Insurance is ripe for private equity

Regulatory changes and an economic downturn could make German insurance the perfect target for private equity

For many years it looked like the German insurance industry would remain a closed shop, strategically controlled by the big German insurance groups or scattered amongst the members of mutual insurance companies. Transactions in the financial services sector in general, and in insurance in particular, are considered very complex because of German regulatory hurdles and, on the face of it, are not very appealing. Lately, however, the private equity industry has begun to turn its attention to insurance. This article outlines the economic rationale behind private equity-backed investments in the German insurance sector, why early movers may benefit and how they may cope with differences to their traditional targets.

Private equity-backed takeovers in the German insurance industry have historically been few and far between. In 2005, the acquisition of Württembergische & Badische Versicherungs AG by JC Flowers was the first such takeover. Yet, despite private equity putting more effort into this highly complex and regulated market segment, it took a further 18 months before the next private equity-backed acquisition was completed. Cerberus showed a great deal of interest in Gerling Beteiligungs GmbH, before it was taken over by Talanx, the big German insurance player, for €1.3 billion in 2005. Then in July of 2006, JC Flowers announced that it will acquire, through its initial portfolio investment, the German insurer DARAG Deutsche Versicherungs-und Rückversicherungs.

The rationale

As private equity funds get larger and more flush with capital, they look for new market segments and target companies. And everyone expects the German insurance market to consolidate. Private equity could meet the managerial challenge of rising pressure on costs, a declining sales trend in the life insurance business (particularly bad in Germany due to the cutback of tax incentives), and increasing price-competition, such as in the automobile insurance business. Customer satisfaction has also room for improvement, and insurance administration in general and the cost of claims administration in particular could be optimized, both providing an opportunity for private equity firms to add value to German insurance companies.

"Mutual insurance corporations should be on the short list of targets for private equity funds"

In the near future, industry consolidation is also expected because of changing capital requirements under Solvency II, the new European insurance solvency rules that are under preparation (a draft EU Directive is expected in mid-2007). To the extent the new framework calls for greater capital in the market, private equity could smooth the impact of Solvency II on European insurance companies. Early movers, who have grown more knowledgeable about the complex regulatory framework, could therefore be ahead of their competitors.

Last but not least, private equity would gain from an investment in the insurance business because it is distinct and separate from macroeconomic developments because the insurance cycle usually runs quite independently of the economic cycle. (For another take on what private equity firms should do in a downturn, see page 50.)

The following peculiarities earmark private equity investment in the insurance sector.

Supervision and financial strength of bidder

Any intention to acquire a qualifying participation of 10% or more of the voting rights or nominal capital in an insurance undertaking (primary insurer or reinsurer) and any intention to increase the participation by an amount resulting in the thresholds of 20%, 33% or 50% being reached or exceeded, must be notified to BaFin (the Federal Financial Supervisory Authority).

BaFin can prohibit an intended acquisition of a qualifying participation, or its increase, within three months from receipt of the notice if it can conclude that the bidder is not of good repute. This also applies if for other reasons the bidder does not meet the requirements of sound and prudent management of insurance undertakings. The acquirer must demonstrate that it has suitable and sufficient funds to implement its plans for the continuation and development of the insurance undertaking's operations (the financial strength test).

Despite initial scepticism it has been clarified that the acquirer does not assume any liability under this financial strength test and is not obliged, in this respect, to make any additional contributions later on.

Acquisitions by financial investors are generally highly leveraged – the financial sponsors gain control of the target company's equity by the use of borrowed money or debt. The financial strength test should not *per se* inhibit the acquirer to leverage the takeover of an insurance company provided the acquirer has a sound capital base (which may also consist of borrowed funds).

In practice, however, BaFin is testing the financial situation of the acquirer in detail. This extension of BaFin's authority may have positive effects, because its decisions have become more predictable compared to the legal situation prior to the enactment of the financial strength test. To avoid surprises in this respect, BaFin should be involved in the takeover process at an early stage. BaFin may also prohibit the intended acquisition if there are facts from which it concludes that there is an affiliation between the insurance undertaking and the holder of a qualifying participation and that, due to this affiliation, effective supervision of the insurance undertaking is not possible.

Finally, BaFin can prohibit or limit the acquisition of a participation in an insurance undertaking if it results in the target becoming the subsidiary of an insurance company outside the EU, provided that the latter is not subject to effective financial supervision in the country of its registered office or its head office, or the latter's competent supervisory authority is not willing to cooperate satisfactorily with BaFin. The often complex, tax-driven acquisition structures of private equity funds, using acquisition vehicles in offshore jurisdictions, should be re-assessed, if necessary, with a view to effective financial supervision to avoid BaFin carrying out an investigation in this respect.

Even the intention to indirectly hold a qualifying participation or to indirectly reach the other thresholds mentioned above, must be notified to BaFin. As a consequence, private equity funds may have to disclose the identity of individual sponsors and force them to take the financial strength test. However, the private equity funds sponsoring the acquisition vehicle should have sufficient funds of their own to meet the financial strength test requirements.

