Financial Regulation international

Worldwide regulatory developments and their implications for the financial services industry

Private equity in the German insurance industry

Private equity as an investment form is gaining ground in the German insurance industry. Against the background of rising pressure on returns, insurance companies increasingly invest in the asset class 'private equity' which comes up with strong long-term historical returns, in average ranging between 10% and 15%, and which already forms an essential part of insurance companies' portfolios.

However, private equity-backed takeovers in the German insurance industry, ie the acquisition of an insurance company or certain of its assets by a private equity firm, have remained at a low level for years.

- In Germany, J.C. Flowers became the first ever private equity backer of an insurance acquisition with its 'Württembergische & Badische Versicherungs-AG' investment at the end of 2004 / beginning of 2005.
- Also in the European market, only a limited number of takeovers have occurred over recent years. The Cypress Group, JP Morgan Corsair Partners and Capital Z, among others, committed approximately USD 460 million to the property and casualty insurance and reinsurance company Catlin Group in July 2002. Barclays Private Equity, the UK private equity firm, backed a management buy-out of a 90% stake in Albingia, the French corporate risk insurance company in 2003. Saga, the holidays and insurance company, was acquired in a management buy-out backed by private equity firm Charterhouse for £1.35 billion in 2004.

Apart from the aforementioned few exceptions it seems that the insurance industry still remains a closed shop, strategically controlled by the big insurance company groups. Transactions in the financial services sector in general, and in insurance as a sub-sector within financial services in particular, are considered to be very complex because of the regulatory hurdles and, prima facie, not very appealing.

Lately, however, it appears that the private equity industry has begun to turn its attention to insurance and has put more efforts into this market segment. In the German market, Cerberus was interested in Gerling Beteiligungs GmbH which was finally taken over by Talanx, the German insurance group for EUR 1.3 billion (unconfirmed) in 2005. And in June 2006, Paris Re Holdings, a newly-created company with a capitalisation of approximately USD 1.5 billion, sponsored by a consortium of international investors led by Trident III (a fund managed by Stone Point Capital), with other lead investors including Hellman & Friedman, acquired the reinsurance business of AXA RE. This deal is expected to become effective in 2007. The rationale behind this is:

- As private equity funds get larger and more flush with capital, they look for new market segments and target companies.
- Rising capital requirements under Solvency II, the new framework for enhanced European insurance solvency rules which is currently under preparation (a draft EU directive is expected to be published in mid-2007), call for an alternative form of financing. Private equity could tackle the issue and smooth the impact of Solvency II on European insurance companies.
- Rising pressure on costs, a declining sales trend in the life insurance business (in particular in Germany due to the cutback of tax incentives) and rising price-competition in the automobile insurance business boost the pressure on industry consolidation.
- Customer satisfaction has room for improvement and insurance administration in general and the cost of claims administration in particular could be optimised, both providing an opportunity for private equity firms to add significant value to insurance companies.
- The insurance cycle usually runs quite independently of the economic cycle. The aforementioned

complexity of financial transactions, in particular in the insurance subsector, can be kept under control if these transactions are carefully planned and the Federal Financial Supervisory Authority (BaFin) is involved at an early stage.

The following peculiarities earmark the private equity investments in the insurance sector:

1. Supervision and financial strength of bidder

Any intention to directly or indirectly 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 such participation by an amount resulting in the thresholds of 20%, 33% or 50% of the voting rights or nominal capital being reached or exceeded, must be notified to the BaFin.

The BaFin may prohibit the intended acquisition of a qualifying participation, or its increase, within a period of three months from receipt of the notice if there are facts from which it may conclude that the prospective holder giving such notice or, if the holder is a legal person or partnership, the legal or statutory representatives or personally liable partners, are not of good repute; this shall also apply if for other reasons they do not meet the requirements of sound and prudent management of insurance undertakings. The acquirer shall demonstrate that it has suitable and sufficient funds necessary to implement its plans for the continuation and development of the insurance undertaking's operations (financial strength test).

