LEGAL ANALYSIS

LEGISLATIVE DEVELOPMENTS & CASE REVIEWS

A Re-awakening of Monetisation: Insurance Monetisation, Private Equity and Germany

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In the last two years there has been significant interest in consolidation activity within the insurance sector. Sometimes it results in completed transactions, or alternatively preliminary discussions or ceaseless speculation. Examples include Resolution's purchase of the life business of Abbey from Santander for £3.6 billion, Aviva's acquisition of AmerUS for £1.6 billion 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 in relation to Scottish Widows.

The funding of acquisitions in the industry have seen the development of some interesting innovations, for example a mixture of internal resources, external debt and equity (rights issues). A considerable amount of private equity capital has also come into the industry through companies such as Pearl Group and Resolution Plc. Interestingly, 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. What are the reasons for this?

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.

This article considers the practical effects of monetisations, the flow of private equity coming into the insurance market, and opportunities for acquisitions in Germany as a future target market place.

Monetisation

An overview of monetisation

The Groups Directive, the Basel II reforms and the decline in equity values have produced both a greater need for capital and greater innovation in 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.

The Groups Directive amongst other things introduced arrangements that preclude the double use of the same capital to cover risks in an insurer and its related undertakings. Basel II is the international initiative that requires financial services companies to have a more risk sensitive framework for the assessment of regulatory capital. Both of these involve increasing the amount of capital.

Life assurance companies are required to maintain a minimum level of regulatory capital against the risks to which their businesses are subject, to ensure that they are always able to meet their liabilities to policyholders as they fall due. The FSA regulations lay down detailed rules about the amount and quality of capital that such companies must maintain, based in large part on the developing rules for banks following Basel II.

In particular the capital requirements for life assurance companies involve the stratification of capital in terms of tier 1 (broadly equivalent to equity capital) and tier 2 (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 per cent of the capital is made up of tier 1 capital. However, equity capital is an expensive form of capital and the increasing demand for this has led life assurance companies to look for cheaper alternatives which nonetheless retain sufficient of the characteristics of equity for them to rank as equity for regulatory purposes.

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For similar reasons many banks have in the past succeeded in devising debt instruments which have had some equity characteristics and a number have raised some so-called innovative tier 1 or hybrid 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 per cent of the equity capital requirement for such companies can be made up of hybrid capital. So a couple of years ago we saw the very successful rehabilitation of an idea first tried (rather less successfully) by NPI in the late 1990s, the so-called securitisation of embedded value.

What has been done is to take advantage of a little known provision in the regulations which enables life assurance companies to treat as equity capital borrowings which are limited recourse to future profits from their existing policies (referred to as the value of in force or VIF). Although popularly referred to as securitisations, transactions of this sort do not involve the giving of security over third party obligations in the way that mortgage book securitisations do. In effect there is merely a pledge by the life assurance company that its profits from its existing business as realised each year over the term of the debt will be used to service the debt obligations. Monetisation of the value of in force business might be a more accurate (if less catchy) way of describing these transactions.

The two successful headline monetisations of a defined book of life policies are the Gracechurch and Box Hill transactions. Gracechurch involved the monetisation of the VIF of the entire book of life policies of Barclays Life, providing equity capital of £400 million. 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 that to back the notes of £400 million issued to the capital markets. A similar structure was subsequently adopted in Box Hill where the VIF of a defined book of life policies held by Friends Provident was monetised to provide capital of £380 million. In both cases the notes issued to the markets were wrapped by a monoline to provide a AAA rating.

Both of these transactions related to a closed book of life policies which made documenting the arrangements relatively easy to achieve. This is particularly true in the case of Gracechurch where the policies were largely unit linked so that the insurer retained no significant investment risk. Nevertheless, opportunities abound for more innovative monetisations involving new business, potentially volatile types of business such as annuities and even with profits business. The reduction or elimination of risk in such books of business, but in a way which retains the principle of equity capital, is the next goal to which the alchemists should turn their attention.

This is a new and complex area not only for the market and for advisers but also for the Financial Services Authority (FSA). It took many years to develop the regulatory framework which now applies to the securitisation of mortgage books and other asset-backed debt issues. Understandably the FSA are being extremely cautious; crucial to any successful deal is early and detailed explanation to them of what is proposed in order to demonstrate that it falls squarely within the underlying principles that apply to capital generally and to the significant risk transfer concepts encapsulated in the existing rules on securitisations of mortgage books. Much of the structural complexity of the two transactions that have taken place was driven by the sometimes conflicting requirements of the FSA, the monolines, the rating agencies, and the Inland Revenue. One objective of any future transaction must be to satisfy all the requirements of all these parties but in a simpler format.

