients face-to-face and explain exactly how the process works, what we need, why we need it, and more.

All of us providers in the run-off space have realised with captives that more education is needed. We are all making the effort in terms of educating the space, whether it is the owners themselves, the captive managers or all of the other service providers. I think we agree that more education is needed as time goes on. It is going to take time for everyone to get comfortable with run-off in the captive space and how it can be used strategically. The reality is that closing transactions and demonstrating to people that we can achieve what we have stated will help build momentum. People will naturally become more comfortable with the concept when they see others doing it as it becomes a more familiar practice.

> "We like to meet with clients face-to-face and explain exactly how the process works"

We are likely a few years behind the traditional space where run-off has been very successful, but I believe all of the run-off providers can offer a service that is unique. Captive owners and their respective advisors should look to RiverStone to provide solutions, knowing that we can be creative and address each situation individually. We will evaluate and advise our clients on the best way in which to proceed given their unique set of circumstances.

CR: What are the main benefits of the services you offer?

MK: Depending on the situation, there is economic finality to be gained via the reinsurance arrangement as well as legal finality in the sale of the policies. If the captive is no longer being used, there's an obvious expense drag around maintaining the captive, and these can also be defrayed with an exit strategy. And ultimately, if there is money trapped in the captive – which may be in the form of share capital or collateral – the exit strategy gives the captive owner an opportunity to gain this back to deploy elsewhere. Whichever of these situations the captive is in, RiverStone can advise and implement a successful path forward.

CR: What unique service provision does RiverStone offer its clients?

MK: We have been doing these types of transactions for over 20 years in the commercial space with in-house capabilities. Not only do we have a balance sheet that can take the insurance risk, we also have teams of actuaries, claims processors, legal experts, and reinsurance collectors. We see ourselves as a full-service provider in this space. We manage every aspect of the run-off; we do not typically outsource anything and can, therefore, be held fully accountable. We are not relying on other companies; each client receives our utmost attention and focus.

CR: Are there any myths around run-off that you want to dispel? How do you see the space moving forward?

MK: People need to understand that run-off is, in fact, a growing space. Typically, run-off is thought of as a place where companies 'go to die' but what we've been seeing for a number of years in the commercial space and now increasingly in the captive space, is that run-off is being used as a strategic tool. It is not merely a last resort if all else fails. Companies are nowadays utilising run-off to get economic or legal finality, capital management, and also able to deploy if something is not core to the ongoing business, then reaching out to a run-off provider like RiverStone, can remove another headache for them.

GLOBAL LEGACY MARKET EXPANSION

Tom Booth of DARAG reflects on the factors transforming the legacy marketplace

A multifaceted transformation has started to reshape the worldwide legacy sector. At its core is the growing realisation that run-off is a practical, respectable, and sound business tool which can be beneficial to policyholders, risk carriers, and investors alike.

Not long ago, the transfer of a company or risk-pool portfolio to a run-off specialist was a last-resort alternative pursued only in the wake of failure. Now it is an option frequently and actively considered by strong, live businesses that wish to improve their outcomes by transferring only a portion of their outstanding liabilities, perhaps a class of business or a book underwritten in certain years, and by brokers with clients in possession of redundant captive insurers.

Tom Booth

Tom Booth joined DARAG in July 2018 after almost 10 years at R&Q, mostly as group CFO. He worked primarily on legacy M&A activity during his tenure at R&Q. He has extensive experience of portfolio transfers and insurance company acquisitions across a wide range of European markets. Booth previously held insurance M&A and capital markets roles at Numis, a London-based investment bank, and at Aon.

European advantage

Europe is a key region where this course of action has proved valuable. British and continental insurers have warmed to the solutions offered by legacy providers as the balance-sheet benefits they may deliver under the EU's Solvency II capital requirements have become clear. A legacy transfer will reduce the capital required to back business underwritten in discontinued lines of business, or for prior years' underwriting, either to increase solvency ratios or to release regularity capital for deployment against newly acquired risks. In the current business and investment environments, it is difficult to justify to shareholders the retention of capital-intensive portfolios when that capital could be deployed more profitably elsewhere, or returned to shareholders.

This clear business benefit has helped to dislodge the understandable belief of reputation-conscious insurers that portfolio transfer is a mark of failure. Instead, it is now seen as a savvy business decision. It is a choice made in partnership with established legacy carriers who will be jointly responsible for both their own continued success, and for that of the original underwriters. That goal is achieved only when the run-off manager deals with claims at least as well as their client insurers would have done.

It has become much more common in recent years for underwriting businesses to exit lines of business which have been deemed non-core, or to withdraw from specific territories. Sometimes this can occur as a result of underperformance, but the decision may also result from a business restructuring or a change in priorities. In either case, the transfer of old portfolios – often along with the claims experts who handle them – to a run-off specialist will reduce expenses, release capital, and improve outcomes for all.

Another related factor has driven the increase in European portfolio transfers. The long-term pressure of potential adverse reserve development – especially in today's environment of long-tail claims inflation, which is spreading from the US to the UK, Europe, and Australia – can be a weighty negative in the eyes of investors and regulators. This has often driven managements to seek relief through a portfolio transfer, particularly for lines such as industrial injury and motor liabilities.

A transfer which secures legal finality of liability for the relevant policies is in these cases more favourable than a solution such as an adverse development cover, under which liability that exceeds reinsured thresholds will return to the original insurer (although such reinsurances are often used to provide interim relief until a court-approved, final transfer can be arranged and completed). In other cases, a loss portfolio transfer may be more attractive.

However, some original insurers will choose to retain control of claims handling, but to divest the economic risk to gain balance-sheet advantage. In these situations, a reinsurance solution may be more attractive.

Benefits of insurance company transfer

A third area where the legacy market has proved its value has been in the transfer of captive insurance companies. A decade ago, captive insurance vehicles were seen as a must-have by the risk managers at many large corporations, but requirements in Europe and elsewhere to hold higher levels of regulatory capital have often made captive ownership into a costly operational experiment in an area of speciality which is alien to the captive owner, and even a capital sinkhole. In addition, a large number of captives have been made redundant through merger and acquisition activity.

Transferring costly or duplicate captives to a suitable specialist legacy provider alleviates these concerns, while providing stability and certainty for their corporate sponsors.

