Could Germany be next in line for insurance market consolidation?

With the recent spate of mergers and acquisitions and all the attendant speculation the market is ripe for innovation, writes **Jennifer Donohue**

IN THE past two years there has been significant interest in consolidation activity within the insurance sector.

This has resulted in completed transactions, preliminary discussions and ceaseless speculation. Examples include Resolution's purchase of the life business of Abbey from Santander for £3.6bn ($6.8bn), Aviva's acquisition of AmerUS for £1.6bn as well as its failed approach for UK rival Prudential, Swiss Re's acquisition of GE Insurance Solutions, takeover talk following Standard Life's demutualisation and speculation relating to the auction of GE Life.

The funding of acquisitions has seen the development of some interesting innovations; a mixture of internal resources, external debt and equity (rights issues). A considerable amount of private equity capital has come into the industry through companies such as Pearl Group and Resolution.

After the pioneering developments in monetisation of the value of in force policies, culminating in the Gracechurch and Box Hill transactions in November 2003 and December 2004 respectively, this capital-raising technique has been largely ignored. Why?

Despite a large amount of interest in monetisation as a source of capital, the market appears to have taken a wait-and-see approach; companies have been viewing monetisations from a distance to see how they perform over time and are waiting to see who will move next. There is a general feeling that when one of the well known market consolidators taps into this source of capital, others will follow suit. There is also concern over the 'real' outcome of Solvency II requirements.

Let us consider the practical effects of monetisations and opportunities for acquisitions in the German market as a future target market place.

The Groups Directive, the Basel II reforms and the decline in equity values produced a greater need for capital and greater innovation in the ways of raising it at an acceptable price.

Aside from raising capital for regulatory purposes, increased amounts of capital are necessary for the renewed interest in acquisitions within the insurance sector. In relation to the capital requirements for life assurance companies, for example, capital can be defined in terms of tier one (broadly equivalent to equity capital) and tier two (broadly equivalent to long term debt) in much the same way as that approach has been used by banks since Basel I.

The rules require that at least 50% of capital comprises tier one capital. However, equity capital is an expensive form and the increasing demand for this has led life assurance companies to search for cheaper alternatives which retain sufficient characteristics of equity for them to rank as equity for regulatory purposes.

So-called innovative tier one, or hybrid capital — i.e. debt instruments with some equity characteristics — has been devised in the past as an alternative to equity capital.

However, there is a significant limitation in the regulations for both banks and life assurance companies in the extent to which such instruments can be treated as equity capital for regulatory purposes.

No more than 15% of the equity capital requirement for such companies can be made up of hybrid capital. To counter this, the monetisation of embedded value has developed as a source of equity.

A provision in the regulations enables life assurance companies to treat as equity capital borrowings which have limited recourse to future profits from their existing policies (the value in force, or VIF). In effect there is a pledge by the life assurance company that its profit from existing business as realised each year over the term of

Winds of change: the industry paid out large sums for disasters like Hurricane Wilma, above. AP

the debt will be used to service the debt obligations.

The Gracechurch and Box Hill monetisations are at the forefront of this technology. Gracechurch involved the monetisation of the VIF of the entire book of life policies of Barclays Life, providing equity capital of £400m.

The VIF was reinsured with a Dublin-based captive insurance company which used it to back a limited recourse loan from a finance vehicle which itself used it to back the notes of £400m issued to the capital markets. Box Hill used a similar structure; the VIF of a defined book of life policies held by Friends Provident was monetised to provide capital of £380m. In both cases the notes issued to the markets were wrapped by a monoline to provide an AAA rating.

The use of monetisation as a capital raising method has not yet taken off but, in today's climate, where can it fit in? The most obvious use is to help meet the current regulatory capital requirements — monetisation allows capital borrowings to be treated as equity. Looking further ahead, capital requirements will increase under Solvency II. Monetisation can be used to smooth the impact of Solvency II on European insurance companies.

Given the current consolidation frenzy in the European insurance market, monetisation may also be used to raise capital for funding acquisitions. This can be either through the monetisation of existing books of business to raise finance for acquisitions, or to partly fund an acquisition by monetising some or all of the books of business gained under the acquisition.

After the September 11 terrorist attacks and again after hurricanes Katrina, Rita and Wilma in 2005, the insurance industry made large payouts. Coupled with this, the premiums for terrorism and property/casualty risks increased substantially. Private equity saw the need for more capital in the industry and the opportunity for profits.

A lot of private equity money was invested in the Bermuda and, to a lesser extent, London markets to finance new ventures. Over the same period many insurers in the UK closed funds to new business (i.e. put them into run-off). The same insurers needed to generate additional capital and one way of doing this has been to sell the closed funds to private equity market consolidators such as Resolution and the Pearl Group.

These market consolidators are able to benefit from operational efficiencies and economies of scale by buying up a portfolio of closed funds. As private equity gets more familiar and comfortable with the market we can expect to see it invest further, especially in areas where there is a shortage of capital.

It is not just the UK insurance market that has seen a surge in acquisition activity.

In Germany, private equity has started to turn its attention to the insurance market for the following reasons:

- As private equity funds get larger and more capital rich, they look for new market segments and target companies.
- Rising capital requirements under Solvency II call for an alternative form of financing.
- Rising pressure on costs, a declining sales trend in the life insurance business and rising price competition in the automobile insurance business boost the pressure on industry consolidation.
- Insurance administration and claims administration in particular could be optimised, providing an opportunity for private equity firms to add significant value to insurance companies.
- The insurance cycle is independent of the economic cycle.

There are limitations on how the acquisition of insurance companies may be structured owing to strict regulatory and solvency requirements. Any potential purchaser should clear the intended financing and collateral structure with the Federal Financial Supervisory Authority (BaFin).

It may be possible to import the concept of monetisation into Germany as a capital raising tool. However, as was the case in the UK with the FSA, it will be necessary to notify and educate BaFin.

Mutual insurance corporations are likely to be troubled by the tightened solvency framework as access to financial support might be limited due to their legal form.

Instead of the expected demutualisations, large mutual insurance corporations 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.

Private equity funds may find investing in these stocks of interest, and mutual insurance corporations should be on their shortlist.

The increase in acquisitive activity in the German insurance market suggests plenty of scope for economies of scale and attractive profits. It seems a good time for UK market consolidators to turn their attention to Germany, especially given the lack of attractive targets and competitive nature of consolidation in the UK.

We may also see monetisation as a source of capital move in to a second phase in the UK and seriously test the waters in Germany.

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