Monetisation in the current climate

As stated above, 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, the new framework for enhanced European insurance solvency rules currently under preparation (a draft EU directive is expected to be published in mid-2007). Monetisation can be used to tackle the issue and smooth the impact of Solvency II on European insurance companies.

Given the present consolidation frenzy in the European insurance market, monetisation may also be used as a neat way of raising capital to fund 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.

Private equity investments

After the September 11, 2001 terrorist attacks and again after hurricanes Katrina, Rita and Wilma in 2005, the insurance industry made large pay-outs. 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 United Kingdom 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 Plc and the Pearl Group. As the name suggests, 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.

Expansion into Germany

It is not just the UK insurance market that has seen a surge in acquisition activity. In Germany, the private equity industry has started to turn its attention to the insurance market in a change from the historically low level of activity in this area. We now turn our attention to the economic rationale behind private equity-backed investments in the German insurance sector, why early movers may benefit and how they may cope with the differences to their traditional targets.

Private equity backed takeovers of German insurance companies

Private equity-backed takeovers in the German insurance industry, i.e. the acquisition of an insurance company or certain of its assets by a private equity firm, have historically been few and far between.

In 2005, the acquisition of Württembergische & Badische Versicherungs-AG by JC Flowers was the first private equity-backed takeover of a German insurer. Since then, private equity has begun to turn its attention to insurance and has put more efforts into this highly complex and regulated market segment. However, it took a further 18 months before the next private equity-backed acquisition of a German insurance company 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 (unconfirmed) in 2005. In July 2006, JC Flowers announced that it would acquire, through its initial portfolio investment, the German insurer DARAG.

The rationale

As private equity funds get larger and more flush with capital, they look for new market segments and target companies.

Early movers who have grown more knowledgeable about the complex framework in recent years, may even benefit from the complexity. The demand for sophisticated managerial skills, consolidation pressure and the need of capital in the market constitute a favourable environment for private equity-backed takeovers.

In the short run, private equity could meet the managerial challenge to cope with 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 a rising price-competition, for instance in the automobile insurance business. Customer satisfaction also 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 German insurance companies. In the near future, this operational pressure could be supplemented by regulatory pressure on industry consolidation caused by changing capital requirements under Solvency II. If the new framework should call for a need of capital in the market, private equity could tackle the issue and smooth the impact of Solvency II on European insurance companies.

Last but not least, an investment in the insurance business is, to a certain extent, distinct and separate from macroeconomic developments because the insurance cycle usually runs quite independently of the economic cycle.

Peculiarities in the German insurance sector

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

Supervision and financial strength of bidder

Any intention to acquire directly or indirectly a qualifying participation of 10 per cent 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 per cent, 33 per cent or 50 per cent of the voting rights or nominal capital being reached or exceeded, must be notified to BaFin (the Federal Financial Supervisory Authority).

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 scepticism 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, i.e. 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, BaFin is testing the financial situation of the acquirer in detail. This extension of the authority of 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 European Community 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 co-operate satisfactorily with BaFin. The often complex, tax-driven acquisition structures of private equity funds, using acquisition vehicles in offshore jurisdictions, should be reassessed, if necessary, with a view to effective financial supervision, to avoid BaFin carrying out an investigation in this respect.

As mentioned above, even the intention (i) to hold indirectly a qualifying participation or (ii) to reach indirectly the other thresholds mentioned above, must be notified to 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.

Obligation to obtain approval 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.

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 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 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, i.e. capital paid up in exchange for the granting of subordinated loans or in exchange for profit participating rights, 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 is therefore a forbidden transaction, which can be justified only in exceptional cases.[1] 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.

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 is subject to supplementary supervision according to s.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

1. Circular Letter 15/2005.

the practice of "sound and prudent management". In addition, BaFin will supervise the adjusted solvency calculated according to Directive 98/78[2] 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.

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.

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 BaFin.

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

To the extent that 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 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 BaFin, provided the latter did not object. 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 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.* and ss.54 *et seq.* of the Law of the Supervision of Insurance Undertakings and statutory regulations.

2. Directive 98/78 on the supplementary supervision of insurance undertakings in an insurance group [1998] O.J. L330/1.

Mutual insurance corporations

It is generally agreed that mutual insurance corporations 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. First, this is because of the quasi-co-operative 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 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.

Outlook

The increase in acquisitive activity in the German insurance market suggests plenty of scope for economies of scale and attractive profits. That private equity has started to target this market, as it has done so for several years now in the United Kingdom, only reinforces this perception. 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 United Kingdom. We may also see monetisation as a source of capital move into a second phase in the United Kingdom and seriously test the waters in Germany.