The process of transferring risk portfolios and captives to third parties has been eased in recent years by regulators' increased familiarity with run-off and its benefits. Legal frameworks such as the UK's Part VII transfer regime may be well established, but regulators have not always been the first to see third-party run-off as a valid alternative for continuing strong underwriting businesses. That situation has shifted dramatically with the increase in run-off activity and the significant expansion of the legacy sector.

> "In the current business and investment environments, it is difficult to justify to shareholders the retention of capital-intensive portfolios when that capital could be deployed more profitably elsewhere"

Insurance supervisory bodies' widespread acceptance of the proposition of business transfers has been supported by better-informed insurers, and better-capitalised, more experienced legacy carriers. European regulators including BaFin (Germany), have also seen the benefits that accrue to the stability of the insurance market overall through the successful execution of legacy transfers, since they result in the improved strength of continuing insurance entities. Regulatory staff are now much more confident in assessing the viability of proposals to transfer prior-year and discontinued risk portfolios.

Established market players

A further boost to regulators' confidence has arrived with the evolution of several dedicated legacy market players with very large balance sheets. Any regulator's greatest fear must be the approval of a transfer of business to a standalone run-off manager that is unable to meet the commitments under the transfer that now rests solely with that third party.

Despite exceptional due diligence on the part of the legacy acquirer, and even when claims and asset management are exemplary, it is possible for transferred portfolios to generate a loss. The very large balance sheets of the world's strongest legacy providers, fuelled by a broadening investor appetite to profit from run-off, are able to withstand such eventualities. This has bolstered regulators' faith in this expanding sector of the insurance market.

At present the legacy market is well capitalised, but not overcapitalised. Alongside the growing flow of legacy portfolios for transfer, that has made competition to assume portfolios healthy, but not reckless.

Legacy specialists' operational efficiencies and focus on claims excellence means that transactions can be completed at prices which are beneficial for both parties to the transaction. That too will fuel the continued growth of the legacy market.

Most of the ingredients are in place for significant expansion to take place. Over the past five years, several new ventures have attracted capital and entered the growing sector. New entrants' success has not always been swift, since the reputation and experience of any run-off manager is critical to the creation of confidence among client insurers, but their presence indicates the opportunity that exists in the specialist legacy sector.

That opportunity is likely to increase dramatically as legislation matures, regulatory comfort with business transfers expands, insurers' understanding of the benefits of the process permeates boardrooms, and brokers continue to promote the third-party legacy market as an alternative to be considered by even the strongest insurers.

THE M&A EFFECT

Eric Haller of Fleming Re determines how M&A activity is influencing the run-off marketplace

Captive Review (CR): The expectation for the future of M&A activity is one of continued growth. What does this mean for run-off?

Eric Haller (EH): As we approach the start of a new decade, it is clear that 2019 was another year of positive growth in global M&A activity. E&Y reported that global M&A annual value has reached over $2trn since 2015, with a total of $2.6trn in 2018. Developed countries tend to dominate most cross-border M&A activity with the top countries being the United States and the UK. Corporate M&A trends point to further acceleration of deal flow, including the number and size of transactions. This is set to extend several years of record M&A activity.

Drivers of run-off transactions vary and include not only discontinued lines of business or companies but more recently an increased demand for finality solutions driven by M&A activity. M&A is increasingly occurring both within the insurance and reinsurance industry as well as in the broader corporate market across different industry sectors. There are distinct advantages to seeking a run-off solution for a book of business or even a company as a strategic corporate solution, as well as additional benefits specific to M&A transactions.

Specifically, with corporate M&A transactions, the acquiring company may not want to assume the exposures and other obligations related to the company being acquired. These exposures can be held in a variety of structures and we have seen a significant amount held within captive structures. A legacy transaction is perfectly suited to accomplish this goal.

During the last few years, there has been an increased level of appreciation of the benefits surrounding run-off. It is gaining wider recognition as a viable liquidity and financing solution that works for non-insurance corporates, insurance companies and captives. Market disruptions are also driving demand for new products and solutions. Run-off is becoming more readily accepted as a strategic tool for the overall efficient management of capital.

The challenges include determining which legacy providers have a strong understanding of the corporate M&A process, and which can achieve the clients' goals and also deliver a solution within the established deadlines. It is extremely likely that the high frequency of M&A activity will continue and the counterparties will look more at run-off and finality transactions as a viable solution. Corporations will favour solution providers who have a proven track record, continue to innovate and help the market evolve.

Eric Haller

Eric Haller is CEO of Fleming Re, a specialist run-off reinsurer based in Bermuda. Haller's reinsurance experience spans more than 20 years and includes business development, underwriting, treasury, accounting, investment management, risk and regulatory compliance. Haller has held senior roles at various companies, including Safe Harbor Re (CFO & CRO), Randall & Quilter Investment Holdings (head of North American M&A), Athene Holdings (head of strategic planning), XL Capital's Investment Management Group, and Deloitte & Touche. He graduated with honors from Marquette University.

CR: How does Fleming Re address legacy liabilities in a corporate M&A process?

EH: In a corporate M&A transaction, the acquiring company typically requires economic and legal finality of the historical liabilities. Acquirers prefer to have a clean start instead of assuming capital requirements, exposures and other obligations from liabilities not related to their ongoing business. The process for a legacy transaction supporting an M&A transaction requires a holistic, streamlined approach to determine the goals of the transaction, structural and jurisdictional considerations as well as the ability to transfer these liabilities within an expected timeframe that coincides with the final execution of the M&A transaction.

As an example, Fleming Re structured a run-off transaction to support a corporate M&A process. The client had several goals for the transaction – the most important of which was certainty of closure by the execution date of the overlying M&A transaction; timing was imperative. It should be noted that the secondary transaction can also be executed in advance of the corporate transaction closing so the transactions will be effective concurrently. We performed full due diligence, received regulatory approval, and finalised the transaction documentation within 30 days to achieve the client's goals.

Adding an additional entity into a transaction can also increase the complexity. This can be mitigated with clear communication between the parties. An important step in the communication process is to agree an established transaction timeline. Also critical is that the requirements of the run-off transaction are known and understood by each party involved. Knowledge of and experience in jurisdictional requirements and approval(s) is also an important factor in managing the process. As with any transaction, there could be multiple regulatory approvals required. Finally, providing complete information on a timely basis in order to facilitate the due diligence process is imperative.

CR: In corporate M&A transactions, what should acquirers understand about the process and benefits of run-off?

