

# sigma

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## **M&A in insurance: start of a new wave?**

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# Executive summary

Overall M&A activity in insurance is rising but it is still well below pre-crisis levels.

Mergers and acquisitions (M&A) tend to come in waves. After declining sharply in the wake of the financial crisis, overall M&A activity in the insurance sector has been relatively low in recent years and has only just started to increase. Surveys also suggest sentiment towards M&A is turning as insurers look for ways to deploy excess capital, boost or diversify revenue growth, build scale and ultimately bolster profitability in the face of ongoing economic headwinds.

M&A in insurance responds to structural and cyclical factors.

In insurance, M&A activity responds to both structural and cyclical factors. Changes in regulation, technology and distribution can all be catalysts given that they affect competitive conditions, but their impact is gradual. Developments in the business cycle, associated moves in financial markets and underwriting market conditions are also important influences on firms' M&A decisions, although by themselves they probably explain only around half of the variation in M&A activity in insurance.

There has been relatively strong M&A activity among agents/brokers, emerging market insurers and specialty P&C re/insurers recently.

Despite the relatively low number of transactions in the past few years, there have been pockets of activity driven by shifts in the industry environment. Key recent M&A themes in insurance include defensive divestments and strategic sales of closed blocks and run-off operations, increased involvement of alternative investors, and strategic (regular and forced) deals focused on expanding expertise, distribution capabilities and geographical reach. Activity in Asia Pacific and Latin America has gained momentum in recent years and of late there has also been a pick-up in M&A deals in the Property & Casualty (P&C) reinsurance sector. Likewise there has been significant consolidation among intermediaries in response to structural shifts in insurance distribution.

Deal success in insurance varies widely.

M&A success in insurance, as with other industries, is highly variable. In terms of stock returns, on average target firms tend to gain most in the short-term, while acquirers often struggle to extract value for shareholders. There is some evidence that on average, M&A deals do generate positive returns for buyers in the longer run but there is wide variation across transactions. The deals that seem to create value most consistently are those where insurers are from the same country and those involving vertical integration of firms at different stages of the insurance value chain.

Reinsurance can be an important tool to restructure balance sheets before and after an M&A.

The task of mitigating operational and business risks to achieve M&A success rests with the managers of insurance companies. However, reinsurance solutions can potentially help strengthen or relieve pressure on insurers' balance sheets either as a preparatory step before a sale or in the aftermath of an acquisition. Reinsurance is underutilised as an M&A capital management tool, perhaps because it is perceived as expensive or because it is not typically recommended by M&A advisors.

Momentum behind M&A activity appears to be increasing in certain segments of insurance rather than across the whole industry.

The recent spate of announced deals involving specialty P&C re/insurance firms, the continued consolidation among intermediaries and some notable high value acquisitions all suggest that momentum behind M&A is building. But in light of ongoing macroeconomic and regulatory uncertainty, the outlook for overall M&A activity in the insurance industry points to an upswing in particular segments rather than an industry-wide surge in transactions.

The upward momentum is mainly due to changes in regulation, new trends in distribution and the influx of alternative capital.

The introduction of regulations such as Solvency II will encourage some insurers to restructure in pursuit of capital efficiencies and/or economies of scale or scope. Similarly, the influx of alternative capital will continue to stimulate deals, especially if financial investors become active sellers as well as buyers. Access to digital distribution technology is another M&A driver that will likely carry increasing weight.

Ongoing globalisation will boost M&A deals, but the challenges of cross border integration should not be underestimated.

Globalisation is also driving M&A. Insurers from advanced countries continue to focus on overseas expansion in high growth markets. Increasingly too, insurers from developing economies, especially Asia, are eyeing acquisitions in advanced markets as a way to deploy their growing capital and diversify geographically. However, executing successful cross-border M&A is more challenging than domestic deals, reinforcing the need for targets with high synergies and ease-of-integration potential.

# M&A waves

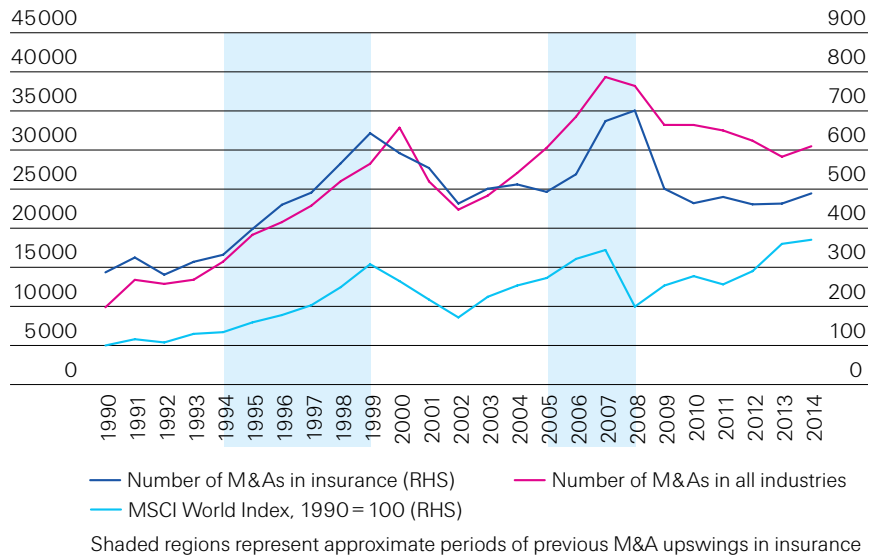
There have been two periods of heightened M&A activity across sectors in the last 25 years.

Past M&A waves have coincided with stock market booms.

There have been two episodes of heightened M&A activity in insurance over the last 25 years. The first was in the late 1990s and the second in the mid-to-late 2000s, prior to the 2008 financial crisis and subsequent global economic downturn. M&A activity in other industries has followed a broadly similar historical pattern (see Figure 1). The oscillations between periods of high and low levels of activity over time and across industries are what many authors dub merger “waves”.

Empirical studies have found that M&A waves tend to correlate with stock market performance.<sup>1</sup> But this is not always the case. While global stock markets have recovered in the years after the recent financial crisis, the level of M&A activity has remained low, suggesting that other factors also play a role. For example, in recent years equity markets have risen significantly in response to injections of central bank liquidity rather than to any major reappraisal of the long-term outlook for corporate earnings which might be more relevant for M&A.

**Figure 1:**  
M&A in insurance and all industries  
(number of completed transactions by  
year of announcement) vs stock market  
performance (MSCI World Index)



Note: Insurance M&A refers to completed transactions in the financial industry where either the target or the acquirer is an insurance entity. They include mergers, acquisitions, acquisitions of assets, acquisitions of majority, partial or remaining interest, as categorised in the Thomson ONE database. Equity buybacks, recapitalisations, exchange offers and intragroup deals are excluded. Similarly, privatisations and nationalisations of insurance companies are not counted as M&A.

Source: Thomson ONE, Datastream, Swiss Re Economic Research & Consulting.

<sup>1</sup> K. Gugler, D. Mueller, and M. Weichselbaumer, “The Determinants of merger waves: An international perspective”, *International Journal of Industrial Organization*, vol 30, no 1, 2012.

## Sources of waves

M&A waves may reflect responses to shifts in the business environment ...

There are two broad explanations for waves in M&A activity. First, waves can be caused by shifts in the business environment such as changes in macroeconomic conditions, in regulation, the emergence of new technologies, distribution channels and substitute products, shifts in customer preferences, and changes in the cost and availability of capital. Factors like these alter prospective competitive conditions and therefore profitability, prompting firms to reallocate assets to improve efficiency.

... but the effects are not always straightforward.

The shifts can affect several industries simultaneously, driving economy-wide merger waves, but the effects are not always straightforward.<sup>2</sup> A positive macro-economic outlook may encourage firms to acquire in order to complement organic growth. Conversely, in times of economic lull, firms may also look to acquisitions as a means of finding top-line growth. Similarly, while regulatory change can often be a catalyst for M&A, the design of new rules and how they are implemented crucially affects the nature and speed of corporate acquisitions and disposals.

Management and investor behaviour may also encourage takeover activity ...

The other main explanation for M&A waves focuses on management and investor actions, in particular the role of market imperfections and behavioural biases. This provides a link between merger waves and the psychology of the stock market. Management of companies with richly valued stock may seek to acquire lower-valued firms. Since more firms may become overvalued during stock market booms, peaks in merger activity may result. Similarly, management may engage in mergers seemingly for personal objectives rather than maximising shareholders' value.

... perhaps linked to underlying changes in the macro or industry environment.

These theories are not mutually exclusive and some researchers combine elements of both to explain M&A waves. Some studies argue that managerial decisions to engage in mergers are often driven by envy or hubris which, together with shifts in the general economic environment, can generate M&A cycles.<sup>3</sup>

## Structural and cyclical factors affect insurance M&A

Deregulation, the economy and developments in underwriting conditions all played a role in the late 1990s merger wave in insurance.

Merger activity in insurance in the last 25 years has been influenced by how firms and their managers respond to structural shifts in the industry and to cyclical economic factors. The merger wave of the late 1990s, for example, took place when deregulation and liberalisation in many markets fuelled price and product competition. Increased risk-absorbing capacity due to a lack of major loss events also led to a persistent softening in non-life insurance premium rates, and this encouraged consolidation in parts of the sector. Meanwhile, booming stock markets and availability of cheap credit created favourable financing conditions for M&A.

There was a lot of activity in the life sector in particular, and a number of mega deals were completed.

Demutualisations of large life insurers and the lifting of restrictions on financial conglomeration prompted a number of mega transactions.<sup>4</sup> Mergers between banks and insurers became particularly popular in Europe, though the US also completed some large deals (eg, the Citicorp-Travelers merger in 1998 valued at USD 73 billion).

Similar factors were at work in the mid-to-late 2000s ...

The wave of M&A activity in the mid-to-late 2000s also coincided with robust economic growth and rising stock markets. Earlier deregulation and structural innovations provided additional impetus. In particular, the adoption of new risk transfer techniques and products attracted alternative capital into insurance markets. This intensified competitive pressure and prompted some consolidation among insurers seeking increased scale and international diversification.

<sup>2</sup> K. Ahern and J. Harford, "The importance of industry links in merger waves", *The Journal of Finance*, vol 69, no 2, 2014.

<sup>3</sup> A. Goel and A. Thakor, "Do Envious CEOs Cause Merger Waves?", *Review of Financial Studies*, vol 23, no 2, 2009.

<sup>4</sup> See *sigma* 6/1999 – Life insurance: will the urge to merge continue? and *sigma* 1/2006 – Getting together: globals take the lead in life insurance M&A, Swiss Re.

## M&A waves

...although legacy loss concerns meant that deals were generally relatively small.

Macroeconomic factors explain about half of M&A activity.

M&A activity in insurance has been relatively subdued in recent years ...

...but it picked up towards the end of 2014 and surveys suggest the upturn may gather momentum

Legacy loss exposures and capital adequacy concerns, especially in the life sector, generally discouraged large acquisitions in the 2000s, and average deal sizes were small relative to the late 1990s. In some markets such as the US and UK, there was an increase in transactions involving portfolio transfers, which attracted new run-off providers and reinsurers.<sup>5</sup>

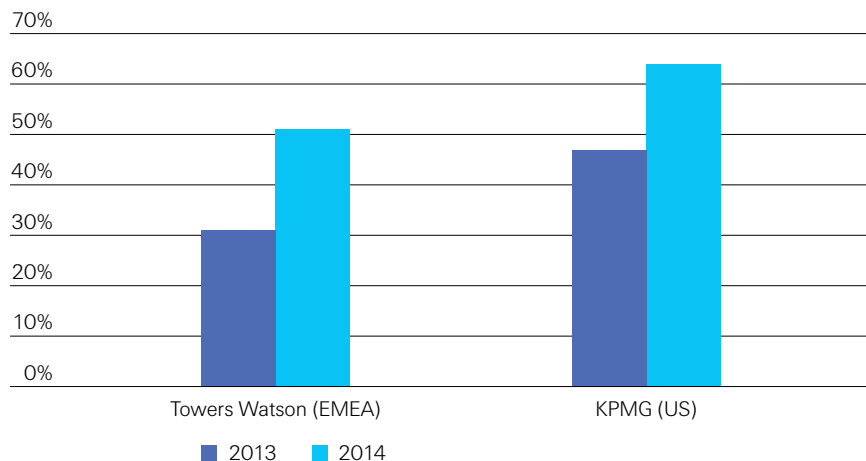
Statistical analysis of the link between insurance M&A transactions and the macroeconomic environment shows that the number of mergers tends to vary with the business cycle. However, on average business cycle developments explain only around half of the variation in aggregate insurance M&A.<sup>6</sup>

### Is a renewed M&A upswing underway?

After declining sharply in 2009 as the global economy retrenched, overall M&A activity in the insurance sector remained relatively low. The financial crisis left a long-lasting scar on the global economy and insurance industry. The sharp deterioration in equity and credit markets destroyed asset values, weakening insurers' balance sheets and significantly eroding capital. In addition, the muted economic recovery and persistently low interest rates have constrained insurers' revenues and profitability, denting firms' enthusiasm for M&A.

Over recent months, however, M&A activity has picked up. Survey evidence also indicates that sentiment towards M&A may be turning as confidence about the economic outlook gradually improves, market participants adjust to lower profitability, and M&A is viewed as a route to growth or an improved capital position. According to a recent survey conducted by Towers Watson, 51% of insurance executives expect merger activity in Europe, the Middle East and Africa to pick up over the next three years, compared with only 4% in 2013.<sup>7</sup> This broadly echoes the findings of other recent surveys (see Figure 2).

**Figure 2:**  
Survey expectations of M&A activity in insurance, percent of respondents



Note: KPMG – Insurers are very/somewhat likely to be a buyer or seller over the next 12 months.  
Tower Watson – Average percentage of insurers who intend to divest, acquire or see a rise in mergers over the next three years.

Source: Towers Watson, KPMG.<sup>8</sup>

<sup>5</sup> Portfolio transfers are acquisitions of blocks of business sometimes placed in run-off with no new business added to the books.

<sup>6</sup> Spectral analysis shows that only about 50% of the variation in aggregate M&A activity in insurance can be attributed to periodic swings in the business cycle.

<sup>7</sup> *Ready for Take-off: The Outlook for Insurance M&A in EMEA*, Towers Watson, October 2014.

<sup>8</sup> *Insurance Industry Outlook Survey – Revolution, Not Evolution*, KPMG, August 2014; Towers Watson, October 2014, op. cit.

An improved appetite for M&A is also evident in other sectors.

Structure of the *sigma*.

An improved appetite for M&A is apparent not just in insurance. According to one global survey of corporate conditions, almost two thirds of executives expect overall deal volumes to increase further in 2015, with 40% of actively intending to pursue acquisitions.<sup>9</sup> The rise in M&A is anticipated across all sectors and geographies.

Strengthening macroeconomic conditions and the prospect of normalisation in monetary policy in some parts of the world may underpin the improved M&A outlook, as insurers look to expand their businesses through strategic acquisitions. At the same time, ongoing challenges to organic growth in key markets and heightened competitive pressure in parts of the industry may encourage more defensive consolidation. To examine the underlying drivers of M&A in insurance, the next chapter examines how transactions have varied across sectors and regions in recent years. The report goes on to review evidence of whether recent M&A transactions have benefited shareholders. It then looks at the role of reinsurance solutions in facilitating successful M&A deals, and the near-term outlook for M&A in insurance.