Despite initial skepticism it has been clarified that the acquirer does not, at this point, assume any liability by way of the aforementioned 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, ie 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 highly leverage the takeover of an insurance undertaking provided the acquirer has a sound capital base (which may also consist of borrowed funds). In practice, however, the BaFin is testing the financial situation of the acquirer in detail. This extension of authority of the BaFin may have positive effects, too, 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 (i) that there is an affiliation between the insurance undertaking and the holder of a qualifying participation and (ii) that, due to this affiliation of undertakings or the structure of the affiliation of the undertaking holding a qualifying participation with other undertakings, effective supervision of the insurance undertaking is not possible.

Finally, BaFin may prohibit or limit the acquisition of a direct or indirect participation in an insurance undertaking if it results in the targeted insurance undertaking becoming the subsidiary of an insurance undertaking located outside the EC and outside the other EEA Member States, provided (i) the latter is not subject to effective financial supervision in the country of its registered office or its head office or (ii) the latter's competent supervisory authority is not willing to cooperate satisfactorily with the 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 the BaFin carrying out an investigation in this respect.

As mentioned above, even the intention (i) to indirectly hold a qualifying participation or (ii) to indirectly reach the other thresholds mentioned above, must be notified to the BaFin. As a consequence, the private equity funds may have to disclose the identity of individual sponsors and the individuals in turn have to take the financial strength test. However, the private equity funds sponsoring the acquisition vehicle should generally have sufficient own funds to meet the financial strength test requirements.

2. Obligation to obtain a permit for the transfer of the business in force

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

3. Financing and collateralisation

Private equity transactions, as mentioned above, are regularly 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 (debt-pushdown). This financing form, however, is limited if an insurance undertaking is to be taken over:

- The borrowings of insurance undertakings are limited due to solvency requirements. The insurance undertakings must ensure that their liabilities under the insurance contracts can be permanently met. Therefore the insurance undertakings are obliged to establish free uncommitted own 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, ie 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 meets the requirements to qualify as regulatory equity.
- BaFin takes the view that insurance undertakings generally may not raise credits because raising credits is not directly related to the insurance business and therefore a forbidden transaction, which can be justified only in exceptional cases (Circular Letter 15/2005). In other words borrowings, if at all, (i) shall prepare for capital investments or shall ensure capital investments, (ii) shall be based on commercially sound financial budgeting only and (iii) shall not – in their type, volume and maturity – go beyond the limits which should also apply to insurance companies. Given the vagueness of these requirements, the bidder should clear the intended financing and collateral structure with BaFin.

4. 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-member state are subject to supplementary supervision according to s104c 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 thereby review the financial situation not only of the insurance undertaking on a stand-alone basis but will also analyse the financial circumstances of the undertaking as part of the group. The supplementary review shall 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.

5. Restrictions to qualify 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.

6. Restructuring and Outsourcing

If, and to the extent that, 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, eg any merger, splitting up, spin-off or change of form, is subject to the BaFin's approval.
- To the extent any agreements shall be concluded for the purpose of permanently transferring, 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 outsourcing agreement shall be submitted to the BaFin. Any such contracts concluded with insurance undertakings which are subject to supervision under this law shall 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 the BaFin, provided the latter did not object. The BaFin shall be authorised to extend this period to six months where this is justified by circumstances, however, this period of time shall end earlier as soon as the 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 ss 66

et seq., ss54 et seq. of the Law of the Supervision of Insurance Undertakings and statutory regulations.

7. Mutual Insurance Corporations

It is generally agreed that mutual insurance corporations (VVaG) will be troubled by the tightened solvency framework because their access to financial support might be limited due to their legal form. Therefore, mutual insurance corporations should be on the short list of private equity funds in the future.

Unlike the UK market, the expected large-scale demutualisation of these entities has so far failed to appear in Germany. Firstly, this is because of the quasi-cooperative character of mutual insurance corporations, which shall provide - based on the idea of mutuality - insurance cover to its members. Secondly, this is because of the strong position of the management, whose interest in a demutualisation is generally rather low.

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.

8. Outlook

Private Equity Investments in the insurance industry are complex. The acquisition structure needs to be planned diligently and requires the early involvement of the BaFin. The transaction risks can hence be controlled.

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