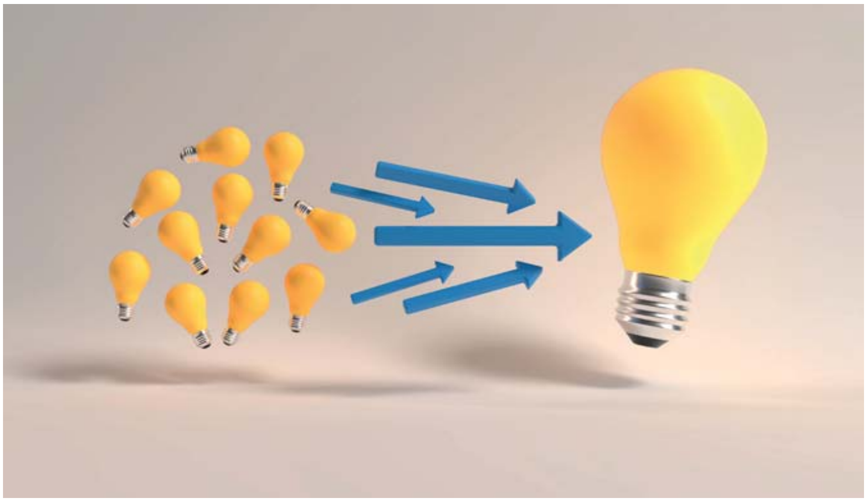
EH: Typically for run-off transactions that provide full finality, transaction structures take the form of acquisitions, loss portfolio transfer (LPT) with assumption (assumed risk), or novation. These solutions offer both economic and legal finality. Sometimes, to accommodate the M&A timeline, solutions that offer economic finality initially and then move towards full finality may need to be used. This would be done because economic-only transactions can usually be completed more quickly. For example, the run-off transaction can start with a reinsurance agreement (achieving only economic finality) and at a later date, the liabilities can be assumed through the established structures to provide full finality.

The transaction process is very similar to a typical run-off transaction. It will involve an initial evaluation of the transaction which includes identifying the client's goals, structuring options and an overall risk assessment; execution of a letter of intent to finalise the structure and outline the agreed-upon terms and timeline of the potential transaction; perform due diligence and ensure appropriate regulatory approvals are obtained; and finalise the transaction. Within this general process, any specific items required to accommodate the M&A transaction will be addressed.

Examples of benefits that can be achieved through legacy transaction solutions range from capital relief, full finality from liabilities, improved solvency and reduced burden of operating expenses resulting in more effective capital structures. We expect that captive owners will continue to consider the wide-ranging benefits achieved through successful run-off transactions.

CR: What differentiates Fleming from its peers?

EH: Over the last decade, solutions in the run-off market have evolved and are now more focused on the benefits that can be offered to counterparties versus transactions focused on toxic liabilities or solvency issues. Fleming Re has focused on three things that differentiate us: specialisation, cost structure/cost of capital, and flexible structuring. We are highly focused on the market we know best, which includes captive structures, US P&C liabilities and portfolios on the smaller end of the size spectrum (<$100m) where there are lower economies of scale and less willingness for large competitors to transact. We are most competitive in this segment because we have private capital with a long-term, patient orientation, fewer arbitrary annual return hurdles to manage and ultimately a lower combined cost of capital.



> "Fleming Re is uniquely positioned to provide customised, tailored solutions to entities with the most complex structures and risks in order to achieve clients' goals in a very efficient and effective way"

As a newer entrant to the market, we have a lean expense structure and have avoided the high legacy cost burden of established competitors whose strategies have either creeped into live underwriting or are saddled with public listing compliance costs and quarterly earnings targets. We have developed a hybrid resource infrastructure platform driven by innovative technology, where critical functions are controlled in-house and processes like routine claims administration can be outsourced with proper in-house oversight. These factors all amount to a sustainable competitive advantage in this growing sector.

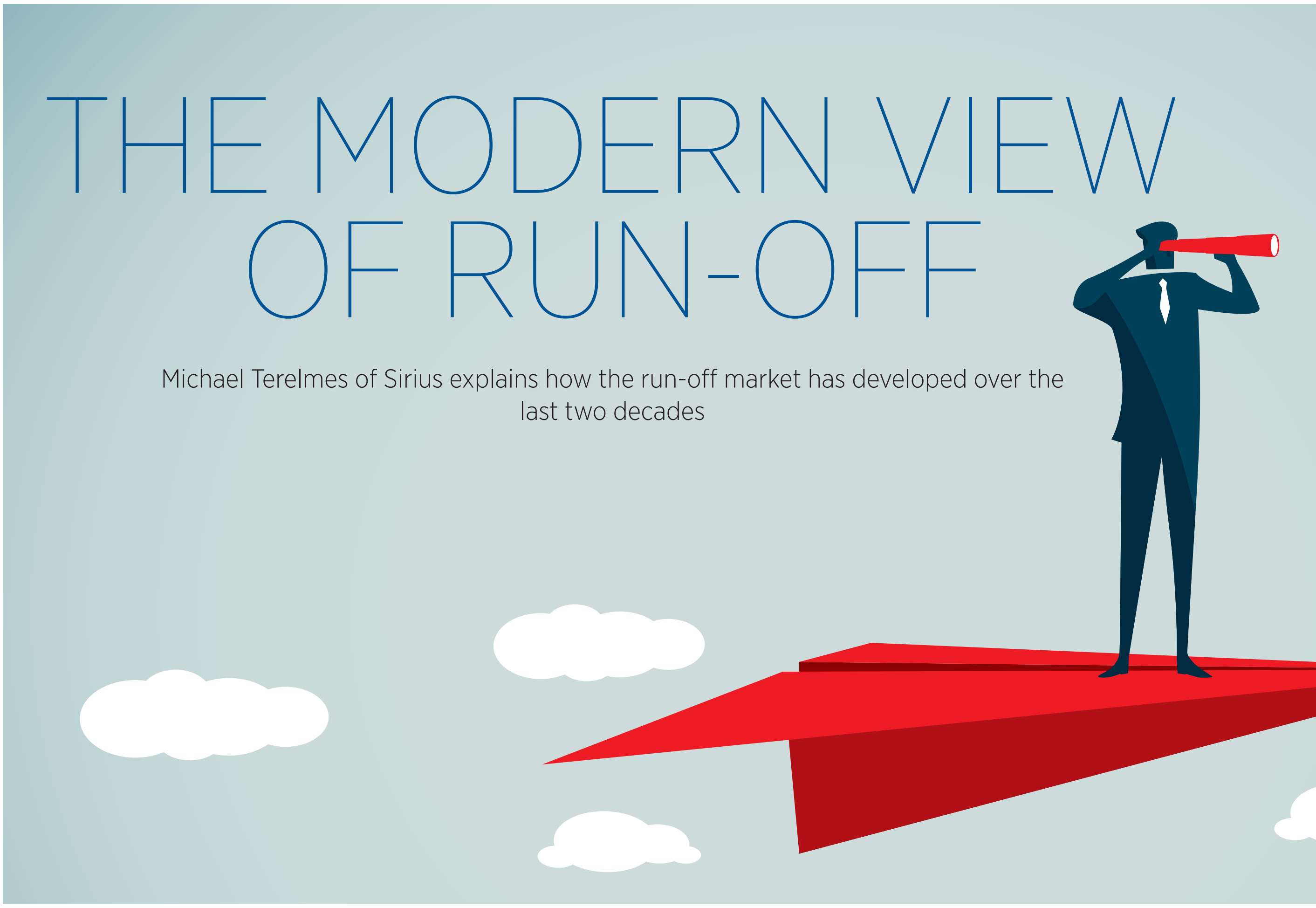
Our specific focus for M&A transactions is to address the inefficiencies in the market by providing competitive solutions that are easy for the counterparties to understand, execute and be completed within the agreed timeline. We pride ourselves on our ability to quickly assess and understand our counterparties' objectives and then structure unique solutions that are better aligned to accomplish those specific objectives – whether it be maximising liquidity, shared risk taking, speed to closing and move toward finality.