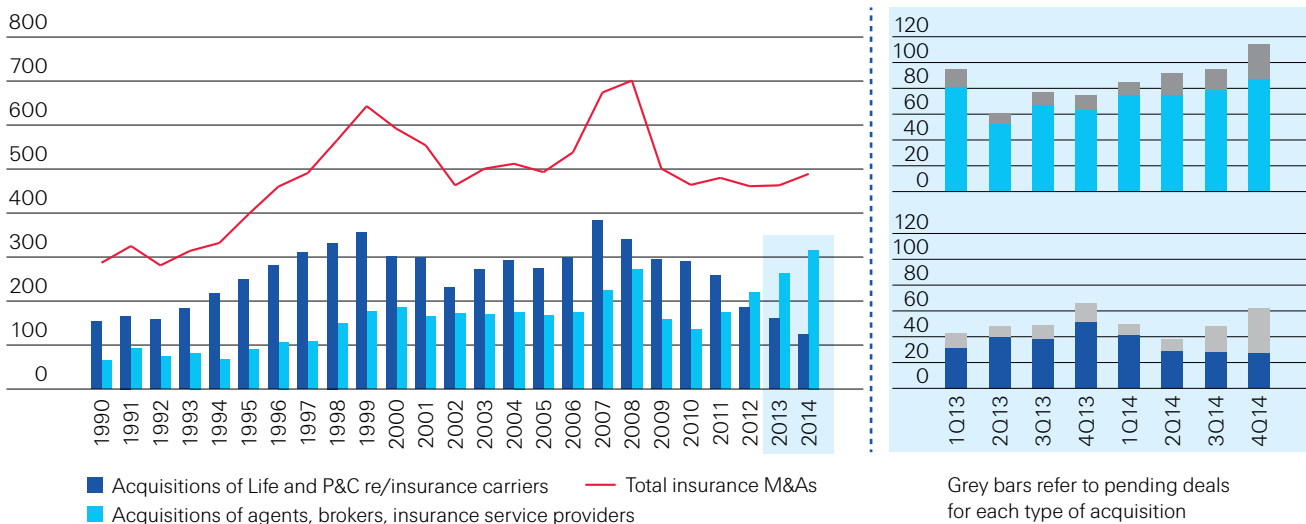
<sup>9</sup> *Global Capital Confidence Barometer*, Ernst&Young, October 2014.

# Recent patterns of M&A in insurance

The low aggregate level of M&A in insurance in recent years masks some resurgent activity in specific areas.

The overall amount of merger activity in insurance in the years after the financial crisis has remained well below pre-crisis levels. However, the aggregate masks some resurgent activity in specific areas. The pipeline of future deals has also increased: total M&A announcements accelerated notably in the second half of 2014 to 359 from 295 announcements in the first, including a few high-value deals such as UK life insurer Aviva's takeover of Friends Life. M&A activity involving emerging market insurers and consolidation among some specialist re/insurance providers has also picked up, while strategic sales of subsidiaries and closed books by insurers in the advanced economies has continued. Furthermore, there has recently been a surge in the number of M&A transactions in the insurance intermediaries sector to levels beyond those in the boom years of 2007–2008 (see Figure 3). This chapter looks at these recent trends in the context of the life, P&C and intermediaries sectors.

**Figure 3:**  
Total insurance M&As in 1990–2014, completed number of deals by year of announcement



Note: Transactions in which an insurance entity acquired another financial entity outside the insurance sector account for the difference between total insurance M&As and M&As that targeted re/insurance carriers and intermediaries.  
Source: Thomson ONE, Swiss Re Economic Research & Consulting.

## Recent M&A activity in the life sector

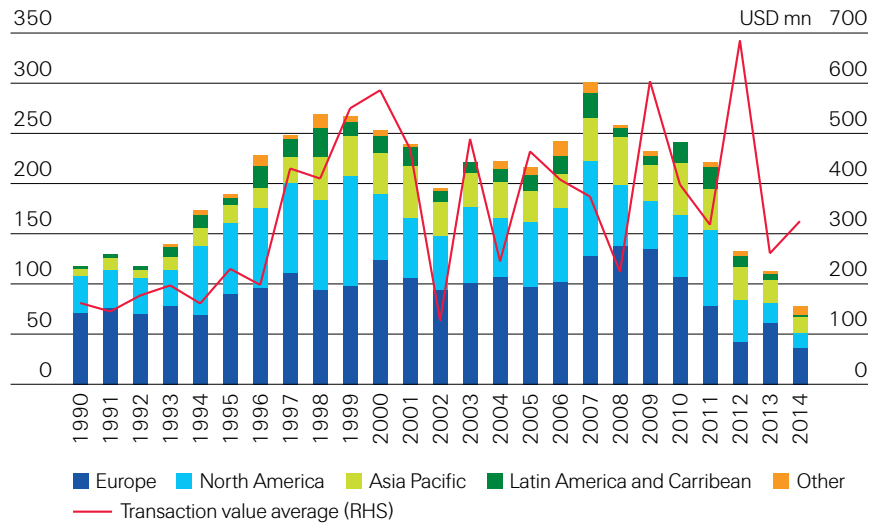
Motivations for life M&A changed dramatically after the financial crisis.

Aggregate M&A activity in the life sector dropped after the global financial crisis (see Figure 4) and the motivations to engage in M&A shifted dramatically, reflecting the deep changes in the economic and regulatory environment. In Europe and North America, financial distress and the need to strengthen balance sheets prompted numerous forced and strategic divestments. In Japan, poor growth prospects at home motivated companies to expand their footprint in other advanced markets and in emerging economies in the region. In emerging markets, M&A activity has been rising in recent years driven by regulatory reforms and the strong growth potential, which has attracted foreign buyers from mature markets. Meanwhile, some large global players have stepped up efforts to grow their asset-management arms via acquisitions of retirement plan services in order to diversify income streams.<sup>10</sup>

<sup>10</sup> For example, Great-West acquired J.P. Morgan's Retirement Plan Services, and Manulife announced it will acquire New York Life's Retirement Plan Services Business in 2014.



**Figure 4:**  
Acquisitions of life insurers in 1990–2014, number of completed deals and average deal value, by year of announcement and target region



Source: Thomson ONE, Swiss Re Economic Research & Consulting.

Forced divestitures drove some of the largest deals.

#### Defensive strategies come to the fore

Forced divestments by life insurers that came under severe stress during the financial crisis and had to accept government assistance have driven some of the largest deals in the post-crisis period. In Europe, for example, the European Commission imposed restructuring plans on bancassurers that received state aid, forcing them to divest their insurance operations. In the US, AIG had to restructure and divest part of its insurance operations to repay the USD 80 billion government aid. AIG's sale of ALICO to MetLife,<sup>11</sup> its sale of two Japanese insurers to Prudential Financial,<sup>12</sup> and ING's sale of its Latin American pensions, life insurance and investment management operations<sup>13</sup> were some of the largest deals completed as a direct fallout from the crisis. Shareholders also pushed hard for structural changes at companies hit by the crisis, leading to divestitures of unprofitable or non-core business.<sup>14</sup>

Balance sheet preservation became a key driver of strategic sales.

#### Repositioning of global players drives strategic sales

Also, a number of European and North American life insurers sold non-core and annuity units, and exited markets where performance had not met expectations. Having driven the pre-crisis rise in M&A activity, European insurers' appetite for acquisitions reversed sharply as the financial crisis evolved into a sovereign debt crisis in Europe, and also due to mounting regulatory uncertainty.

<sup>11</sup> AIG's sale of American Life Insurance Co (ALICO) to MetLife in 2010 was valued at USD 16 billion.

<sup>12</sup> AIG sold AIG Star Life Insurance and AIG Edison Life Insurance to Prudential in 2011 for USD 4.8 billion.

<sup>13</sup> ING's sale of its insurance and pension operations in Latin America to an investor group in 2011 was valued at USD 3.6 billion.

<sup>14</sup> In the case of Hartford, hedge fund investor John Paulson called for a breakup of the company to address its low stock valuation and increase shareholder value. In 2012, Hartford exited the annuities and life insurance businesses to focus on P&C insurance.

## Recent patterns of M&A in insurance

Numerous divestments by global insurance and banking groups partly reversed earlier trends of consolidation and bancassurance.

Alternative investors have emerged as prominent buyers of blocks of savings business.

In the US, there was a flurry of divestments by Canadian and European life insurers (eg, Sun Life, Manulife, Industrial Alliance, Aviva, Generali, Aegon and Old Mutual), partly motivated by regulatory differences in reporting and capital requirement standards, the expected impact of Solvency II, and uncertainty about harmonisation of solvency capital requirements. Global life insurers have also exited or scaled back operations in other developed and emerging markets in the face of lower-than-anticipated returns.<sup>15</sup> Moreover, financial conglomerates such as ING, HSBC, BBVA and Santander have retreated from bancassurance to concentrate on core banking operations. This has partly reversed the trends of consolidation and bancassurance that were prominent drivers of M&A activity in insurance in the late 1990s and early-to-mid 2000s.

### Alternative investors emerge as consolidators of savings business

The record low interest rates of recent years have made it challenging for insurers to earn enough investment income to cover fixed-return guarantees on savings business, resulting in lower profitability and pressures on capital. Additionally, new regulations such as Solvency II are making some fixed annuities very capital intensive. This has prompted a number of sales of blocks of savings business (fixed, equity-indexed annuities), particularly in the US. The investor base for life blocks of business has typically been relatively specialised, but it widened after the financial crisis as a number of private equity (PE) and hedge funds came into the market (see Table 1 below). Likewise, in the UK consolidators backed by PE have been important players in recent years, although the recent Aviva-Friends Life deal suggests that the pool of buyers of legacy business may widen.

**Table 1:**

Recent life and annuity M&A transactions in the US by alternative investors

Investors	Date	Target	Deal type
Athene	Jul 2009	American Equity Investment Life	Reinsurance of a block of business
	Oct 2010	Liberty Life Insurance (US operations of RBC Insurance)	Purchase of a company (life and health business reinsured to Protective Life)
	Feb 2011	Investors Insurance Corporation (SCOR's annuity business)	Purchase of a company
	Dec 2011	Transamerica Life Insurance	Reinsurance of a block of business
	Jul 2012	Presidential Life Insurance Company	Purchase of a company
	Dec 2012	Aviva Life and Annuity Company	Purchase of a company
Guggenheim	Dec 2010	Standard Life Insurance	Reinsurance of a block of business
	Oct 2011	EquiTrust Life Insurance Company	Purchase of a company
	Aug 2012	Industrial Alliance (US fixed annuities)	Reinsurance of a block of business
	Dec 2012	Sun Life Assurance Company of Canada	Purchase of a company
Global Atlantic Financial Group (Goldman Sachs/Investors)	Apr 2013	Presidential Life Insurance Company – USA (Athene)	Purchase of a company
	May 2013	Aviva USA Life & Annuity's life insurance business	Reinsurance of a block of business
	Sep 2013	Forethought Financial Group, Inc.	Purchase of a company
	May 2014	ReliaStar Life Insurance (ING's annuity business)	Reinsurance of a block of business
Prosperity Life Insurance Group Reservoir Capital/Black Diamond Capital Partners)	May 2011	Shenandoah Life Insurance Company	Purchase of a company
	Jan 2013	SBLI USA Mutual Life Insurance Company, Inc.	Purchase of a company through a sponsored demutualization
Harbinger Capital Partners	Aug 2010	Fidelity & Guarantee Life (US operations of Old Mutual)	Purchase of a company

Source: Thomson ONE, Swiss Re Economic Research & Consulting.

<sup>15</sup> For example, AXA, Standard Life and Aegon sold their Canadian operations; Aviva, ING, AIG and New York Life reduced their operations in Asia; Aviva sold its Turkish general insurance business Sigorta and its stake in Italian life insurer Eurovita; Axa divested of business in Hungary and Romania; and Generali has indicated plans to sell its Swiss asset management operation after pulling out of Mexico and Israel.

Investors have established themselves as consolidators of asset-intensive businesses.

The increased involvement of financial buyers as aggregators of life insurance policies has been driven by the opportunity to consolidate large amounts of insurance assets at attractive valuations and employ non-traditional investment strategies to boost investment returns. Life insurance, especially the savings business, has high asset-to-equity ratios and a small increase in investment yields can lead to significant improvement in profitability. The long-term nature of life insurance liabilities also provides financial investors with a steady and predictable form of funding which can be invested in relatively illiquid assets.

Several specialist consolidators have merged or have been acquired.

In addition to financial buyers, specialist consolidators focused on liability management rather than enhancement of investment returns have continued to acquire closed books of life insurance business in recent years and, in some cases, stand-alone companies. Specialist consolidators have themselves merged or have been acquired. In the US, some domestic consolidators have been bought by foreign companies looking to deploy capital in the closed block market.<sup>16</sup> In the UK, some of the consolidators have merged to form mega-consolidators, the two largest of which are Resolution (now part of Friends Life) and Phoenix. This consolidation has been prompted by regulatory initiatives like Solvency II which highlight the full costs associated with legacy portfolios, including the cost of capital, to support the business.

Strong growth in Southeast Asia markets has attracted foreign buyers.

#### **Emerging markets account for growing share of M&A deals**

Historically, Europe and North America have been the main target regions of M&A activity in the life sector. Since the crisis, however, the share of Asia Pacific and Latin America of total transaction values has risen (see Figure 5). As some global insurers retreated from these regions due to balance sheet strain or for strategic reasons, well-capitalised Asian and other foreign firms (including AIA, Manulife, Sun Life, MetLife and Prudential) moved in to buy the businesses being sold. Strong economic growth, rising penetration, and large and expanding populations have made Indonesia, Thailand, Malaysia and Vietnam particularly attractive for foreign life insurers.

Japanese life insurers have been especially active acquirers overseas.

Within Asia, Japanese life insurers have been especially active acquirers in an attempt to widen their international footprint. The moribund Japanese economy, already-high insurance penetration and ageing population offer poor growth prospects. At the same time, low domestic funding costs have encouraged investment in overseas markets where prospective returns are higher. Japanese insurers have expanded into other advanced markets for the same reasons.<sup>17</sup>

In Latin America, both domestic and cross-regional activity has increased.

M&A activity in the life sector in Latin America has also picked up in recent years. Domestic activity has been strong in Brazil and Chile, where regulators' desire for strong domestic insurers and a move towards stricter risk-based capital frameworks have driven consolidation. Acquisitions of Latin American Companies by buyers outside the region, including bancassurance deals, have also increased. Foreign buyers' have sought to capitalise on the region's growing middle class and the rising role of private retirement solutions in some countries such as Chile.<sup>18</sup>

<sup>16</sup> For example, Protective Life was acquired by Dai-ichi and Wilton Re by Canada Pension Plan Investment Board in 2014. Also, Jackson National (Prudential UK) acquired Swiss Re's Admin Re business in 2012 and UK consolidator Resolution Life (Resolution Group UK) entered the market by acquiring Lincoln Benefit Life in 2013.

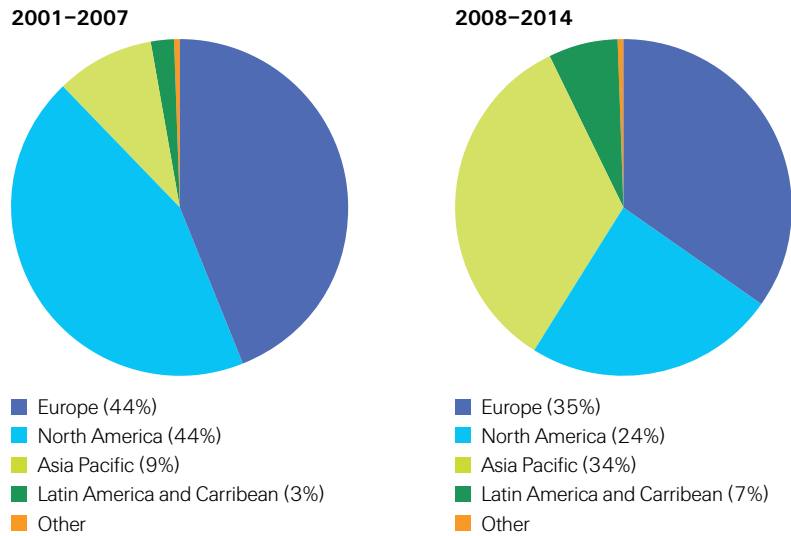
<sup>17</sup> For example, Tokio Marine acquired Delphi Financial in 2011 and Dai-ichi's acquired Protective Life in 2014.

<sup>18</sup> Notable deals completed recently include Zurich's acquisition of a majority interest in the Latin American operations of Santander Seguros, AXA's acquisition of ING's business in Mexico, Yasuda Seguros, a unit of Sampo Japan, buying a majority interest in Maritima Seguros in Brazil, and MetLife's acquisition of a 64% stake in AFP Provida S.A., the largest private pension fund administrator in Chile, from BBVA.

## Recent patterns of M&A in insurance

**Figure 5:**

Split of life insurer acquisitions by target region (based on transaction value)



Note: The split is based on deals where the value of the transaction is publicly disclosed.  
Source: Thomson ONE, Swiss Re Economic Research & Consulting.

However, inflated valuations and limits on investment have been a drag on M&A activity in emerging markets.