Approval for the transfer of the business

Any contract by which a portfolio of insurance contracts is transferred wholly or partly to another undertaking (an asset deal or block transaction) must be approved by BaFin. The transferee must prove that after the transfer it will dispose of its own funds in the amount of the solvency margin. Although the rights and obligations of the transferor under the insurance contracts, including those in relation to the policyholders, are transferred to the transferee, the transfer itself is not subject to the consent of the policyholders.

Financing and collateralization

Private equity transactions, as mentioned above, are often highly leveraged. Therefore, the assets of the company being acquired are often used as collateral for the loans in addition to the assets of the acquiring company. For the same purpose and for tax purposes, the acquisition vehicle and the target company are usually merged post-closing (a debt-pushdown). This financing form, however, is of limited scope if an insurance undertaking is to be taken over.

The borrowings of insurance undertakings are limited due to solvency requirements. The insurance companies must ensure that their liabilities under insurance contracts can be permanently met. Therefore they are obliged to establish free, uncommitted funds in an amount not less than the solvency margin (which depends on the total volume of business). As a result, debt financing has been widely replaced in the insurance industry by mezzanine capital – capital paid up in exchange for the granting of subordinated loans (*nachrangige Verbindlichkeiten*) or in exchange for profit participating rights (*Genussrechte*), provided such mezzanine capital qualifies as regulatory equity.

BaFin generally takes the view that insurance companies cannot raise credit because raising credit is not directly related to the insurance business. It can be justified only in exceptional cases (see Circular Letter 15/2005). Any borrowings must prepare for capital investments or ensure capital investments, be based on commercially-sound financial budgeting only and shall not (in their type, volume and maturity) go beyond the limits that also apply to insurance companies. Given the vagueness of these requirements, the bidder must clear the intended financing and collateral structure with BaFin.

Supplementary supervision

When structuring the transaction, one must take into account that a subsidiary of an insurance holding company, or a subsidiary of an insurance undertaking of a non-EU member state, are subject to supplementary supervision under Section 104c of the Law of the Supervision of Insurance Undertakings. BaFin will closely review group-wide transactions, in particular loans, corporate guarantees, investments and cost sharing agreements, to assess whether these transactions are in accordance with the principles of the practice of "sound and prudent management".

In addition, BaFin will supervise the adjusted solvency calculated according to Directive 98/78/EEC and will review the financial situation not only of the insurance undertaking on a stand-alone basis but the financial circumstances of the undertaking as part of the group. The supplementary review will avoid the risks following a "double gearing" of equity and the procurement of group internal capital. However, in a private equity transaction one should try to avoid the complex regulations of supplementary supervision by BaFin.

Qualifying as a fiscal unity

A fiscal unity between a life insurance or health insurance undertaking and its parent company cannot be established. As a consequence, any profits and losses of a life insurance or health insurance undertaking cannot be offset against profits or losses of its parent. Please note, however, that this restriction might conflict with constitutional law.

Restructuring and outsourcing

If the private equity fund intends to add value by way of restructuring the acquired insurance group, several measures should be cleared with the BaFin.

Any transformation of an insurance undertaking, for example any merger, splitting up, spin-off or change of form, is subject to the BaFin's approval.

To the extent that any agreements are concluded to permanently transfer, wholly or an essential part of, the distribution, management of the portfolio of insurance contracts, handling of claims, accounting, investments or asset management of the insurance undertaking to another undertaking (outsourcing), such an agreement must be submitted to BaFin. Any such contracts that are subject to supervision under this law will not become effective until they have been submitted to BaFin. Any such contracts concluded with other undertakings shall not become effective until three months have elapsed from their deposit with BaFin, provided the latter does not object. BaFin is also authorized to extend this period to six months where it is justified by circumstances, however this period of time can end earlier if BaFin finds that the contracts are unobjectionable.

The composition of the capital investments of insurance undertakings is strictly regulated and must comply with the set of provisions stipulated in Sections 66 and 54 and their subsections of the Law of the Supervision of Insurance Undertakings and statutory regulations.

Mutual insurance corporations

It is generally agreed that mutual insurance corporations (VVaG) will be adversely affected by the amended solvency framework because their access to financial support might be limited as a result of their legal form. Therefore, mutual insurance corporations should be on the short list of targets for private equity funds in the future.

Unlike the UK market, the large-scale demutualization of these entities has so far failed to appear in Germany. This is because of the quasi-cooperative character of mutual insurance corporations, which provide (based on the idea of mutuality) insurance cover to their members. This is also due to the strong position of the management, whose interest in a demutualization is generally rather small.

In practice, however, large mutual insurance corporations in Germany have started to transfer their businesses to subsidiaries in the legal form of stock corporations, and to limit their activities to the holding and administration of these subsidiaries. To private equity funds, an investment in these stock corporations could be of interest in the future.

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