Our team has industry knowledge across various jurisdictions and lines of business coupled with significant experience in structuring customised transactions both in the legacy and corporate M&A sectors. We work with our clients to understand and clearly define their needs and then specifically tailor solutions to achieve their goals.

Fleming Re is at the forefront of identifying, structuring and implementing innovations that will advance the sector. We are able to streamline processes in order to move the market to the next level as it continues to evolve. With regards to M&A transactions for corporations, Fleming Re is uniquely positioned to provide customised, tailored solutions to entities with the most complex structures and risks in order to achieve clients' goals in a very efficient and effective way. Key differentiators such as these will make the process and structuring of run-off transactions more favourable and available to the general market.

THE MODERN VIEW OF RUN-OFF

Michael Terelmes of Sirius explains how the run-off market has developed over the last two decades



CR (Captive Review): Why is there a need for exit strategies?

Michael Terelmes (MT): It's hard to move forward when you can't escape the past. This is true in nearly every area of life, and for the past several decades this has been one of the driving forces in the run-off industry. Historically, insurers and captives have looked at their reserves and considered exit strategies only when they found themselves in dire straits. When legacy liabilities became unattractive and the P&L started to suffer, a run-off transaction was a means of repairing those past underwriting mistakes.

When Sirius first started looking at such transactions over two decades ago, we were generally approached by companies concerned about their legacy liabilities. They either had trapped capital from discontinued operations or needed help because their legacy liabilities had developed adversely and they were facing a ratings downgrade or additional required capital contributions.

Michael Terelmes

Michael Terelmes is the chief financial officer of Sirius Global Solutions, a subsidiary of Sirius Group (NASDAQ: SG), that specialises in providing exit strategies and run-off solutions to insurers, reinsurers, captives and risk retention groups. As a founding member of Sirius Global Solutions, Terelmes has played a primary role in the acquisition of several companies and in the underwriting of a variety of insurance and reinsurance solutions. He also serves as the CFO of a number of subsidiary insurance companies and is a member of their boards of directors.

Nowadays, there are different, less doom-laden reasons for an exit strategy. The number of transactions we've looked at over the past several years have veered away from the distressed seller, and have moved more towards the strategic seller. We have recently been looking at companies looking to expand the lines of business that they are writing. They have two options: raise capital or lay off legacy liabilities and use the capital supporting those liabilities to underwrite this new business. The cost of capital for the latter option is far less than the cost of raising capital in the debt or equity markets.

Whether a company has a poorly performing book of business that is a drain on the P&L and requires additional capital, or a company simply wants to redeploy existing capital supporting legacy exposures (that may actually be profitable) into other underwriting ventures, exit strategies offer captives and captive owners both flexibility and finality.

CR: What are some of the underlying reasons a captive may look to pursue an exit strategy?

MT: As I mentioned above, more recently we have seen strategic choices. A merger between two parent companies that both own a captive is one such strategy. By selling one of the captives – which is effectively

an illiquid asset on the captive owner's balance sheet – the captive's equity can be converted to cash, and in an M&A situation this is always favourable.

Sometimes there is simply a change in purpose. For example, the captive may have been set up when rates were not especially attractive in the primary market, and it made more sense to bring the liabilities in-house. But now rates in the primary market may have softened, and the owner can purchase more coverage and lay off risk in a different and more efficient manner. In other cases, a captive or RRG was originally setup to write one line of business, but now the parent has moved away from this line of business. With over 2,000 dormant captives worldwide, we suspect that there is a considerable amount of trapped capital that is unutilised.

An exit strategy can also help to alleviate operational expenses in a dormant structure. While the investment income on such a portfolio may mitigate some of these ongoing expenses, the capital supporting these liabilities could generate greater returns elsewhere within the group.

Another reason for exit strategies could be that while the business written still looks good today, there are changes in the marketplace causing the captive owner to have different expectations in both the liabilities once underwritten or in the regulatory or legal environment surrounding those liabilities. Forward-thinking captive owners want to get ahead of these potential issues and transfer those liabilities to control reserve related P&L volatility and minimise exposure to future adverse development.

CR: What exit strategies are most common in the US?

MT: In the US, most exit solutions fall into two buckets – a finality bucket and a reinsurance bucket. For finality, an outright sale is probably the most straightforward for the captive owner. The other option is a novation. A novation is effectively a replacement policy where the novated contract replaces the original policy or agreement. For example, if a captive reinsured a fronting carrier, a third-party reinsurer can assume that contract and effectively stand in place of the captive. In these cases, the fronting carrier will generally be more comfortable with "A" rated admitted paper, and the captive's collateral requirements will be borne by the reinsurer.