Interest in M&A in the emerging markets remains strong, though a number of factors continue to act as a drag on deal activity (in both life and non-life insurance).<sup>19</sup> In particular, increased buyer interest has led to inflated valuations, with sellers pricing aggressively based on anticipated future growth potential, leading some acquirers to retreat. Activity is also often stymied by difficulties around finding the right targets and limitations on investments in many markets. Table 2 shows some of the restrictions on foreign ownership currently in place in Asia.

**Table 2:**

FDI restrictions in select Asian insurance sectors

Country	Foreign direct investment (FDI) restrictions
China	Foreign investors are limited to a 50% stake in domestic life insurers. There is no limit to the shareholding in P&C insurers. For foreign investors to hold more than 25% of the equity of the insurer, more restrictive rules are applied than for domestic investors.
India	In early 2015, the limit on direct and indirect foreign equity ownership in life and non-life insurers was increased from 26% to 49%. Foreign reinsurers may also now open branches in India.
Indonesia	The foreign shareholding of any entity involved in insurance activities is limited to 80% at establishment.
Malaysia	Foreign equity ownership is limited to 70%. Investments in excess of 70% are considered on a case-by-case basis for entities that can facilitate industry consolidation and rationalisation.
Myanmar	Foreign investment in the insurance industry is not permitted.
Phillipines	There is no limit on foreign equity ownership in a domestic insurer. Foreign equity ownership in a domestic loss adjuster company cannot exceed 40%.
Thailand	Foreign investment in re/insurers is permitted; equity stakes between 25% and 49% require regulatory approval, and those above 49% require government approval. Brokers can be 100% foreign-owned but firms with foreign equity investments above 49% need to be licensed under the Foreign Business Act.

Source: Norton Rose Fulbright<sup>20</sup> and Swiss Re Economic Research & Consulting.

<sup>19</sup> *How the Asia Pacific region bucks the global insurance M&A trend*, Clyde & Co LLP, May 2014.

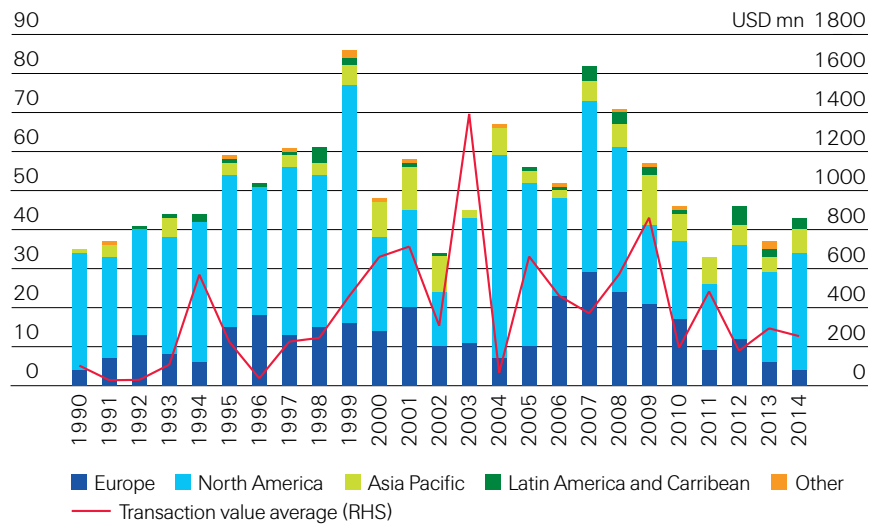
<sup>20</sup> *Insurance regulation in Asia Pacific*, Norton Rose Fulbright, January 2014.

There are generally fewer acquisitions of P&C firms than of life and intermediaries.

### Recent M&A activity in the P&C sector

There tend to be fewer M&A deals in P&C than in the life or intermediaries sectors, and those deals that do happen often cluster in particular episodes. The strategic rationale for M&A typically focuses on acquiring specialised underwriting and distribution skills, and optimising the scale of operations. The underwriting cycle also influences insurers' appetite to engage in M&A. During soft markets, capital is abundant and M&A activity tends to rise because declining rates and premiums make acquisitions an attractive alternative to organic growth. The opposite is true in hard markets, when robust premium rate increases boost profitability.

**Figure 6:** Acquisitions of P&C insurers, 1990–2014, number of completed deals and average deal value, by year of announcement and target region



Source: Thomson ONE, Swiss Re Economic Research & Consulting.

After the financial crisis, weak profitability and low market valuations discouraged M&A.

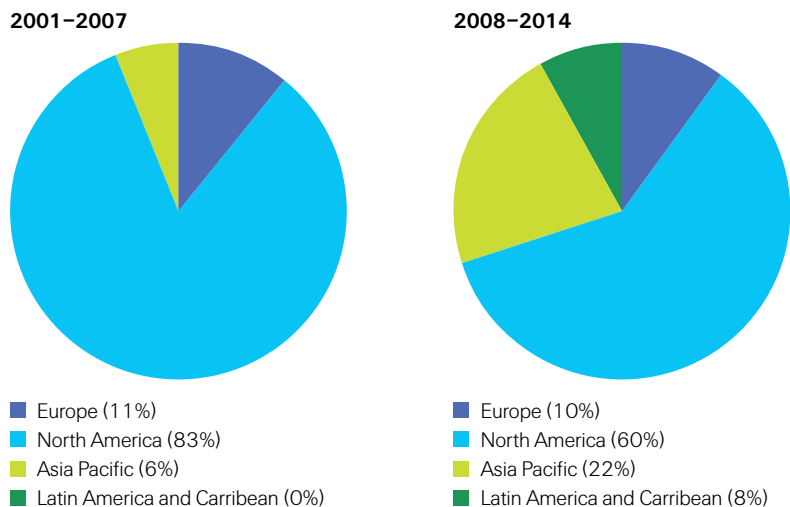
### The centre of gravity shifts away from North America<sup>21</sup>

The overall level of M&A activity in the P&C sector declined in the years after the financial crisis, and the average deal size also fell (see Figure 6). The slow global economy and weak profitability due to negative underwriting results and depressed investment yields kept buyers' interest subdued. Meanwhile, insurers' low market valuations discouraged potential sellers. Over recent months, however, the number of announced deals and total transaction values have risen.

<sup>21</sup> North America refers to the US and Canada and excludes Bermuda.

## Recent patterns of M&A in insurance

**Figure 7:**  
Split of P&C insurer acquisitions by target region (based on transaction value)



Note: The split is based on deals where the value of the transaction is publicly disclosed.

Source: Thomson ONE, Swiss Re Economic Research & Consulting.

But activity outside of the US has become more significant.

Over recent years, the centre of M&A activity in the P&C sector has moved away from North America to Asia Pacific, Europe and Latin America (see Figure 7). Within that shift, key regional developments include:

- *North America* – Domestic M&A remains dominant but a few large, cross-border deals have been completed since 2008.<sup>22</sup> Specialised insurers (eg, energy, D&O and professional liability) have become attractive targets because their favourable combined ratios offer respite from persistently low investment yields. Consolidation among mutual companies has also picked up, driven by cost pressures, rising capital requirements, growth limitations and a need to expand distribution channels.
- *Europe* – The fallout from the financial crisis prompted several prominent deals in P&C, such as the sale of insurance units by financial conglomerates (eg, Fortis<sup>23</sup>) and composite insurers divesting select non-core insurance operations (eg, Generali<sup>24</sup>). Acquisitions were also motivated by a desire to gain exposure in the high growth markets of Central and Eastern Europe.
- *Asia Pacific* – The largest domestic consolidation deals were in Japan, motivated by lack of organic growth opportunities and pressure to cut costs.<sup>25</sup> Japanese insurers have also pursued acquisitions in Southeast Asia and beyond in a bid to diversify away from domestic natural catastrophe risk exposures such as typhoon and earthquake damage.<sup>26</sup>

<sup>22</sup> The largest deals included the acquisition of AIG's 21st Century by Farmers (Zurich Financial) and Tokio Fire & Marine's acquisition of Philadelphia Insurance.

<sup>23</sup> Dutch state-owned Fortis Corporate Insurance was sold to Amlin in 2009.

<sup>24</sup> For example, Generali sold its controlling stake in Israeli insurance company Migdal in 2012 and its agricultural risk business unit Fata Assicurazioni Danni in 2013.

<sup>25</sup> For example, Mitsui Sumitomo merged with Aioi and Nissay Dowa General, creating Japan's largest non-life insurer, and Sompo bought Nipponkoa.

<sup>26</sup> For example in 2008, Tokio Marine, one of the largest Japanese non-life insurers, acquired Philadelphia Consolidated, a US P&C insurer, and the Kiln Group, an underwriter of a broad range of specialist lines and part of the Lloyd's specialist insurance market.

- *Latin America* – Both domestic and cross-border activity in P&C has accelerated in recent years, especially in Brazil, Mexico and Argentina. The region has remained attractive to foreign buyers,<sup>27</sup> but high market concentrations in Brazil and Mexico present significant challenges.
- *Africa* – Deal-making has been on the rise in recent years, especially in Sub-Saharan Africa where cross-border activity has accelerated, supported by strong market growth and regulatory changes (see Box: “M&A activity in Sub-Saharan Africa on the rise” below).

M&A activity in SSA has increased recently and it includes foreign buyers.

### M&A activity in Sub-Saharan Africa on the rise

In the early- to mid-2000s, M&As in Africa were confined almost exclusively to the more advanced markets of South Africa and those in northern Africa. But activity in the other 40 plus countries in Sub-Saharan Africa (SSA) has been on the rise recently. Nigeria and Kenya have become particularly attractive target markets due to their size (second and third in SSA after South Africa) and rapid economic growth. Regulatory changes, including new rules in Nigeria requiring banks to divest their insurance subsidiaries or clearly separate them in a holding company structure, have also spurred M&A. The region is increasingly attracting foreign buyers, primarily from Western Europe. Pan-African insurance groups (eg, Old Mutual, Santam/Sanlam, Morocco headquartered Saham group) have also expanded strongly into SSA.

Fragmented markets, PE capital and regulatory changes will further increase M&A activity.

M&A activity in SSA seems set to gain further momentum. Many markets in the region remain highly fragmented providing ample scope for consolidation. Licensing restrictions also mean market entry by new players is often only possible by acquisition. Furthermore, PE firms raised an estimated USD 4 billion for investments in Africa in 2014, which could further boost M&A activity in insurance.<sup>28</sup> At the same time, the upgrade of solvency regimes (eg, in South Africa to a Solvency II type regime and Kenya to a risk-based capital framework) and changes in reporting standards (eg, the switch to IFRS accounting in Nigeria) will likely trigger further sector consolidation in SSA, especially among small insurers.

Sales of books in run-off have increased.

### Activity in the run-off segment becomes more significant

Acquisitions of P&C business placed in run off have increased since the financial crisis hit, especially in 2011 to 2013 (see Figure 8). The UK has been a core market for legacy acquisitions given its favourable legal and regulatory environment.<sup>29</sup> With the UK non-life run-off sector reaching maturity, legacy acquirers are reportedly looking to expand in the US and continental Europe, where the size of run-off portfolios are significant. The majority of the traditional run-off market acquirers have a foothold in one or both of these markets.<sup>30</sup> Portfolio disposals can be a quick and effective way to achieve early exit from business in run-off so that capital may be redeployed to support new or expanded lines of business. Surveys persistently suggest that more efficient capital management remains the most influential driver of run-off restructuring activities.<sup>31</sup>

<sup>27</sup> Recent acquisitions include ACE’s acquisition of two P&C insurers in Mexico and one in Ecuador for a combined USD 1.21 billion, Liberty Mutual buying two insurers in Ecuador, and AXA’s acquisition of HSBC’s Mexican P&C insurance operations.

<sup>28</sup> See *A Sub-Saharan Scramble*, The Economist, 24 January 2015.

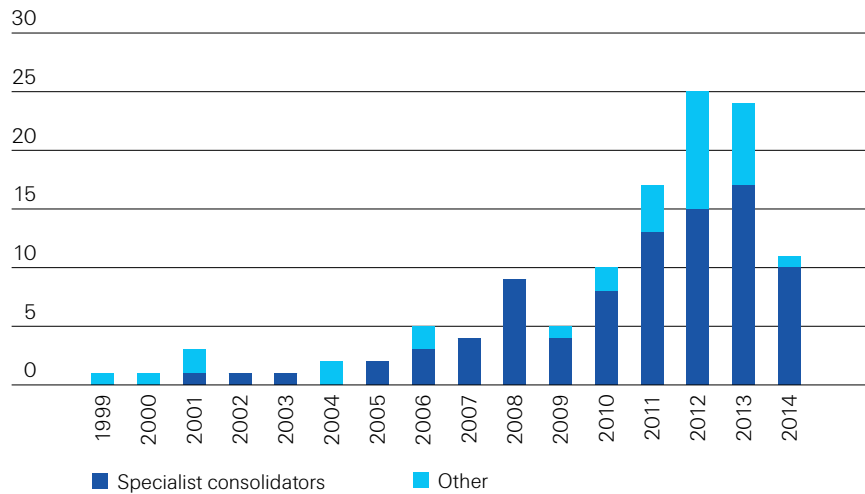
<sup>29</sup> For example, so-called (solvent) schemes of arrangement have been developed in UK common law to enable rapid and legally binding re-structuring of legacy portfolios for onward sale to a third party.

<sup>30</sup> For example, Enstar has Copenhagen Re (Denmark) and Providence Washington Insurance (US); Catalina owns Glacier Re (Switzerland) and Residential Loss Control Holdings (US); and Tawa has Chilington Group (Germany and Europe) and Lincoln General (US).

<sup>31</sup> See for example, *Unlocking value in run-off: A Survey of Discontinued Insurance Business in Europe* (seventh edition), PwC, September 2013.

## Recent patterns of M&A in insurance

**Figure 8:**  
Number of acquisitions of non-life run-off portfolios



Data from 1999 to September 2013 based on information published by *Insurance Insider*. More recent data compiled from news stories reported on the website of the journal of legacy re/insurance business.

Source: Insurance Insider and Swiss Re Economic Research & Consulting calculations.

The run-off business model has evolved to include new risks and markets.

Traditionally focused on casualty lines, run-off acquirers have expanded into much shorter tail business such as motor and other personal and commercial insurance.<sup>32</sup> Recycling of run-off portfolios has also become more common with books of business changing hands once the original buyer's strategy for the business is concluded.<sup>33</sup> Some traditional run-off consolidators have also acquired live entities, expanding their business models beyond servicing discontinued policies. In some cases, the acquired portfolios have subsequently been closed and placed in run off. But alongside this trend has been the creation of specialist business units seeking to leverage their expertise in managing legacy portfolios for ongoing business. In so doing, consolidators aim to secure diversification benefits to smooth out the lumpy returns often associated with legacy business.<sup>34</sup>

An abundance of capital has prompted consolidation among specialist re/insurers.

### Alternative capital growth sparks consolidation of specialist re/insurers

Low interest rates, benign natural catastrophe (nat cat) losses and the perceived low correlation between nat cat and financial market risks have attracted private and institutional investors into the P&C re/insurance market. Alternative capacity from hedge funds, investment banks and more recently pension funds into cat bonds, sidecars, insurance-linked securities and industry loss warranties has surged, prompting pricing for some property and casualty lines to slide. This has motivated defensive consolidation among specialist wholesale re/insurers in Bermuda and Lloyd's of London, as these smaller re/insurers have sought to combine risk-bearing capacity to take on wider and emerging corporate risks and reduce costs through operational synergies.

<sup>32</sup> Recent examples include the HSBC Corinthian UK motor book acquired by RITC Syndicate Management; the Inter Hannover commercial and retail business acquired by Enstar; and the run-off of Brit Insurance Limited, a predominately small-to-medium-sized enterprise commercial business.

<sup>33</sup> An example is Audley Capital's sale of Scottish Lion to Berkshire Hathaway.

<sup>34</sup> Recent examples include Tawa's launch of broking platform Q360 and Randall & Quilter's launch of a Lloyd's syndicate for 2013.



**Table 3:**  
Recent M&A transactions involving  
Lloyd's and Bermudan re/insurers

Date of announcement	Acquirer	Target	Deal value, USD bn
Dec 2012	Aquiline	Equity Redstar	0.1
Jun 2013	Enstar/Stone Point	Atrium	0.2
Jul 2013	Enstar/Stone Point	Torus	0.7
Aug 2013	Ian Beaton and Management	Ark Syndicate Management	0.4
Aug 2013	Lancashire	Cathedral	0.4
Aug 2013	AmTrust	Sagicor	0.1
Sep 2013	ANV	Jubilee Managing Agency	N/A
Dec 2013	Sompo	Canopus	1.0
Feb 2014	Qatar Insurance Company	Antares	0.2
Jul 2014	BTG Pactual	Ariel Re	0.4
Nov 2014	RenaissanceRe	Platinum Underwriters	1.9
Dec 2014	XL Group	Catlin	4.1
Jan 2015	PartnerRe	AXIS	11.0
Feb 2015	Fairfax Financial Holdings	Brit	1.9

Source: Insurance Insider, Thomson ONE, SNL Financial, various public sources.

M&A transactions involving Lloyd's and Bermuda insurers have picked up recently.

A number of deals among Lloyd's and Bermudan re/insurers were concluded in the past two years, mostly involving small participants. Over the past few months, however, several larger deals were announced including the acquisitions of Platinum by RenaissanceRe, Catlin by XL Group, Brit by Fairfax and the merger between PartnerRe and Axis Capital (see Table 3). M&A is seen as offering a more straight forward entry into markets such as Lloyd's compared with a syndicate start-up. Specialist re/insurers may also have become more willing sellers than in the past given pending regulatory changes which will impose higher solvency requirements to cover the significant concentrations of catastrophe risk that such firms typically assume. As discussed in the box "Recent drivers of M&A in reinsurance", ongoing structural shifts in reinsurance markets are underpinning sector consolidation, especially among small- and mid-tier firms.

Structural shifts in reinsurance markets are prompting consolidation.

New sources of reinsurance capacity are putting downward pressure on premium rates.

The severity of some insurance losses increasingly favours internationally diversified reinsurers with large capital buffers.

Many cedants want to partner with a small number of highly-rated global reinsurers.

Reinsurers from emerging markets are seeking a global presence.

There has been significant M&A activity in the intermediaries sector in recent years.

### Recent drivers of M&A in reinsurance

Shifts in the competitive landscape have intensified pressures on small to mid-tier (especially mono-line, property catastrophe-focused) reinsurers in recent years. This has encouraged them to look for potential takeover targets or strategic mergers to boost their capacity and market reach. The following stand out as key influences on reinsurers' desired corporate structures and in particular their willingness to engage in M&A:

- *New "permanent" sources of alternative capital.* Alongside the development of insurance-linked securitisations (ILS), a number of hedge funds/asset managers have started up or acquired reinsurers. These new sources of capital in reinsurance have contributed to "soft" underwriting conditions.
- *Perceptions that balance sheet size is crucial.* The increasing scale of peak risks means some classes of business can often only be underwritten by reinsurers with large capital buffers. The unexpectedly high reinsurance losses from the Chilean earthquake in 2010 and the Thai floods of 2011 highlight the dangers of being undercapitalised. Those reinsurers with a global footprint can diversify risks internationally and across sectors and thereby optimise capital.
- *Changing reinsurance buyer behaviour.* Driven partly by recent regulation and resulting changes to the way they manage their capital, primary insurance companies (especially the large global firms) have tended to buy less reinsurance, rationalise the set of reinsurers they use, or turn to alternative capital providers. This has intensified price competition and made it more difficult for smaller, less well-diversified reinsurers to compete.
- *Global ambitions of emerging market reinsurers.* A number of reinsurers from emerging markets such as China, India and Brazil have a stated goal to expand their footprint internationally. For example, India's GIC Re, is one of the leading reinsurers in the Middle East.<sup>35</sup> It already generates around 40% of its premiums from overseas business and aims to become a top five global player.<sup>36</sup>

### M&A activity in the insurance intermediaries sector

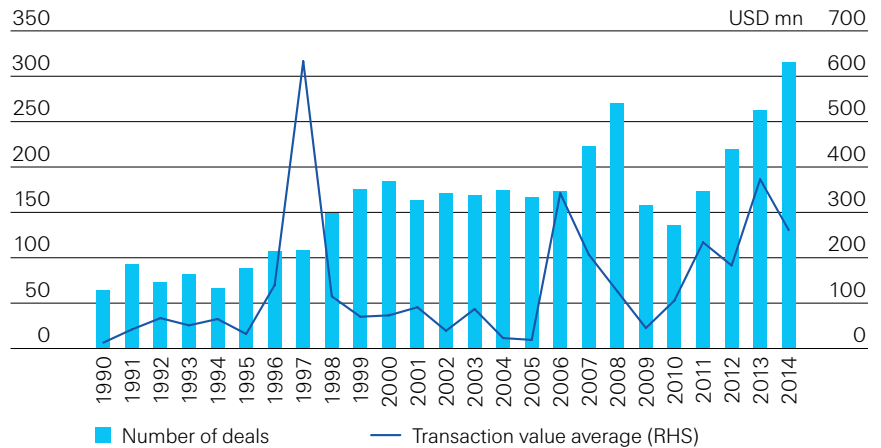
M&A transactions involving insurance intermediaries – agents, brokers and service providers – have become progressively more significant in recent years both in number and in terms of deal size (see Figure 9). Compared with insurance carriers, activity in this sector is less cyclical, likely due to the companies' low balance sheet risks. Consolidation of insurance agents and brokers has been ongoing as brokers in the mid-tier segment combine capacity to compete with very large firms such as Aon, Willis and Marsh, which themselves have been making acquisitions to consolidate their market positions. In most cases, acquisitions have been driven by scale economies since intermediaries require substantial investments in infrastructure and new technology.

<sup>35</sup> *Reinsurance 2020: breaking the mould*, PwC, 2013.

<sup>36</sup> In April 2014, Indian reinsurer GIC Re acquired South African reinsurer Saxum Re in what is the company's first overseas transaction.

**Figure 9:**

Acquisitions of agents, brokers, and insurance service providers, 1990–2014, number of completed deals and average deal value, by year announced



Source: Thomson ONE, Swiss Re Economic Research & Consulting.

M&A volumes were hit hard by the crisis.

**Buyers retreated during the crisis, but have since come back strongly**

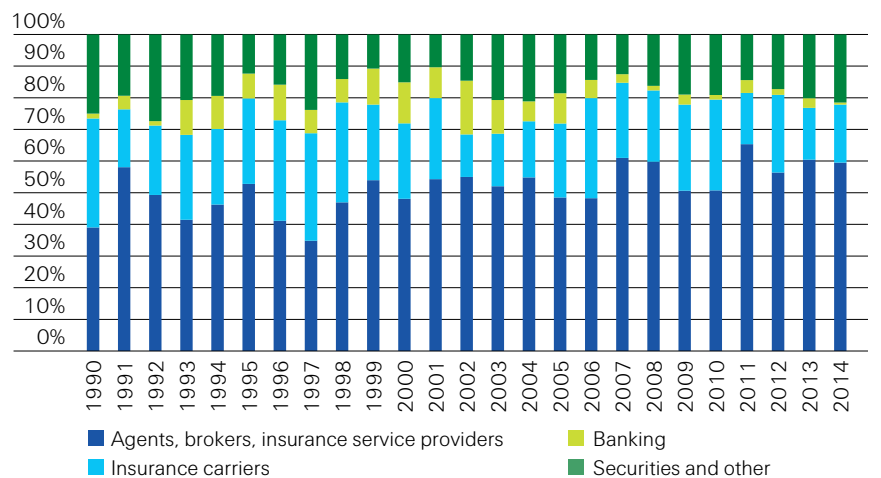
Having accelerated in 2007–2008, in part due to disruptions in the US market caused by the investigation of insurance industry practices,<sup>37</sup> the number of acquisitions of agents, brokers and insurance service providers fell sharply in the wake of the financial crisis (see Figure 10). Balance sheet pressures and general scarcity of credit prompted acquirers to pull back significantly, especially trade buyers (ie, those already in the insurance sector).

But activity has since rebounded, driven by targeted acquisitions of small, specialised insurance agencies and the international expansion of large brokers.

But the slowdown in M&A activity proved temporary. Acquisitions of insurance intermediaries have picked up again since 2011. Interest in cross-border transactions has risen, with large brokers actively pursuing international expansion to be better positioned to meet the needs of large corporate clients wanting to partner with a firm with a global footprint. Domestic activity has accelerated as well, with brokers acquiring small- and mid-sized distribution firms in order to gain scale and provide a full range of intermediary services and analytical support capabilities, including actuarial expertise. Vertical integration, with insurers acquiring agencies and services companies and vice versa, has also been a theme. In addition, bank-owned agencies have continued to pursue growth through M&A.

**Figure 10:**

Completed acquisitions of agents, brokers and insurance service providers, 1990 to 2014, by year of announcement and type of acquirer, % of total



Source: Thomson ONE, Swiss Re Economic Research & Consulting.

<sup>37</sup> Disruptions in the distribution market followed the then-New York Attorney General Eliot Spitzer’s investigations into insurance industry practices starting in 2004. The investigations focused mostly on bidding processes and potential conflicts of interest caused by contingent commission agreements. Other states and the Securities and Exchange Commission launched similar investigations.

## Recent patterns of M&A in insurance

Insurance brokerage markets have correspondingly become more concentrated.

PE funds have been significant acquirers of US insurance agents/brokers.

**Table 4:**

Select recent US private equity acquisitions of insurance brokers

According to recent research by Finaccord, 61 of the world's top 150 broking groups made at least one acquisition relevant to commercial lines broking between January 2012 and June 2014, and 10 made at least 10 such acquisitions.<sup>38</sup> As a result, the wholesale broking market has become more concentrated: in 2013, the top 15 broker firms accounted for 43.1% of global commercial non-life revenues. More generally, in all lines of business, market consolidation has occurred most among mid-tier firms. The cumulative share of total brokerage revenues accounted for by the sixth to 15th largest brokers was 34.9% in 2013 up from 25.6% in 2002.<sup>39</sup>

### Private equity investors have also become active again

There has been a resurgence in acquisitions of insurance brokers by PE firms also. The fee-based service nature of insurance brokers typically delivers stable cash-flows while carrying low balance sheet risk, a structure that fits well with the leveraged risk and return strategy employed by PE funds. Table 4 shows a selection of recent PE deals involving US insurance brokers. Many of the PE-backed brokers changed ownership, most in secondary buyouts between private equity firms. These agencies were originally acquired by PE firms in the period 2005 to mid 2008, when cheap credit was typically readily available.<sup>40</sup>

Date announced	Investor	Target	Deal value, USD bn	Form
Apr 2012	New Mountain Capital LLC	AmWINS Group Inc	1.3	Leveraged buyout
Nov 2012	Kohlberg Kravis Roberts & Co.	Alliant Insurance Services	n/a	Tertiary buyout
Nov 2012	Onex Corp	USI Holdings Corp	2.3	Secondary buyout
Apr 2013	Madison Dearborn Partners	National Financial Partners Corp.	1.3	Leveraged buyout
Jun 2013	Kohlberg & Co LLC	Risk Strategies Co Inc	n/a	Leveraged buyout
Aug 2013	Hellman & Friedman LLC	Hub International Ltd	4.4	Secondary buyout
Jan 2014	Kohlberg Kravis Roberts & Co.	Sedgwick Claims Mgmt Svcs Inc	2.4	Leveraged buyout
Jul 2014	Onex Corp	York Risk Services Group Inc	1.3	Secondary buyout

Source: Thomson ONE, Swiss Re Economic Research & Consulting based on various public sources.

PE interest in the London market brokers has also risen.

Outside of the US, PE interest in London market brokers has also increased. In 2012 and 2013, PE firms invested in leading independent London market brokers to further their acquisition-led growth strategies. A PE-backed London market broker consolidator – Global Risk Partners – was launched in 2013. It made its first acquisition in November 2013 and is reportedly targeting other small- and mid-sized brokers.

<sup>38</sup> *Global Insurance Broking: A Strategic Review of the World's Top 150 Commercial Non-Life Insurance Brokers*, Finaccord, October 2014.

<sup>39</sup> Based on data from various *Top 50 brokers*, Insurance Times/IMAS surveys.

<sup>40</sup> In 2007–2008, PE capital was responsible for the acquisition of four of the top 20 US brokers (USI, Hub, Alliant and Bollinger).

# Does M&A in insurance add value?

A successful M&A boosts shareholder wealth.

From shareholders' perspective, an acquisition is successful if it creates economic value and boosts wealth. There should be a favourable impact on the amount, timing and risk of the future cash flows of the combined institution compared to that of the acquiring and target firms as independent entities. The extra value created by a merger or acquisition reflects the synergies that can be harvested by a combined entity. This chapter looks at the economic rationale for M&A, and also whether deals in the last 10 years have created or destroyed shareholder value.

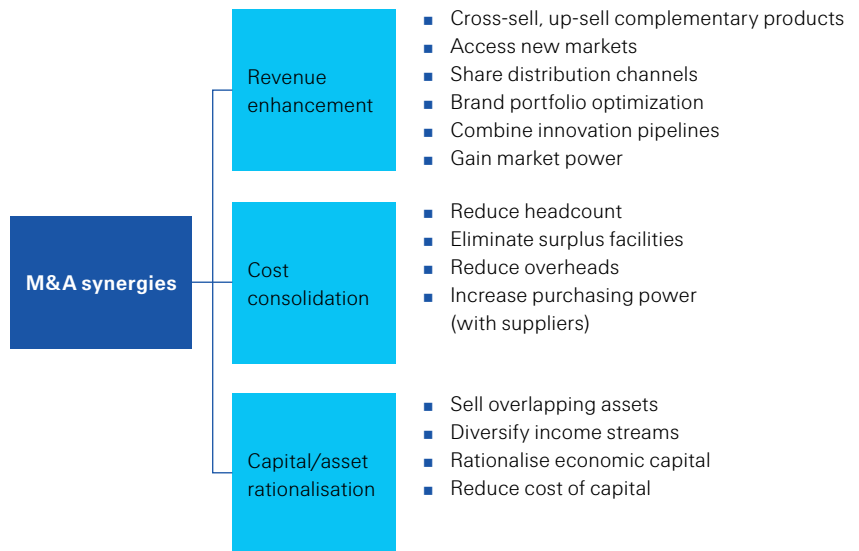
The extra value comes from exploiting the synergies of a combined entity.

## Sources of synergy

The specific path to value creation by M&A depends on the underlying economics of the businesses involved. In general, there are three areas of prospective synergies: revenue growth, cost consolidation and capital/asset rationalisation (see Figure 11).

**Figure 11:**

Key sources of synergy in an M&A



Source: Adapted from *M&A deal evaluation: challenging metrics myths*, AT&Kearney, 2013.

Such synergies typically relate to potential revenue enhancements, ...

*Revenue-enhancement synergies* refer to the increase in sales generated by the integration of the operations of the bidder and target firms. Synergies may arise from the sharing of complementary resources and revenue-based economies of scope. For example, access to banks' branch networks and the potential to cross- and up-sell banking and insurance products have been key drivers in the rise of bancassurance.

... scope for cost consolidation ...

*Cost-based synergies* may arise from economies of scale and/or scope. Economies of scale can be achieved when the fixed costs of operations are spread over a larger customer base. Economies of scope are realised when the costs of producing and distributing multiple products by one company are lower than by separate firms. Cost economies of scope generally arise from the joint use of inputs such as managerial expertise, customer lists and technology. Revenue economies of scope are often due to reductions in consumer search costs and improvements in service quality from the joint provision of products such as home and automobile insurance.

## Does M&A in insurance add value?

...and capital/asset rationalisation.

*Capital/asset rationalisation.* By diversifying across different activities, firms may be able to economise on assets, lower earnings volatility and reduce the amount of shareholder funds required to cover unexpected losses. Composite insurers that issue a broad array of life and non-life policies often say their business mix makes them less vulnerable to a weakening of market conditions in a particular line. Large firms may also have better access to external capital to finance growth than smaller ones.

But there may also be negative synergies which can undermine gains from a merger or acquisition.

In practice, however, realising synergies can be challenging. In part this may be because combining firms can generate unforeseen or under-appreciated negative synergies. Successful mergers are often impeded by frictions arising from integrating corporate systems and cultures of the previously separate firms. M&A activity may also distract managers' attention from the core business, which can impact profitability in the short-term and more permanently if, for example, it leads to customer dissatisfaction and defections.

Positive synergies may also be illusory if the deals are driven more by manager than shareholder interests.