> "The number of transactions we've looked at over the past several years have veered away from the distressed seller, and have moved more towards the strategic seller"

In the reinsurance bucket there are essentially two types of transactions. One is a loss portfolio transfer (LPT) which is a transfer of a portfolio of reserves from one party to another. The captive is provided a limit up to an agreed upon amount that gives them protection against volatility, adverse development and may even include claims handling. A second type of transaction is an adverse development cover (ADC) which is a reinsurance agreement that attaches at the insured's carried reserves and provides a limit above those reserves. As the term implies, it's a cover – think top hat – that provides room for adverse development above carried reserves. There is also an ADC/LPT hybrid product that will attach in the money (below the insured's carried reserves) and provide a limit above the reserves.

CR: Is run-off only for those who no longer write business?

MT: Most insurance companies have run-off liabilities on their books. We often think of run-off companies as entities that no longer write premium; however, run-off is simply business written in the past that is no longer currently being written. While many of these companies continue to actively manage their run-off claims, they would not consider themselves run-off insurers.

These run-off liabilities are tying up capital, and if things go sideways with unforeseen developments, like we've seen recently with social inflation, reserves that were once stable suddenly become volatile. When that happens, the company ends up with capital being tied up for longer than anticipated and the potential that additional reserve development could tie up even more capital. For these companies, there are exit strategy tools which can increase capital efficiency and provide owners with additional capital or additional comfort in the reserves they currently have carried on their books.

CR: Is this a common run-off area or one that's growing?

MT: Sirius has been in this space for the past two decades and even before that, the concept of run-off and transferring legacy liabilities was always there. The amount of legacy liabilities worldwide seems to grow every year, but what we have seen in the past 5-7 years has been a change in the participants. On the seller's side we see far more strategic sellers, and on the buyer's side we see far more capital in the market. As more capital enters the market, the laws of supply and demand kick in and prices react accordingly.

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THE RISE OF THE RUN-OFF MARKET ROUNDTABLE

IN ASSOCIATION WITH

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RUN-OFF ROUNDTABLE

Participants in the run-off space provide their views on some of the key challenges and developments being seen in the space

In a discussion moderated by Carolyn Fahey, the executive director of AIRROC, some of the leaders in the run-off market gathered to offer their opinions on the growing interest in exit solutions for captives.

In a recently issued A.M. Best Company report, the rating agency offered data from Strategic Risk Solutions, Inc. which showed that the number of new formations in the US was relatively flat but there was an increase in captives that closed.

As far as the AIRROC membership – we have seen an increased interest from captives in learning about exit solutions for captives. We find this to be a very exciting and growing area for AIRROC members.

Carolyn Fahey (CF): What are the main reasons that a captive might need a run-off solution?

Eric Haller (EH): There is a long list of reasons why a captive may look for a run-off solution. Most commonly, it will be because the owners want to release trapped capital. Another common reason is the desire to eliminate operating expenses. Many captives end up not having the scale to make it economically feasible to support the operating expenses once they are no longer writing new business. A relatively large operating expense base creates a situation where the captive is no longer a valuable tool operationally. Another common reason, and one where we've seen a significant amount of activity recently, is driven by the corporate

Carolyn Fahey, moderator

Carolyn Fahey is the executive director of AIRROC (Association of Insurance and Reinsurance Run-Off Companies). In that role she works with the AIRROC Board of Directors to set and execute the overall strategy for the association, as well as having responsibility for AIRROC's operations. She is a frequent speaker and author on the run-off industry for regulatory bodies, other associations and industry groups.

Michael Terelmes

Michael Terelmes is the chief financial officer of Sirius Global Solutions, a subsidiary of Sirius Group (NASDAQ: SG), that specialises in providing exit strategies and run-off solutions to insurers, reinsurers, captives and risk retention groups. As a founding member of Sirius Global Solutions, Terelmes has played a primary role in the acquisition of several companies and in the underwriting of a variety of insurance and reinsurance solutions. He also serves as the CFO of a number of subsidiary insurance companies and is a member of their boards of directors.

Paul Corver

Paul Corver is the group head of Legacy M&A at R&Q and has been active in the run-off space for almost 30 years. Aside from managing both solvent and insolvent run-off companies, for the past 10 years he has been actively acquiring portfolios of legacy liabilities for R&Q. These have included acquisitions, LPT's, Part VII and business transfers, novations, mergers and assumptions. Transactions have been concluded in numerous territories and with companies such as Unilever, John Laing, Virgin Atlantic, Clariant, Astra Zeneca, Chubb and Axa LM.

Matt Kunish

Matt Kunish is the chief business development officer at RiverStone, a run-off and legacy solutions provider. With over 25 years of insurance industry experience, he leads the actuarial and business development groups in the US. Kunish began his career as a consulting actuary for Deloitte (formerly Bacon & Woodrow) in London. He earned a BSc with honors, in mathematics and economics from the University of Bristol.

Tom Booth

Tom Booth joined DARAG in July 2018 after almost 10 years at R&Q, mostly as group CFO. He worked primarily on legacy M&A activity during his tenure at R&Q. He has extensive experience of portfolio transfers and insurance company acquisitions across a wide range of European markets. Booth previously held insurance M&A and capital markets roles at Numis, a London based investment bank and at Aon.

Eric Haller

Eric Haller is CEO of Fleming Re, a specialist run-off reinsurer based in Bermuda. Haller's reinsurance experience spans more than 20 years and includes business development, underwriting, treasury, accounting, investment management, risk and regulatory compliance. Haller has held senior roles at various companies; Safe Harbor Re (CFO & CRO), Randall & Quilter Investment Holdings (head of North American M&A), Athene Holdings (head of strategic planning), XL Capital's Investment Management Group and Deloitte & Touche. He graduated with honours from Marquette University.

M&A process. The acquiring company wants to complete a run-off transaction to eliminate the pre-existing liabilities of the company being acquired.

Paul Corver (PC): In Europe, we have seen opportunities arising out of the impact of Solvency II. This led to positions where captives were leaving the EU, either selling their captives outright or transferring business. Across the globe we see concerns from corporate parents about the possible impact on their reputation of being seen to have an offshore company into which large sums of premium are being paid. This has caused corporates to rethink their strategies and contemplate disposal of their offshore entities.