Managers of companies may not always have the same objectives and incentives as shareholders. They may undertake takeovers or head off hostile takeovers in pursuit of their own interests rather than those of shareholders. Takeovers with questionable long-term value for the firm may thus occur while others, which would benefit shareholders, are avoided.

And any gains from a takeover may be expropriated by the sellers at the expense of the acquirers.

Even when the synergies are net positive and the incentives of shareholders and executives are broadly aligned, the value created by a takeover may not always accrue to the shareholders of the acquirer. Sellers will anticipate the buyers' synergies and demand takeover premiums which could expropriate all of any gains from the transaction. Managers may also be prone to overconfidence about their own abilities to extract synergies from an acquisition, resulting in overpayment for the target company. In a 2012 Bain & Company survey of global executives, overestimating synergies was the second most common reason for disappointing deal outcomes.<sup>41</sup> Revenue synergies from an M&A may be particularly hard to achieve relative to cost synergies.<sup>42</sup>

Ultimately, the success of an M&A depends on management's ability to deal with key strategic and operational challenges.

M&A success depends on individual firm and deal characteristics, and is often a function of strategic complementarity, cultural fit and degree of integration achieved. The smooth assimilation of people and systems are typically some of the most important factors in a successful merger. Coping with such operational and strategic business risks ultimately boils down to the skill of management both in identifying suitable targets and in executing and delivering the potential synergies from combining entities or portfolios.

### Judging M&A performance in insurance

Measuring the impact of an M&A on economic value is challenging.

Measuring the value of a merger or an acquisition is an inexact science, not least because it is difficult to isolate the empirical impact of an M&A on firms' performance. To the extent that changes in the external market environment (eg, regulation) or internal organisation (eg, departure of key staff) coincide with a merger, the firms' financial returns will be a function of all those effects and not just the impact of the M&A.

<sup>41</sup> Survey of 352 executives in North America, Europe and Asia, conducted by the *Economist Intelligence Unit* on behalf of Bain & Company, 2012.

<sup>42</sup> *M&A Integration: Looking beyond the here and now*, PwC, 2014. In this survey, 67% of respondents reported favourable results for capturing cost synergies, while only just over half (54%) reported favourable results from capturing revenue synergies.

Stock price reaction to an announced deal can provide some indication ...

An indicator of M&A performance most commonly cited is the movement in stock prices of firms involved in the transaction.<sup>43</sup> If financial markets are efficient, the impact of an M&A on all future profits of the firms involved should show up in the share prices of the acquirer and/or target companies immediately after announcement of the deal. Crucially though, to evaluate the effect of the merger or acquisition, stock returns must be compared with what might have been expected absent the transaction in order to calculate a so-called “abnormal return”.

... but judging abnormal stock returns due to M&A is necessarily imprecise.

Since investors’ expectations are not directly observable, researchers have employed various models to estimate and test the statistical significance of implied abnormal stock returns associated with events such as M&A. Typically the approach varies according to how the expected or normal return is calibrated and the time horizon over which the full effects of the specific event are assumed to be revealed in stock prices (see Appendix). For short- and long-term analysis, the cumulative average abnormal return (CAAR) is often used. For the long-term, average buy and hold abnormal returns (BHAR) are another measure.

The empirical evidence on abnormal stock returns that can be attributed to M&A is mixed.

#### Previous empirical studies

Many previous studies have examined the issue of M&A performance, albeit mostly for firms outside the financial services/insurance sector. At best, the results are mixed. Some studies have found significant improvement in the firms’ share prices post-acquisition, some a significant deterioration, and others not much change. Also, to the extent that there are gains from an M&A, the weight of evidence seems to suggest that most of the value accrues to the target rather than the acquiring firm.<sup>44</sup>

Studies focused on insurance sector deals show similarly equivocal results.

The relatively few studies that have focused on deals in the insurance sector reveal similarly ambiguous results (see Table 5). The studies employ different metrics, consider different firm samples/time periods and use different statistical approaches, so strict comparisons are difficult. But the variation and sometimes conflicting nature of the results does raise doubts over the effectiveness of M&A in boosting returns for shareholders, especially those of the acquirer firms.

This section presents a statistical analysis of stock returns of merged or acquired insurance companies.

#### A closer look at performance over the past decade

To examine the robustness of the link between M&A and insurers’ financial performance, the rest of this chapter analyses the results of a battery of statistical tests of stock market returns for both target and acquirer insurance companies involved in an M&A over the past 10 years. In particular, the analysis considers how far the timing (pre- and post-crisis periods), the type (eg, consolidation, vertical integration), the business topography (cross-border vs domestic), the acquisition experience and the size of the deal affect stock market assessments of M&A value creation. Detailed results of the analysis are contained in the Appendix.

<sup>43</sup> As well as stock prices, researchers also consider pre- and post-merger accounting indicators of profitability such as return on assets, and qualitative indicators of corporate performance such as surveys of industry executives.

<sup>44</sup> For example, one study of M&A transactions completed between 1988 and 2010 found that average share price outperformance over a seven-day window centred on the announcement date was 15.5% for the target but –1% for the acquirer. See *Riding the next wave: where are the opportunities to create value?*, Boston Consulting Group, 2011.

## Does M&A in insurance add value?

**Table 5:**

Summary of previous studies on M&A performance in insurance

Study	Sample (period)	Scope	Method	Key findings
BCG (2009) <sup>1</sup>	More than 1100 deals (1999 to 2008)	Insurers from North America and Western Europe where more than 75% of target acquired.	Short-horizon CAAR*, 7 days around announcement.	<ul style="list-style-type: none"> <li>More than 50% of deals do <i>not</i> create value for acquirers.</li> <li>Investors favour deals done in acquirers' home markets.</li> <li>Larger deals deliver less value.</li> </ul>
Accenture (2011) <sup>2</sup>	500 of largest global deals (2002 to 2009)	All industries, including insurance.	Long-horizon excess TRS*, 24 months after deal announced.	<ul style="list-style-type: none"> <li>Median excess return of 20%</li> <li>Insurance ranked 4th behind banking, consumer goods and mining for excess returns.</li> </ul>
McKinsey (2012) <sup>3</sup>	More than 15000 deals (1999 to 2010)	World's top 1,000 non-banking companies.	Long-horizon TRS* versus index, 10 year window.	<ul style="list-style-type: none"> <li>Acquirers tend to produce long-run positive excess returns (average 3.6%)</li> <li>Large acquisitions more successful.</li> </ul>
Towers Watson (2014) <sup>4</sup>	(2008 to 2013)	Publicly-listed insurance companies around the world.	Excess share price, over industry index from six months prior to end of quarter in which deal completed (short term) or two years after completion (long term).	<ul style="list-style-type: none"> <li>Acquirers' equity outperformed in the short run (4.2 percentage points (ppt)). But no long-run valuation premium.</li> <li>Domestic acquisitions create most value (8.3 ppt excess returns in short-term and 7.9 ppt in long run).</li> </ul>
Cummins & Xie (2005) <sup>5</sup>	Around 400 deals (1997 to 2003)	Acquisitions and divestitures in US P&C insurance.	Short-horizon CAAR*, up to 15 days before/after announcement.	<ul style="list-style-type: none"> <li>Both acquirers and targets earn positive abnormal returns. But gains typically much larger for targets (20% versus about 1%).</li> <li>Acquisitions focussed on geography and business line earn highest abnormal returns.</li> </ul>
Cummins, Weiss & Klumpes (2008) <sup>6</sup>	More than 4000 transactions (1990-2006)	North American or Western European insurance company M&A where acquirer obtains controlling stake.	Short-horizon CAAR*, up to 15 days before/after announcement.	<ul style="list-style-type: none"> <li>Small positive abnormal returns for acquirers. But gains for targets more substantial (12% to 15%).</li> <li>For acquirers, no difference in performance between cross-border and domestic deals. Both types create substantial value for targets.</li> </ul>
Cummins & Weiss (2004) <sup>7</sup>	Around 500 transactions (1990–2002)	Acquisitions (including minority stakes) where target or acquirer was an insurance company from Western Europe.	Short-horizon CAAR*, up to 15 days before/after announcement.	<ul style="list-style-type: none"> <li>Small <i>negative</i> abnormal returns for acquirers; targets realised substantial positive returns (12% to 15%).</li> <li>Cross-border transactions value-neutral whereas domestic transactions led to value loss (approx. -2%) for acquirers. For targets, both cross-border and domestic deals led to substantial value-creation.</li> </ul>

Notes: \*CAAR = cumulative average abnormal return; TRS = total return to shareholders.

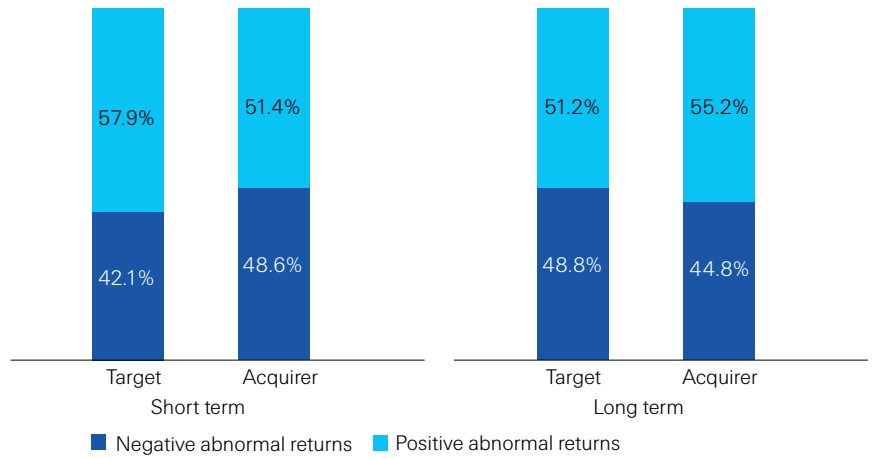
1. *Value creation in insurance: laying the foundation for successful M&A*, Boston Consulting Group, 2009.
2. *Who says M&A doesn't create value?*, Accenture, 2011.
3. *Taking a long-term look at M&A value creation*, McKinsey, 2012.
4. *Acquisitive insurers outperform peers*, Towers Watson, 2014.
5. J.D. Cummins & X. Xie, "Efficiency and value creation in acquisitions and divestitures – evidence from the us property-liability insurance industry", *Journal of Productivity Analysis*, vol 39, Issue 2, April 2013, pp 141–164.
6. J.D. Cummins, M. Weiss & P. Klumpes, "Mergers and Acquisitions (M&A) in the European and US Insurance Industries: Information Asymmetry and Valuation Effects", Temple University/Imperial College London mimeo, 2008.
7. J.D. Cummins & M. Weiss, "Consolidation in the European Insurance Industry—Do Mergers and Acquisitions Create Value for Shareholders?", *Wharton Financial Institutions Centre*, working paper 04-02, 2004.

Recent M&A has generated negative and positive abnormal returns in roughly equal proportions.

Echoing the results of earlier studies, post-merger stock performance has varied considerably over recent years. Of the 1690 insurance deals in the sample, broadly as many transactions led to negative as positive abnormal stock returns. This is true of both short-run as well as long-run indicators of performance (see Figure 12).



**Figure 12:**  
Proportion of insurance M&A deals with positive short-term and long-term abnormal returns

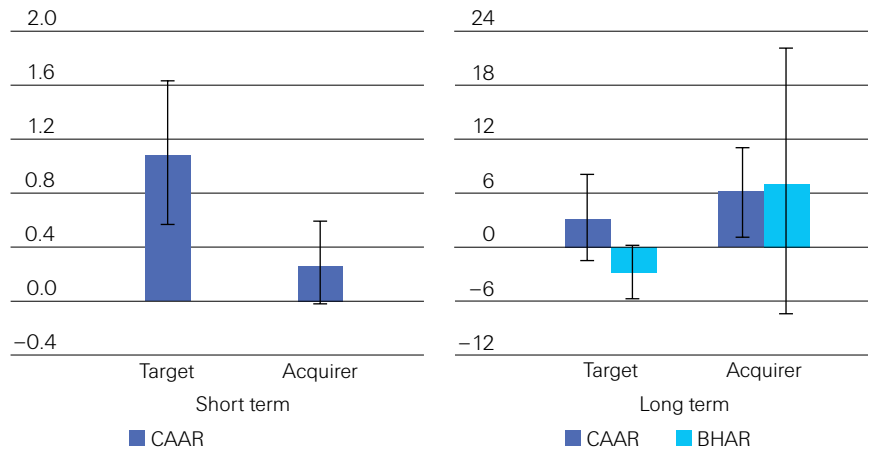


Note: Short term refers to cumulative daily abnormal returns for the period one day before and one day after an M&A was announced. Long term is based on cumulative weekly abnormal returns for the period 52 weeks post deal announcement date (see Appendix for more details).  
Source: Swiss Re Economic Research & Consulting.

On average, both targets and acquirers' stock outperformed around the time of announcement, but this often did not last.

On average, the short-run stock market reaction to insurance M&A has been positive (see Figure 13). Target firms have tended to enjoy abnormal stock returns of around 1 percentage point (ppt) in the days around announcement. The gains for acquirers were generally smaller and on some metrics, abnormal returns were not statistically significant in both the short-run and long-run. This reflects the wide variation in performance across deals, with some transactions generating large positive gains (up to around 20 ppt in the short run) and others actually destroying shareholder wealth (by up to 15 ppt). Similar findings apply for a sub-sample of firms where both targets and acquirers involved in an M&A transaction were publicly listed.

**Figure 13:**  
Short and long-term average abnormal returns for insurance M&A deals between 2003 and 2014, in ppt



Note: CAAR: Cumulative average abnormal return; BHAR: Buy and hold average abnormal returns. Error bars indicate the width of the confidence interval at 95% significance level. Short-term refers to the period one day before and one day after an M&A announcement. Long-term refers to the period 52 weeks following an M&A announcement.  
Source: Swiss Re Economic Research & Consulting.

## Does M&A in insurance add value?

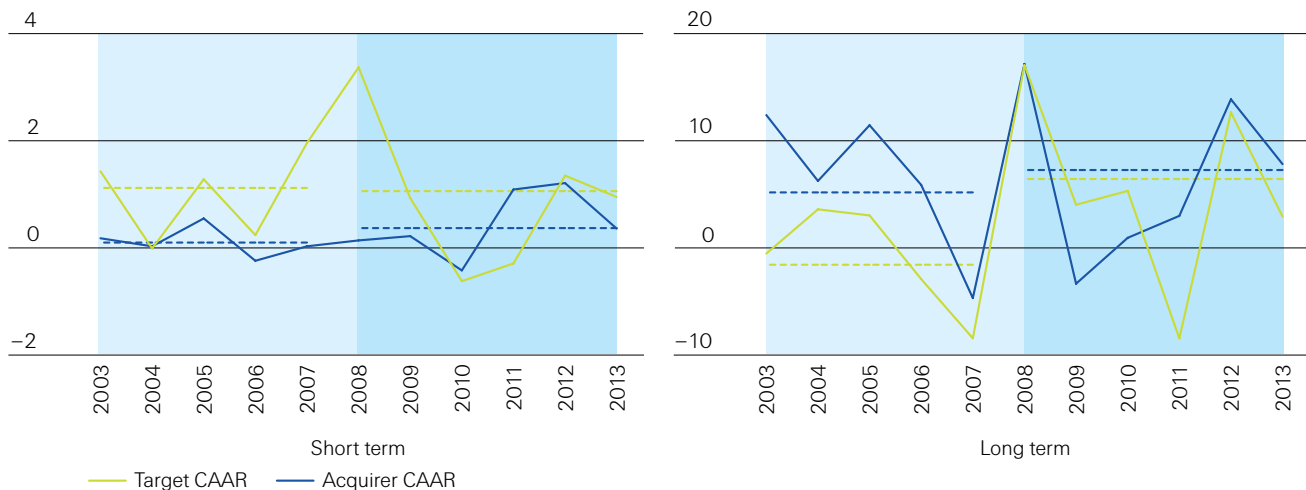
Post-crisis deals have had more positive impact in the long-run than pre-crisis deals, especially for acquirers.

### Pre-crisis versus post-crisis deals

Splitting the sample into two discrete periods, there is little evidence that average short-term gains from M&A in insurance prior to the financial crisis were materially different from those for more recent deals (Figure 14). However, long-run average M&A performance does seem to have improved in the post-crisis period for both targets and acquirers. This could be consistent with acquirers taking advantage of depressed economic and market conditions at the height of the crisis to make purchases that were a good strategic fit at attractive prices. Other studies have found similar results. For example, one found that acquirers' stock returns over a period of up to two years following deal announcement were higher in periods associated with an economic downturn.<sup>45</sup> Target firms may have gained support from a stronger parent during the acute phase of the crisis when balance sheet strains intensified.

**Figure 14:**

Short- and long-term abnormal returns in insurance M&A in pre-crisis and post-crisis periods, in ppt



Note: CAAR: Cumulative average abnormal return; BHAR: Buy and hold average abnormal returns. Short-term refers to the period one day before and one day after an M&A announcement. Long-term refers to the period 52 weeks following an M&A announcement. Annual results may not be statistically significant for all the years but pre-crisis and post-crisis aggregate results are statistically significant at 95% confidence level.

Shading refers to pre- and post-crisis periods. Dashed lines refer to averages in those two periods.

Source: Swiss Re Economic Research & Consulting.

Deals involving vertical integration have been the most successful for acquirers.

### Type of integration

Deals involving firms from different stages of the insurance value chain (ie, vertical integration) seem to have consistently created most positive value for the shareholders of acquirer firms (Figure 15). A recent study on diversification in the US insurance industry found that strategic focus appears to be a better strategy than conglomeration. However, in the current sample, although diversification delivered

<sup>45</sup> Value creation in insurance: laying the foundation for successful M&A, BCG, 2009.

Those involving tie ups with other types of financial institutions have generally not led to long-term outperformance.

**Figure 15:**

Short-term and long-term abnormal returns for acquirers, by type of integration, in ppt

the highest average abnormal returns, the wide variation in performance undermines the statistical significance of the result.<sup>46</sup>

Deals involving consolidation in the insurance industry (ie, deals within the same insurance sector, for instance a life insurance company acquiring another life insurer) have also on average been positively received by the stock market although the results are not statistically significant for some long-term performance metrics. Deals involving convergence (deals where an insurance company buys other financial firms) did not create any value on average in the long term.

Type of M&A	Acquirer		
	Short-term CAAR	Long-term CAAR	Long-term BHAR
Vertical integration	0.44	4.43	1.93
Consolidation	0.39	5.68	17.60
Diversification	0.43	18.59	0.92
Convergence	-0.27	-0.91	-8.49

■ Results are significant at 95% confidence level

■ Results are significant at 90% confidence level

■ Results are not statistically significant

CAAR: Cumulative average abnormal return; BHAR: Buy and hold average abnormal returns.

Short-term refers to the period one day before and one day after an M&A announcement. Long-term refers to the period 52 weeks following an M&A announcement.

Source: Swiss Re Economic Research & Consulting.

In the long run, domestic M&A deals generated higher value than cross-border deals.

Cross-regional transactions created some positive value for acquirers in the long-term, mainly involving acquirers from advanced markets.

### Domestic vs cross-border deals

Analysis of M&A deals by geographical location of the target and the acquirer shows that deals involving domestic transactions are generally rewarded most by investors over the long term. Abnormal returns on cross-border deals, although positive for acquirers, are generally smaller. This result is consistent with similar studies conducted earlier for the period 1999 to 2008 (see Table 5 on page 22).

A closer look at cross-border transactions suggests that deals involving firms from different continents created more value than intra-regional deals for the acquirer, especially in the long run, although there is considerable variation in performance. Among cross-region deals, those involving acquirers from Europe tended to outperform most. Acquisitions in emerging economies by advanced market insurers did on average create positive value for the acquirer in the long term, although the result was heavily influenced by a number of very successful deals.<sup>47</sup> This reinforces the point that integrating businesses with different organisational and cultural profiles can be particularly challenging.<sup>48</sup> As already noted, due to disappointing returns a number of major European and US insurers have recently disposed of their investments in some developing markets.

<sup>46</sup> Conglomeration may lead to conflicts in managerial incentives and a less efficient organisational structure created by managers to increase their span of control. The trend in the insurance industry over recent years has been away from conglomerations toward strategic focus, with many of the M&A deals completed in previous decades being reversed (eg, the inter-industry mergers between banks and life insurers). See J.D. Cummins, M Weiss, X Xie, and H Zi, "Economies of Scope in Financial Services: DEA Efficiency Analysis of the U.S. Insurance Industry", *Journal of Banking and Finance*, vol 34, no 7, 2010.

<sup>47</sup> Consistent with that, the *median* long-run abnormal return associated with transactions involving an insurer from an advanced country making an acquisition in an emerging market is marginally positive, but not statistically significant.

<sup>48</sup> Compared with mature economies, the acquisition and integration process is often more complex in emerging markets. This may reflect issues over verifying the accuracy of the financial information, abiding by ownership and governance practices, and understanding regulatory and legal compliance rules. See *M&A in fast growing countries: traps and structuring opportunities*, Mazars, 2013.

## Does M&A in insurance add value?

The share prices of companies involved in multiple acquisitions have generally outperformed.

However, there may be limits to how far deal experience creates value.

Medium-size deals have generated most positive value for the targets in the short term.

### Serial acquirers vs ad hoc acquirers

Compared with first-time acquirers, companies involved in two or more acquisitions over the past decade have tended to see share price outperformance, particularly in the long term.

However, there are apparent limits to the benefits of such experience. The share price outperformance of serial acquirers – companies making more than five acquisitions over the past 10 years – has on average been lower than for those firms undertaking just a handful of deals (two to five). This could be due to overpayment for targets or to difficulties in the acquiring company extracting synergies from multiple M&A. This result is very true of insurance carriers, although the wide variation in performance across transactions makes it difficult to draw strong conclusions. Some insurers that made multiple acquisitions generated significant shareholder value from the transactions, while others produced negative returns.

### Deal size

Previous studies have found that the majority of smaller insurers operate at a level that permits increasing returns to scale, suggesting that M&A may help these firms achieve optimal size.<sup>49</sup> For M&A transactions where the value of the deal was disclosed, there was some evidence that medium-sized transactions (USD 100 million to USD 1 billion) created positive value for targets, at least in the short-term. For small (less than USD 100 million) as well as large deals (more than USD 1 billion), the average short-run change in insurers' share prices relative to an industry benchmark for both targets and acquirers was insignificant. Yet over the long term, it is not clear that deal size is particularly important for M&A success. While on average small to medium-sized deals generated positive abnormal returns, share price outperformance for both targets and acquirers was generally not statistically significant, irrespective of the size of deal.<sup>50</sup>

<sup>49</sup> J.D. Cummins, X. Xie, Efficiency, productivity and scale economies in the US property-liability Insurance industry, *Journal of Productivity Analysis*, Vol 39, Issue 2, April 2013, pp 141–164.

<sup>50</sup> Deal size information was not available for all of the deals included in our analysis. The sample therefore comprised of 544 acquirer firms and 435 target firms.

# M&A activity and reinsurance

Reinsurance can play an important supporting role in M&A transactions.

Traditional reinsurance can transfer unwanted risks of the acquiring or acquired entity.

Reinsurance can also be a source of protection against the operational risks associated with M&A.

More generally, reinsurance can be an effective tool to manage capital adequacy.

Reinsurance can be used to realise embedded future profits in existing life insurance contracts.

Reinsurance can have three primary roles in M&A both prior to and after a transaction: traditional risk management, balance sheet optimisation and risk financing.<sup>51</sup>

## Traditional risk management

Following an acquisition, or sometimes during the process of purchasing a company or a block of insurance business, the acquiring firm may uncover risks in the portfolio previously unforeseen or relating to legacy business that the acquirer does not wish to retain. Reinsurance is a way to transfer such exposures to an entity better able to absorb/diversify the risks rather than an outright sale of the block of business to a third party. Likewise, the seller may use reinsurance to restructure the risk profile of an entity before putting it up for sale to make it more attractive to potential bidders.<sup>52</sup>

As well as providing protection against insurance risks, reinsurance can absorb some of the heightened operational or transactional risks associated with an M&A. For example, uncertainties over integrating legacy systems or retaining key staff could generate calls from regulators or rating agencies for additional capital buffers. Rather than raise funds externally, reinsurance can be used as a source of capital, at least during the period in which the operational uncertainties are at their greatest.

## Balance sheet optimisation

Reinsurance can be an effective tool to manage capital adequacy by reducing liabilities following an M&A transaction. Acquiring companies can release capital from their own portfolios or free funds tied up in the acquired entity, for example by transferring closed books of business to a reinsurer. In doing so, reinsurance can be used to repackage risks to reduce peak exposures and achieve additional diversification benefits recognised in regulatory and ratings agencies' capital adequacy models.

In life insurance, the value of existing long-term savings and protection policies will often embed significant expected future profits from the premiums to be received over the life of the contract – so called value-in-force (VIF). Reinsurance can be used to monetise these profits, with a reinsurer paying an upfront ceding commission in exchange for rights to the future cash flows under the contracts. Depending on the exact structure of the transaction, the insurer and reinsurer may require collateral to be put in place to safeguard against counterparty risk (See Box: "VIF reinsurance").

<sup>51</sup> A number of commentators have noted that in addition to pursuing traditional M&A, insurers increasingly use vehicles such as reinsurance to position their businesses more efficiently, reduce capital requirements and increase returns on equity. See for example, *European M&A: On the road to recovery? Insights on the Insurance sector*, Clifford Chance, 2013.

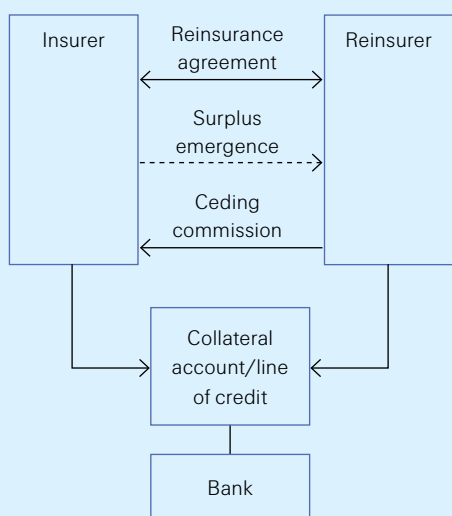
<sup>52</sup> Legally, the contractual relationship in reinsurance is between the cedant and the reinsurer. The ultimate responsibility to policyholders remains with the insurance company. Only in special situations does the reinsurance treaty allow the insured a direct legal claim to the reinsurer, for example in case the insurer becomes insolvent. In practice however, the ceding insurer can use reinsurance to indemnify itself against actual incurred losses that exceed an agreed amount (non-proportional reinsurance) or share a percentage of the maximum liabilities associated with the underlying insurance policies (proportional reinsurance).

Value-in-force reinsurance

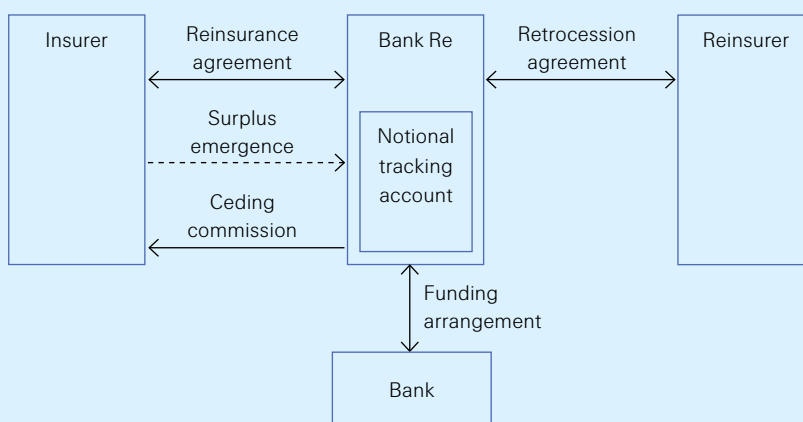
Value-in-force (VIF) reinsurance transactions involve the insurer exchanging the claim on future profits in return for an upfront commission from the reinsurer. The reinsurer pays a price based on the value of the defined book, and the ceding insurer passes future profits to the reinsurer on a regular basis. Similar transactions can be arranged with other types of investors using securities created to each contain a slice of the expected future VIF cash flows.

**Figure 16:**  
Different VIF reinsurance structures

**Single-party arrangement**



**Multi-party arrangement**



Source: Swiss Re Economic Research & Consulting.

Figure 16 provides examples of typical structures for VIF reinsurance. In the single-party (reinsurer) arrangement, a collateral account backed by a credit line from a bank is set up to provide security of payment of the cash flows. The multi-party arrangement involves more than one reinsurer and here again, a bank typically funds the primary credit and repayment timing risks.

VIF reinsurance has grown in Europe in recent years.

VIF reinsurance has become prominent in Europe over recent years, although most transactions have not been linked to a concurrent M&A deal (see Table 6). Pressures on balance sheets in the aftermath of the financial crisis prompted transactions by banks to realise embedded value in their life insurance subsidiaries.

**Table 6:**

Selected VIF reinsurance transactions  
in Europe over recent years

Date of transaction	Insurer/ bancassurer	Investor	Transaction size	Country	Underlying business	Structure	Placement	Linked to an M&A transaction?
Jul 2012	Santander	Abbey Life (Deutsche Bank)	EUR 490 mn	Spain and Portugal	Individual life risk business, including annual renewable term business and single premium term business	Quota share reinsurance 100%	Private (reinsurance)	No
Nov 2012	CaixaBank	Berkshire Hathaway	EUR 524 mn	Spain	Individual life risk business, including annually renewable term business	Quota share reinsurance 100%	Private (reinsurance)	No
Mar 2013	BBVA	SCOR	EUR 630 mn	Spain	Individual life risk business, including annual renewable term business and single premium term business	Quota share reinsurance 90%	Private (reinsurance)	No
Jun 2013	BES Vida	Munich Re	~EUR 150 mn	Spain	Individual life risk business	Reinsurance	Private (reinsurance)	No
Mar 2014	Banco Sabadell	SCOR	EUR 82 mn	Spain	Individual life risk business	Quota share reinsurance 90–100%	Private (reinsurance)	Partly – earlier acquisition.

Source: Towers Watson, based on company press announcements.

Along with the underlying risks, responsibility for policy administration may be transferred to the reinsurer.

Similar to the situation where existing policies are sold outright to a third party, risk transfer via reinsurance may also entail the reinsurer assuming responsibility for policy administration. This has been a feature of some past deals involving the leading closed-book life consolidators such as Resolution Life, Phoenix and Swiss Re's Admin Re. These arrangements can support a seller's overall disposal strategy and help the seller focus on core business.

Other types of reinsurance such as loss portfolio transfers or adverse development cover can also help free up capital.

VIF transactions are less common in the non-life than life sector given the typically much-shorter duration contracts in P&C.<sup>53</sup> Other types of reinsurance structures are available to strengthen or relieve pressure on non-life insurers' balance sheets. The simplest form of (retrospective) reinsurance cover is loss portfolio transfer (LPT). This is where the insurer cedes as-yet unpaid losses on previously incurred liabilities. An often complementary retrospective reinsurance structure is an adverse development cover (ADC), whereby the reinsurer agrees to cover losses on a portfolio of policies beyond an agreed level (see Box: "Retrospective reinsurance"). This is sometimes combined with an LPT to provide economic finality to any future development in reserves.

<sup>53</sup> For a non-life insurer, coverage and premium guarantees do not usually extend beyond one year. The business in force is therefore the run-off of the unearned premiums and associated claims, expenses and investment income on the premiums already written, together with the investment income on the claim (and expense) reserve run off. Collectively these are sometimes referred to as the value of future earnings on reserves.

Retrospective reinsurance provides cover for liabilities arising from past insurable events.

Loss portfolio transfers enable an insurer to cede losses on existing liabilities in exchange for a fixed reinsurance premium.

They cover the insurer against the potential for claims to arrive faster than expected.