Tom Booth (TB): I was going to pick up on the same point that Paul raised about how multinationals have in recent times been wanting to exit some of the offshore jurisdictions. We have also seen and worked on a number of transactions that are motivated by taxation reasons and jurisdictional perception.

CF: Why is there now a surge in the utilisation of run-off solutions?

Mike Terelmes (MT): The captive markets are maturing and when you have mature markets, you generally have captives that are either coming to an end of life situation or to a point where they want to change direction or strategy. The run-off market used to, almost universally, be a tale of distress and failure. Sirius has been in this space since the late 1990s, and back then, people came to us with 'bad news' and were looking for an exit strategy to reduce P&L volatility and capital erosion. The run-off market was a backup camera evaluating what was behind the captive; however, now run-off is being used as a strategic tool that can provide sources of capital for new business or can provide a way to return capital to owners. Notwithstanding the name 'run-off', the run-off market is not about closing down captives, rather it is about helping existing captives become as efficient as possible and providing owners with exit strategies from the earliest stages of formation through dormancy.

Matt Kunish (MK): We too are definitely seeing run-off being used as more of a strategic tool in the present day. We're still relatively new to this space, but I see that there's still a lot more education needed. Certainly in the US, perceptions of run-off remain somewhat fragmented. As time goes on, it will be important to educate owners as to the benefits of run-off. Once the owners understand how everything works, they're more likely to get on board with the concept.

TB: I think people are gradually growing more aware of there being solutions available in the market. And obviously these solutions will need to be well priced for these types of transactions to make sense. There's obviously a balancing act between getting administrative ease out of a run-off solution against the cost of doing it. The more of us trying to find cost-effective solutions and the more people there are in the market, the easier it should be to make people realise what the benefits of run-off are.

PC: I agree with that. I think one of the things we also have to be aware of is that these are insurance companies that are owned and run by corporates in completely different segments, whether it's retail, transport, energy, etc. Therefore, the directors may only have a limited working knowledge of insurance and likely know nothing about run-off or the process of restructuring what they already have on their books.

We're very much reliant on captive managers, who can then bring these opportunities and take the benefits of run-off restructuring to the board. But that's not always possible. So I think there's a greater onus on us as the run-off acquirers to get the message across, because we can't necessarily rely on all the others that are in the chain of decision-making in the captive process.

CF: What exit solutions have you recently worked on?

TB: There are a number of potential solutions we can bring to the market depending on their needs. There still continues to be a flow of such opportunities, and a number of which we've done ourselves, where it's been a straight acquisition of the captive which is a fairly simple and clean way of doing it. At the same time, it certainly doesn't stop there and it's not just a question of people wanting to completely dispose of a captive; it can be that they simply want to make it more efficient. They may have a line of business they're no longer writing through the captive and they perhaps want to free up some collateral and get early liquidity on that, as well as chop off the tail and redeploy the capital elsewhere if they're growing the captive in a different direction and with different coverages.

At least in the captive space, there is a well-established and relatively straightforward path to create finality where you can novate the policies over to another entity. And a number of us have entities that can assume captive policies that have been originally written from a corporate captive and put it into one of our facilities. It tends to be these types of covers that predominate because those finality tools are available.

MK: I echo what Tom says, certainly the ones we've seen in the US, the corporate M&A that was mentioned has been the reason there's an orphan captive looking for a home. The more interesting one we've looked at recently was a Reinsurance To Close (RITC) concept where the owner was looking to 'carve off' the older years but was also looking to form an ongoing relationship and slowly cash-in the older years as they reach a certain level of maturity.

> "The key element of the process, whether it's captive or a regular commercial insurer, is primarily good data"
> Paul Corver

CF: What helps make the run-off process run as smoothly as possible?

PC: We operate from the UK and Bermuda so we see the process on both sides of the pond, but I think the key element of the process, whether it's a captive or a regular commercial insurer, is primarily good data. We're very much reliant upon getting quality data from the captive or captive manager, and timeliness of such data, too. If as much as possible is provided upfront, the bid that goes in is as close to possible as what the final number will look like and doesn't produce too many surprises.

Other aspects to make the process smooth, are the experience and track record of the buyer. Not all aspects come down to price, there's also the reputation of the buyer to bear in mind and the ability for the buyer to evidence that they are not going to 'rock the boat' with regard to claims handling.

MT: I agree with Paul's comments about good data. One thing we see with run-off transactions typically is that the data tend to be a little bit stale and oftentimes inconsistent. When the data are good, the underwriting of the transaction becomes far more efficient. In addition to good data, I would also say that the people involved are critical for execution and transition, both from the acquirer and the seller's side. The seller's staff have the vital information the buyer needs to continue working the transaction after closing. Transition and post-closing execution are almost as important as the due diligence process, so having good people on both sides is essential.

EH: I very much agree with the point about having good people on both sides of the transaction. Overall, we've found that the process runs more smoothly by simply having an initial conversation with the client, identifying their goals and setting key milestones for the transaction. This allows all parties involved to have the same expectations throughout the process and facilitates an efficient transition.

CF: How do the levels of complexity vary depending on a captive's size? What other factors may change the way in which the process is conducted?

EH: In terms of the captive's size, it's not necessarily the factor that will add complexity. Complexity tends to be more a function of a captive's structure, lines of business, any reinsurance in place, as well as other unique characteristics specific to the captive.

If comparing a large and smaller captive, arguably a small captive could be more complex from a transaction perspective because it lacks diversification of exposures. It's a little counterintuitive but when looking at the risk of a smaller transaction, the outcome could be more binary due to that lack of diversification.

Other factors to consider are the existing structure of the captive, the type of transaction and jurisdictional considerations as different regulators have different requirements. With differing types of transactions, an acquisition of a captive will potentially have additional risks such as legal exposures and third-party collectability issues for non-insurance balances, compared to a novation-type transaction.

Then there's the matter of transaction timelines. For example, when completing a transaction related to a corporate M&A process, the timelines can be very tight and lack flexibility on deadlines. This can certainly add to the complexity of the overall transaction.

TB: It doesn't necessarily follow that a captive's size makes it more complex. We've looked at a number of situations and have just done a transaction where the captive is operated over a long period of time and has itself assumed business from prior captives through to the loss portfolio transfer, and sometimes the transaction can be relatively small but complex given its long history and the fact management changes over time can mean that there might be record and data gaps and even things as simple as not having full policy listings or copies of the individual policies. Often as you go further back in time, there can be significant knowledge gaps in terms of what actual coverage was written by the captive. Age may in fact be the overall variable which can create complexity. It may follow that larger captives have written different types of business over longer periods of time in more complex structures.