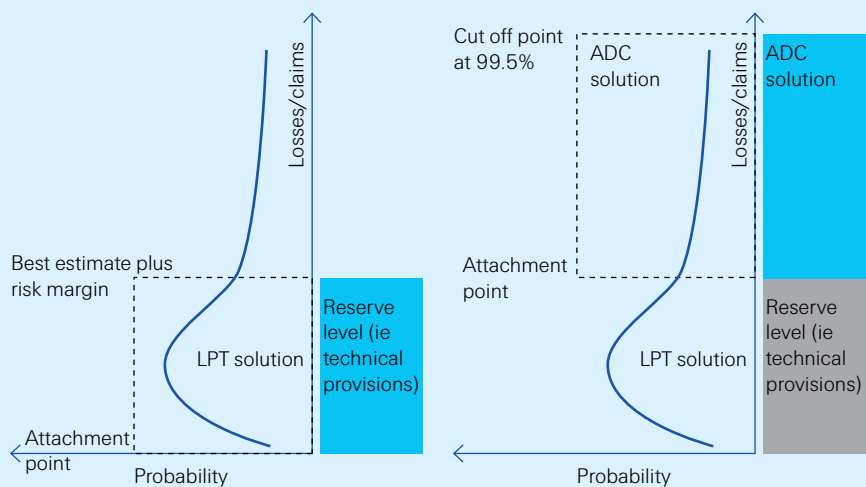
### Retrospective reinsurance

Retrospective reinsurance is used to cover liabilities that arise as a result of past insurable events. The most common retrospective solutions are loss portfolio transfers (LPTs) and adverse development covers (ADCs). For both structures, the reinsurer provides protection against losses that may exceed an insurer's economic reserves in return for a fixed premium.

*Loss Portfolio Transfer.* The insurer cedes all remaining unpaid losses associated with a previously incurred insurance liability to the reinsurer. In addition to an arrangement fee, the cedant typically pays a premium equal to the net present value of reserves it has set aside to cover the transferred liability plus compensation for the uncertainty of the timing of payments associated with the transferred liability. In this way, for a fixed reinsurance charge the insurer exchanges an uncertain stream of future losses up to an agreed confidence level (see left-hand panel of Figure 17).

The only risk covered by an LPT is the potential for losses or claims to arrive at a much faster rate than expected (timing risk). In that case, transferred reserves plus the investment income to be earned from the reinsurance premium may be inadequate to fund the losses. In contrast, if losses occur more slowly than expected, the reinsurer will make gains which, if a profit commission or similar mechanism is included in the contract, may be shared with cedant.<sup>54</sup> The original policy issuer remains responsible to policyholders should the reinsurer fail to honour its obligations.<sup>55</sup> As the timing risk is minor compared to the risk that the loss reserves are insufficient, an LPT is always combined with an ADC.

**Figure 17:**  
LPT and ADC reinsurance structures



Source: Swiss Re Economic Research & Consulting.

<sup>54</sup> In principle, downside risks could also be shared among cedant and reinsurer, although this would undermine the degree of risk transfer and in turn reduce the capital relief offered by reinsurance.

<sup>55</sup> This contrasts with a novation agreement whereby legal responsibility to policyholders is transferred to a third party, which could also be a reinsurer.



Adverse development cover reinsurance structures indemnify insurers against the potential for claims on existing liabilities to exceed reserves.

*Adverse Development Cover.* The reinsurer indemnifies the ceding company for a portion of a loss on a previously incurred liability that exceeds the cedant's current reserves or an agreed retention level (excess-of-loss reinsurance). There is typically no cession of the liabilities or the associated reserves, at least for short-tail lines of business.<sup>56</sup> As a result, ADCs do not reduce reserve leverage to the same extent as LPTs. Instead, the reinsurer agrees to reimburse the insurer if losses on the designated insurance portfolio are above the attachment point, which is the agreed retention level (see right-hand panel of Figure 17). The premium is based on the reinsurer's evaluation of both the potential for adverse development and the expected timing of additional loss payments.

Sometimes retrospective reinsurance can be a temporary mechanism to facilitate full disposal of a portfolio of policies.

Retrospective reinsurance can sometimes be used as a temporary vehicle to facilitate an M&A of a closed book because it insulates the acquirer from future exposure to discontinued business. Specifically, it is a means to release capital that would otherwise have to be held, and gives the buyer operational control of the business until the full legal transfer of obligations is complete. For example, as part of Swiss Re's portfolio transfer of the Zurich Specialties London legacy portfolio in 2011, a reinsurance agreement was put in place which was commuted when the acquisition was eventually finalised.

### Financing vehicle

VIF reinsurance may also act as a direct financing vehicle for M&A.

Reinsurance can also be used to directly finance M&A transactions or as a complementary source of finance to traditional capital market instruments. VIF reinsurance can boost *available* economic capital (ie, total risk absorbing capacity) for use in an M&A by providing an advance on future economic profits. No explicit liability is created to repay the reinsurer. Repayment is directly contingent on the emergence of future surpluses.

Reinsurance can also free up required capital to finance an acquisition.

Other reinsurance structures may also play a financing role in M&A by reconfiguring insurers' balance sheets. Unlike a VIF monetisation, no additional funding need be created. Indeed, the ceding insurer typically pays a premium to the reinsurer to assume the risks. But by removing the uncertainty attached to existing liabilities, the acquiring firm can free up *required* economic capital (eg, that needed to meet internal or regulatory minima) to take on other risks, including financing an acquisition. Reinsurance can often be an efficient form of financing since the same target solvency ratio is achieved using less capital relief compared with raising own funds. Some reinsurance arrangements may also include a VIF monetisation thereby potentially making the LPT/ADC transaction self-financing (see Table 7 for examples of recent M&A deals involving retrospective reinsurance).

A good example is the release of redundant statutory reserves in jurisdictions such as the US.

A particular application of such reinsurance solutions is the unlocking of capital trapped in statutory life insurance reserves. Regulations such as XXX/AXXX in the US require insurers to establish heightened statutory reserves for certain types of life insurance including term life policies with long-term premium guarantees.<sup>57</sup> Relative to the level of economic capital needed to support these policies, this can lead to redundant reserves which can be released with the aid of reinsurance. Such reserve financing has become an important element of some recent M&A transactions. This was a key feature of Resolution Life's purchase of the Lincoln Benefit Life from US life insurer Allstate in 2013 for example, with Hannover Re providing reinsurance for a portion of statutory reserves of the acquired entity.

<sup>56</sup> For longer-tail lines, liabilities can sometimes be ceded via ADCs in order to provide the reinsurer with an opportunity to earn investment return from the associated accumulated premiums. For example, in 2014 Liberty Mutual Insurance ceded approximately USD 3.3 billion of US workers' compensation, asbestos and environmental liabilities under an ADC.

<sup>57</sup> The National Association of Insurance Commissioners (NAIC) Model Regulation XXX requires insurers to establish heightened statutory reserves for term life insurance policies with long-term premium guarantees. Similarly, Actuarial Guideline 38, known as Regulation AXXX, requires insurers to establish heightened statutory reserves for certain universal life insurance policies with secondary guarantees.

## M&A activity and reinsurance

**Table 7:**

Select anonymised examples of M&A deals involving retrospective reinsurance

Deal background	Objective of acquirer	Reinsurance structure
Global insurer acquired mid-sized commercial P&C insurer	Isolate and risk-proof legacy business to cap unexpected losses in acquired entity's portfolio.	ADC involving 90% share agreement with an attachment point 10% above net reserves
Large insurer acquired a large competitor in one of its key markets.	Seller sought reinsurance to replace indemnifications included in the share-purchase agreement (SPA) to achieve clean exit.	Various ADC layers above the acquirer's carried reserves involving various share arrangements.

Source: Swiss Re Economic Research & Consulting.

The use of reinsurance to finance M&A is rare...

It is difficult to ascertain the degree to which reinsurance is used to finance M&A transactions. Most arrangements have been private, or their details have been not widely disclosed. It is almost certainly the case that reinsurance is not used as frequently as other external financing vehicles, which may reflect a greater familiarity of traditional capital market instruments such as debt or equity. It may also reflect the lack of knowledge of M&A advisors about reinsurance.

...perhaps because it is perceived to be expensive relative to other forms of capital.

Reinsurance is also perceived as relatively expensive compared with other forms of capital. This is especially true currently with credit spreads on marketable debt instruments having narrowed significantly from the heights of the financial crisis. Consistent with that, in a recent global survey of mutual life insurers, over 30% cited the cost of reinsurance as a constraint on its use as a vehicle to finance expansion.<sup>58</sup>

However, the advantages of reinsurance are often under appreciated.

All told, some advantages of reinsurance financing are not fully appreciated. For example it protects insurers' available capital at times when protection may be most needed, it can reduce reserves leverage and can also be designed with bespoke structures and flexible terms. These features offer economic value to an insurer by reducing the overall frictional costs of raising external capital.

<sup>58</sup> Global survey of life insurer members of International Cooperative and Mutual Insurance Federation (ICMIF), Partner Re, 2013.

# M&A outlook

An upswing in M&A in insurance appears to be emerging, but it's unlikely to be an industry-wide wave.

Regulatory uncertainty will continue to impact M&A activity.

Risk-based capital frameworks will bring many operational challenges.

But higher capital requirements for certain products will stimulate run off and closed-block divestments.

The fragile state of the global economic recovery and persistently low interest rates continue to pressure insurers' revenues and profitability. With organic growth opportunities still limited, especially in advanced markets, sentiment towards M&A as an alternative source of growth has improved. Yet conditions are not conducive for a renewed industry-wide wave of M&A: surveys indicate that the volatile economic environment and regulatory uncertainties remain key obstacles to acquisitions.<sup>59</sup> But the recent pick-up in deals involving specialty P&C re/insurance firms and also ongoing consolidation among intermediaries suggest there will continue to be pockets of heightened activity which will reshape the competitive landscape in those segments.

## Changes in regulation

Regulatory uncertainty will continue to impact M&A activity, despite some further clarity about prospective changes. For example, the move to a new framework of global capital standards for systemically important financial institutions could dissuade large insurance groups from making acquisitions and/or stimulate further divestments to evade being labelled as "systemically important".<sup>60</sup>

In addition, in many markets new regulatory frameworks (eg, Solvency II in Europe and other risk-based solvency regimes around the globe) will bring operational challenges. This will encourage capital optimisation and a reconfiguration of operations to achieve scale and cost efficiencies. But so far it has not had material impact on M&A beyond the divestments by European firms of US operations due to uncertainty about harmonisation of solvency capital requirements.

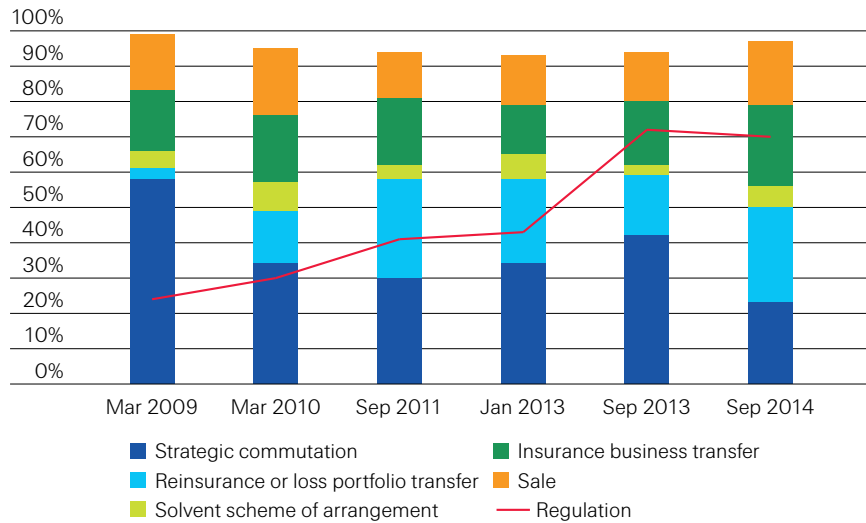
The prospects of higher capital requirements under Solvency II and other regulatory frameworks may yet stimulate more M&A activity. In Europe, mergers involving small mono-line insurers and among mutual companies is expected to rise. Run-off acquisitions could also increase, with regulatory change often cited as a key driver for restructuring activity (see Figure 18). This is especially true in continental Europe where sizeable legacy portfolios provide prime targets for run-off consolidation even though other exit mechanisms such as strategic commutation and reinsurance are available.<sup>61</sup>

<sup>59</sup> See for example, Towers Watson, 2014, op. cit. and KPMG, 2014, op. cit.

<sup>60</sup> There is a concern that any company designated as a systemically important financial institution (SIFI), globally systemically important insurer (G-SII) or an internationally active insurance group will face enhanced regulation and more restrictive capital rules. The Dodd-Frank financial services reform law in the US charged the Federal Reserve with overseeing institutions that could pose a threat to the US financial system, designated as SIFIs. On the international level, the Financial Stability Board is designating G-SIFIs, which would face a proposed global capital standard. Additionally, the International Association of Insurance Supervisors is proposing global capital standards for internationally active insurance groups.

<sup>61</sup> Stricter regulations in some markets may come to favour M&A run-off solutions. For example, in the UK the Prudential Regulation Authority's proposed clampdown on the use of solvent schemes of arrangement by insurers could limit the future use of such exit mechanisms.

**Figure 18:** Surveys on the impact of regulation on insurers' future restructuring activities and expected methods to deal with run-off business, percent of respondents



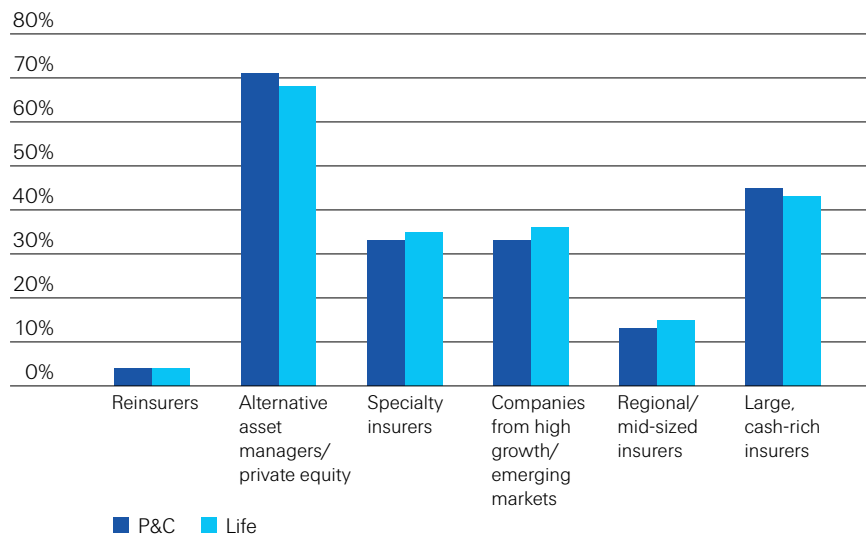
Note: The red line reflects percent of respondents citing regulation as a key driver of anticipated restructuring activities. Bars represent survey responses to questions about the most likely exit mechanisms for dealing with run-off business.  
 Source: PwC survey of discontinued business in Europe, various annual editions.

Alternative investors will continue to be present in life M&A through acquisitions of savings books.

Continued interest from alternative investors

Private equity investors will continue to increase their presence in the insurance industry and are likely to remain active bidders, at least in the near term (see Figure 19). Involvement in life sector M&A may be more challenging than hitherto given greater regulatory scrutiny and the limited use that can be made of leverage in such deals.<sup>62</sup> However, PE companies have broadened their business model and have filled a vacuum left by strategic buyers, some of whom may still be capital constrained.

**Figure 19:** Survey of industry views on source of prospective bidders in insurance sector M&A transactions, percent of respondents



Note: Responses to the question "What type of bidder companies do you expect to drive M&A activity in the life and P&C sectors?"  
 Source: Global Insurance M&A Outlook, Mayer and Brown, 2014.

<sup>62</sup> Recently, insurance regulators in the US and Europe have become concerned about the potential conflict between alternative investors' short-term investment strategies and the long-term nature of insurance liabilities. Regulators in some jurisdictions have introduced higher capital requirements and more stringent policyholder protection for businesses acquired by alternative investors. In other areas, especially Asia, regulators say PE firms should not own life insurance business.

The expanding presence of investors as providers of alternative capital in wholesale re/insurance markets is intensifying pressures on incumbents.

Some investors appear to have a genuine long-term commitment to insurance as an asset class.

The rise of alternative investors could increase shareholder activism towards companies' M&A plans.

Large insurers from advanced markets will continue to expand their presence in emerging markets.

The influx of alternative capital is changing the competitive landscape in insurance and this could have important implications for firms' appetite for M&A. New capital market instruments through which institutional investors gain insurance risk exposure (eg, ILS and sidecars) and the entry of new types of risk carriers (eg, hedge funds offering collateralised cover) are putting more pressure on incumbent insurers and could prompt renewed consolidation. This is most obvious in wholesale re/insurance markets where risks are more commoditised and can be reasonably assessed using public information, which facilitates the deployment of third-party capital.