PC: The larger the transaction, the higher the likelihood it's still going to be on the selling company's agenda as a priority. We've often found some deals go into a dormancy stage because the parent company gets distracted on some other important matter they're attending to themselves. Therefore the larger ones tend to retain the focus of the senior and authoritative level within the seller whereas the smaller captives can sometimes drift off.

CF: Are there any differences in dealing with captives in the US versus other markets?

MK: The regulatory environment is quite different in the US and likely also the most complicated. The lines of business also vary. Workers' comp, for example, exists in the US unlike elsewhere in the world.

PC: We have employers' liability in the UK which is similar to workers' comp, but I think one of the key areas is that the US has a significantly higher level of different structures – including risk retention groups, self-insured trusts, and group captives – all vehicles which don't really exist elsewhere. While this means one needs a more flexible approach in the solution you can provide, it does also present a far greater level of opportunity for providing innovative solutions to meet the seller's ambitions.

CF: What newer risks are emerging in this market and could captives benefit from an emerging risk transaction?

MT: Emerging risk and run-off may initially seem to be at opposing ends of the spectrum – with one being something new and the other end-of-life. When I think about emerging risks, I think first of new risks such as artificial intelligence or nanotechnology, but I also think of risks that have been around for a while but whose context has changed. There is clearly a market for emerging risk run-off transactions in that light, including the likes of the opioid crisis, sexual misconduct and other social inflation exposures that are on the rise. There is an increased need for captives to wall off these exposures and move forward. For example, general liability and auto are not new lines of business, but the increased level of attorney involvement in these exposures is clearly an emerging risk. Captives may have had such lines of business on their books for a while, but they are not necessarily prepared for the exposure that is now arising. The run-off market can provide captives with an opportunity to address those liabilities and move on.

> "As time goes on, it will be important to educate owners as to the benefits of run-off"
> Matt Kunish

EH: I agree with Mike on this. The simple question and answer is 'can the captive benefit?' Absolutely they can. As with any run-off transaction, including those with emerging risk, all the benefits we have previously mentioned can be achieved. Some of the risks seen recently are newer exposure types and these are taking the forefront in terms of a lot of class action lawsuits. Even though the exposure has been there for a while, the dynamic has changed and they may want a way to be able to deal with that risk.

Cyber risk is another newer risk that could look to the legacy market for solutions in the future. We've also seen demand from industry sectors like insurance-linked securities (ILS) that are looking for an exit or liquidity solution. In terms of jurisdictions, Latin America, although it is a newer captive market, has experienced significant growth and given the life cycle of a captive, at some point they will be looking for legacy solutions. I think it is also worth mentioning that with a lot of what we're calling emerging risks, there can be some challenges, especially if it is truly a 'new' risk. These challenges stem from the overall evaluation of the newer risk types, the limited development history, and in certain instances there could be a lack of data which makes it even more challenging.

CF: How do you foresee the continued evolution of the run-off space in the future?

PC: We see a good future for the provision of run-off solutions within the captive sector. As greater awareness appears on board agendas, then hopefully it will continue even further. Probably more on the line of achieving capital efficiency by managing existing captives rather than the pure disposal of run-off captives. I'd like to think that as the professionalism and acceptance of run-off by the captive owners continues, that owners may consider putting more lines of business into captives knowing that if it doesn't work out they have an exit solution lined up and will not be stuck with it forever.

TB: I think the RITC transaction will continue to develop as a number of us are seeing approaches from captive owners where they would like to chop off their tail on certain policies, ending minus one-year, and would like a mechanism where they can buy cover of this nature on a rolling-forward basis. I'm hopeful this becomes more of a routine type of solution which fits in with some of the aforementioned themes of this discussion.

MT: We touched on this earlier but looking ahead there is potential for new mass tort for emerging risks in the industry. Companies with exposure to the likes of vaping, fracking and other exposures which didn't exist a decade ago, may want to move those liabilities to counterparties. With the influx of capital into the run-off space, captive owners have more counterparty options for these exposures.

MK: I think the opportunities are almost unlimited and we have the chance to be very creative in our solutions. I expect more capital to come into the space and as time goes on the acceptability of run-off will increase.

EH: The outlook for the run-off space looks very positive overall. Captive owners are beginning to realise they can use legacy solutions as a liquidity tool, a financing tool and a risk management tool, which has changed a lot over the past decade compared to what the reputation of this space was previously.

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Sirius Global Solutions is a subsidiary of Sirius Group (NASDAQ:SG) that serves insurers, reinsurers, captives and risk retention groups seeking to mitigate or eliminate exposure to legacy liabilities and release trapped capital.
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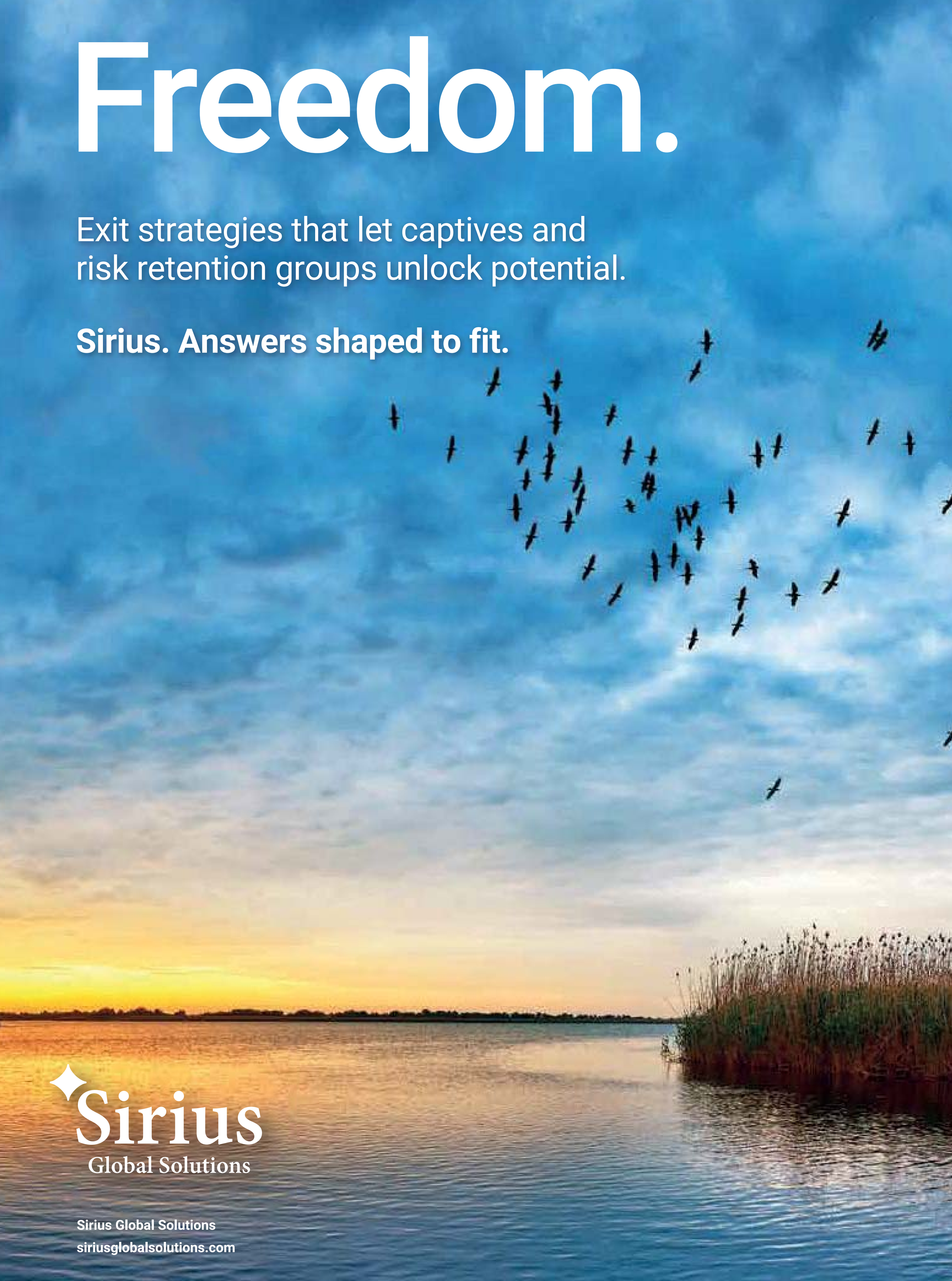
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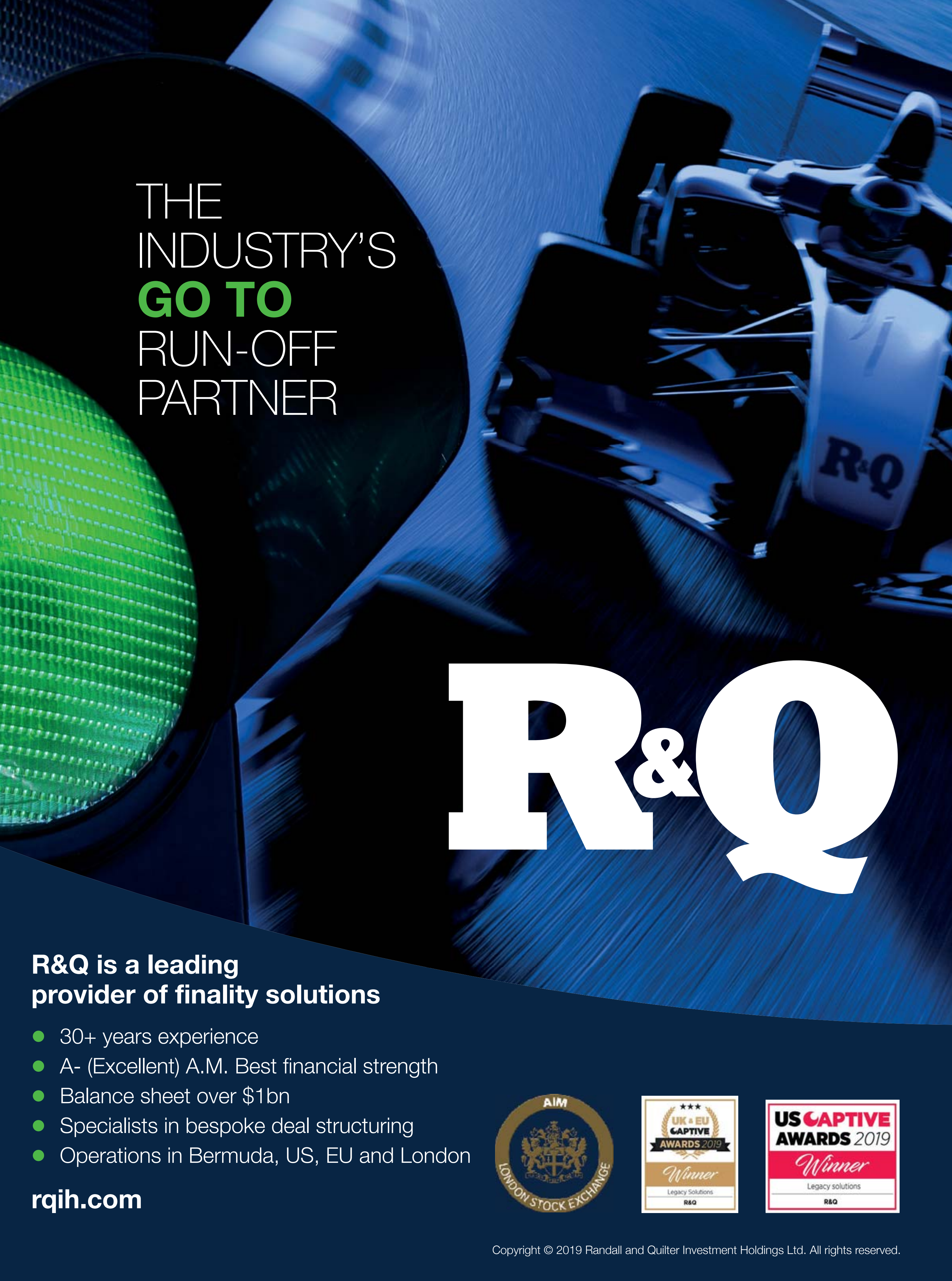
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