Some of the rise of alternative capital could prove temporary. Earlier hedge fund involvement in reinsurance turned out to be largely a temporary affair. The two main examples from the 1990s, Scottish Re and Max Re, were eventually absorbed into larger corporate groups.<sup>63</sup> Likewise, PE investors have a history of moving in and out of the industry.<sup>64</sup> When interest rates normalise and the hunt for yield abates, some PE firms may also exit insurance and return to more traditional asset classes. However, some new re/insurers are backed by investors with multi-generational investment horizons and potentially, therefore, a genuine long-term commitment to the asset class.<sup>65</sup> Likewise, PE backers have formed strategic partnerships with other institutional investors in reinsurance which could signal their longer-term commitment to the sector.<sup>66</sup>

Even if PE involvement does not take the form of outright acquisitions or disposals, shareholder activism is nonetheless likely to be boosted by the shift towards alternative investors, which itself will alter the M&A landscape. Activist investors are widely expected to become more influential in inciting firms to engage in or refrain from acquisitions, and/or to redeploy capital to more productive uses including share buybacks, dividends and divestitures.<sup>67</sup>

### Ongoing globalisation

Given sluggish potential growth in a number of advanced markets, large global life and P&C insurers from Europe and North America will likely continue to look for revenue potential and diversification benefits by growing their footprint in emerging markets. In these countries, underlying trends – such as urbanisation, financial sector development and a rising middle class – underpin a positive outlook for increased insurance penetration. These factors were important in supporting a renewed pick up in gross cross-border capital flows (direct and portfolio investment) in the years following the financial crisis, despite a retrenchment in the degree of global connectivity in trade of goods and services.<sup>68</sup>

<sup>63</sup> "Assessing the new breed of hedge fund-backed reinsurance companies", *valuwalk.com*, 14 August 2014, <http://www.valuwalk.com/2014/08/assessing-the-new-breed-of-hedge-fund-backed-reinsurance-companies/>

<sup>64</sup> For example Apollo, a leading PE investor, started out in insurance by buying assets from the failed Executive Life in 1990-1991. It has subsequently bought and sold insurance investments, including the pending sale of its stake in the Lloyd's of London insurer Brit to Fairfax Financial Holdings. Similarly, Kohlberg Kravis Roberts (KKR) bought American Re in 1992 and four years later sold it to Munich Re.

<sup>65</sup> For example, in May 2014 GreyCastle Holdings Ltd, a newly-formed Bermuda company whose shareholders include large family offices of high net worth investors and university endowments completed the acquisition of XL Life Reinsurance, a wholly-owned subsidiary of XL.

<sup>66</sup> Most notably, in 2013 the PE buy-out specialist KKR took a 25% stake in Nephila, a leading investment manager focused on investing in natural catastrophe risk reinsurance. The investment was made by the firm and not through KKR's investment funds, which some commentators interpreted as a long-term investment.

<sup>67</sup> Recent surveys of investors indicate that a large majority of respondents expect activists to be more vocal about companies' M&A plans. See for example, *Shareholder Activism Insight*, Schulte Roth & Zabel LLP/Mergermarket, 2014.

<sup>68</sup> For more discussion of recent developments in globalisation, see *Global Connectedness Index 2014: Analyzing global flows and their power to increase prosperity*, DHL, 2014.

## M&A outlook

Surveys continue to indicate that expansion through overseas M&A remains a strategic goal.

Cultural and regulatory hurdles present significant challenges to cross-border M&A, although market liberalisation will likely foster foreign investment.

Surveys persistently report that access to new markets and geographies is a key motivator for M&A activity. According to the Accenture/Economist Intelligence Unit 2014 CEO Briefing, more than 60% of insurance executives said their investment focus would be on assets in overseas markets.<sup>69</sup>

Given the mixed success of cross-border M&A deals in delivering enhanced shareholder returns, acquisitions in these markets will likely be more selective than before, driven by strategies to optimise capital deployment. Market liberalisation in countries such as India and China will open up new opportunities, but this is likely to happen only slowly. In 2014, the Chinese authorities relaxed the rules relating to M&A involving insurance companies (see Box: "New M&A regulation relating to insurance in China"). In India, new insurance legislation relaxing rules over corporate ownership and market entry has recently been enacted. Many commentators believe these initiatives will promote increased foreign investment as insurers look to expand their geographic reach.<sup>70</sup> It could also usher in consolidation in the domestic insurance sector particularly in view of other regulatory changes such as new risk-based capital solvency regimes.

New legislation in China provides clarity on M&A activity in the insurance sector.

The new rules make it easier to invest in insurers.

### New M&A regulation relating to insurance in China

On 1 June 2014, the Chinese authorities introduced new legislation ("Regulations on Merger and Acquisition of Insurance Companies") to provide greater clarity on permitted M&A activity in insurance. Before then the rules were fragmented and there was no single law or regulation to address M&A activity in the industry.

Foreign insurers will still only be able to acquire up to 50% equity interest of Chinese life insurance companies, but the new rules will make it easier to invest. The key features of the new M&A regulations are:

- An investor may now concurrently invest in more than one insurance company that competes in similar products.
- Investors can fund potential acquisitions through debt, provided that the loan does not exceed 50% of the monetary price.
- It is no longer required for investors to have at least three years investment history in the Chinese insurance industry.

The development of the ASEAN economic area could boost M&A activity in the region.

Capital flows from the developed and emerging markets of Asia and Latin America to Europe and North America will increase.

The establishment of the ASEAN Community at the end of 2015 could be an important catalyst for intra-regional M&A activity. Reduced barriers to trade in services will lead to a reduction and elimination of foreign equity restrictions and will likely prompt insurers to grow their regional footprint via mergers or acquisitions. That was the experience in the late 1990s in Europe when liberalisation of intra-EU capital markets led to significant cross-border M&A, although parallels between the EU and ASEAN are inexact because of major differences in histories, geopolitics and organisational structures.<sup>71</sup>

Increasingly, well-capitalised insurers and investors from the developed and emerging markets of Asia and Latin America (eg. Japan, China and Brazil) are showing interest in North American and European targets. While there have been some opportunistic deals in the past, recent cross-border acquisitions have been driven by strategic intent to expand overseas. For example, Tokio Marine, Dai-ichi and Fosun (a Chinese conglomerate) have carried out a number of deals. More

<sup>69</sup> Qualitatively similar findings are found in other insurance industry surveys. See for example, KPMG, 2014, op.cit. and Towers Watson, 2013, op. cit.

<sup>70</sup> See for example *Impact of China's Administrative Measures for the Merger and Acquisition of Insurance Companies*, King & Wood Mallesons, 2014.

<sup>71</sup> For more discussion of the likely impact of the development of the ASEAN community, see *Getting together – the ASEAN Economic Community*, Swiss Re, November 2014.

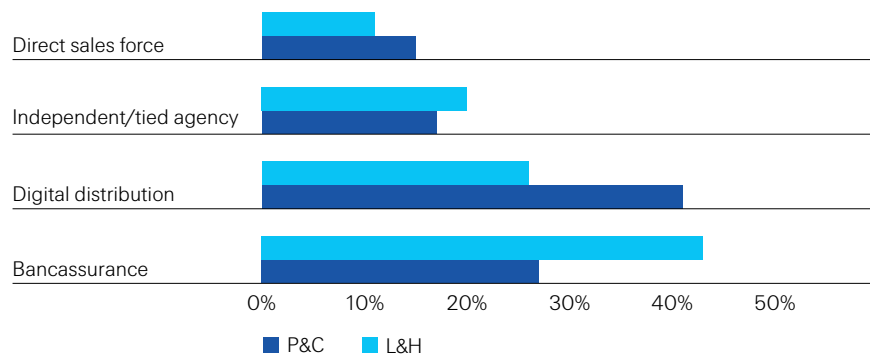
recently, the Chinese Anbang Insurance Group embarked on a round of overseas acquisitions, including buying insurers in continental Europe and South Korea. Along with diversification, future interest in cross-border deals (eg, out of China and Brazil) principally directed toward advanced markets will be driven by the need to acquire underwriting and product expertise, and distribution capabilities, and deploy these capabilities to gain advantage in the fast growing domestic markets. Developing country re/insurers may also pursue targets in other emerging markets, such as GIC Re's acquisition of South African reinsurer Saxum Re announced in April 2014.

In developing markets, M&A activity tied to bancassurance is expected to continue.

### Access to new technology and distribution

M&A activity tied to bancassurance is expected to continue in developing markets where it remains an important distribution channel. Bancassurance is still the preferred M&A route for many L&H insurers because of ongoing challenges in selling complex savings and pension products directly via digital channels (see Figure 20).

**Figure 20:** Survey of most attractive distribution proposition for M&A in insurance, percent of respondents



Source: Towers Watson, 2014, op. cit.

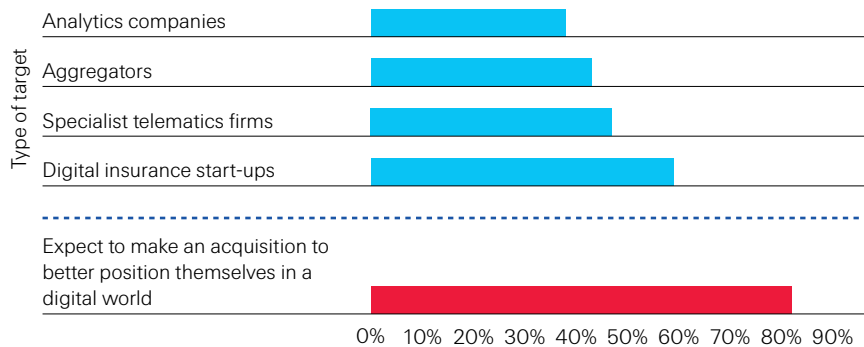
Partnerships with non-financial institutions to broaden distribution capabilities will increase.

Insurers also report that they will look for acquisitions or strategic partnerships with non-financial institutions to broaden their distribution capabilities, especially in gaining access to technology to establish and grow direct-to-consumer distribution platforms. Information security-related M&A may also increase as insurers' use of cloud computing, digital data storage and virtualisation technology develops.

An M&A can sometimes be the fastest way to build up technological expertise.

Digital technology is transforming all aspects of insurance including sales and marketing, product design, underwriting and claims handling. Insurers and intermediaries increasingly require technical expertise in areas such as data analytics (Big Data), automated underwriting, straight-through processing and telematics. In principle, companies can develop the capabilities in-house by investing in new technology and hiring specialist staff. However, an acquisition can be a faster route. A recent survey by Accenture found that a large majority of insurance executives anticipate making an acquisition to enhance their digital expertise (see Figure 21).

**Figure 21:**  
Survey intentions about digital-led acquisitions, percent of respondents



Source: *Digital innovation survey*, Accenture, 2014.

Some recent examples highlight how digital distribution capacity has moved up the M&A agenda.

Although still nascent, a number of recent M&A transactions in insurance highlight the growing influence of technology as a motivating factor. Insurers have been active as either acquirers of technology companies or as targets, especially where digital applications offer enhanced insights about customer needs, wants and behaviours. For example in January 2014, Berkshire Hathaway Specialty Insurance announced plans to purchase MyAssist Inc., a live-agent personal concierge and telematics service provider. Also in 2014, global specialist insurance group, Hiscox, acquired the dedicated Asian online insurer DirectAsia.

Consolidation is expected to continue most actively in the small-to-mid-size segment.

### Consolidation among smaller players

There may be a few isolated transformational deals in the next years, but it is bolt-on acquisitions that will likely remain in vogue. A number of insurance sectors in advanced economies have already gone through periods of significant consolidation, at least among large carriers. Future M&A transactions involving very large financial institutions will probably face significant regulatory hurdles with national authorities anxious to avoid insurance carriers gaining dominant market positions or becoming too large and complex to supervise or wind down.<sup>72</sup> However, consolidation among small- and mid-sized insurers is expected to remain intense, because these firms often struggle to compete with the risk-absorbing capacity of their larger peers, and often do not have the specialist skills that niche players can offer.

M&A involving smaller P&C re/insurers ...

In particular, many small-to-mid-size P&C re/insurers face intense competition on account of the general abundance of capital in the market. With few signs that this situation will reverse anytime soon, the firms could seek cost and operational synergies by merging with others of similar size. In a March 2014 survey of US insurance company CFOs by Towers Watson, more than half of respondents (52%) felt that prolonged soft market conditions could drive reinsurance market consolidation in the future, while competing alternative capital sources were cited by nearly half (48%) as possibly having the same effect.<sup>73</sup>

<sup>72</sup> From January 2015, a new US Federal Reserve Board rule will bar mergers between financial institutions if the combination produces a company with liabilities in excess of 10% of the aggregate consolidated liabilities of all financial companies.

<sup>73</sup> "Trends in Reinsurance and Alternative Forms of Capital", *Property and Casualty Insurance CFO survey*, Towers Watson, March 2014.



... and mutuals could be especially prominent.

The insurance agency/brokerage sector is also ripe for further consolidation.

Smaller, regional mutual insurers in both the life and non-life sectors face similar challenges. As well as coping with cost strains of adapting to new regulations, some mutual insurers reportedly see themselves at a competitive disadvantage in terms of their capability to exploit insights from new technology and data analytics. Over the past few months, mergers among mutual insurers in some European countries have been announced and survey expectations suggest more to come.<sup>74</sup>

The brokerage sector, where commissions have also been pressured by the weak pricing environment and a shift in customer buying behaviour, could see further M&A too. This is on top of the significant consolidation that has already taken place in the wholesale and retail markets. For example, in surveys conducted in 2014, close to 60% of UK brokers said that they are merging or would consider a merger.<sup>75</sup> Similarly, 80% of UK managing general agents believe there will be more M&A and consolidation in the sector over the next three years.<sup>76</sup>

<sup>74</sup> According to *Property-Casualty Mutuals: Resilient and Staying Relevant*, Conning, 2014, around a quarter of US P&C mutual insurers think more mergers in the sector are possible. Similarly, according to a survey, *Ready for Take-off: The Outlook for Insurance M&A in EMEA*, Towers Watson, 2014, around 37% of respondents expect further consolidation among mutual insurers.

<sup>75</sup> *The Sterling Insurance Group Annual Broker Survey*, Sterling Group, 2014.

<sup>76</sup> *MGAA Matters survey*, Managing General Agents' Association and Castel Underwriting Agencies, October-November 2014.

# Conclusion

With the worst of the global financial crisis over, expectations of a revival of M&A have increased.

More M&A activity in insurance seems likely, but it will be confined to segments rather than be an industry-wide surge.

M&A success varies widely: domestic deals and vertical integration seem to yield the most value gains.

The mixed performance of M&A in creating shareholder value warrants a cautious approach in assessing the long-term benefits of potential deals.

M&A activity in insurance, as in other industries, tends to come in waves. There were two main episodes of heightened deal making in the late 1990s and the mid-to-late 2000s due to stronger growth prospects, ongoing financial deregulation, easy financing and increased risk appetite among insurance executives and investors. The financial crisis that hit in 2008 led to a period of subdued activity but six years or so later, industry surveys point to a revival of M&A as a favoured growth-enhancing strategy, at least among insurance carriers. Completed transactions in the sector have picked up and the pipeline of announced deals suggests that this is set to continue.

However, while the external environment may have become less hostile and continued globalisation is opening up new M&A opportunities, a frenzy of deal-making is unlikely. This is not least because there remains considerable uncertainty about the global macroeconomic and regulatory outlook, making selecting value-enhancing deals more challenging. Instead, there will likely be a continuation of recent trends of increased M&A activity in certain segments, such as consolidation among agents/brokers and in the specialty re/insurance sector, as firms respond to cyclical and structural changes in the industry.

The success of M&A in insurance varies widely across time and across types of transaction. The stock market abnormal returns of both acquirer and target firms in an M&A have on average improved over the past five years, although some of that outperformance relates to deals undertaken at the height of crisis as insurers sought strategic partners to shore up their balance sheets. Generally speaking, transactions bringing together entities from different parts of the insurance value chain performed best. Likewise, domestic rather than cross-border deals have tended to deliver better shareholder returns, perhaps reflecting the operational challenges in executing a takeover overseas.

Given the mixed record of re/insurance M&A activity, insurance executives need to select targets judiciously for genuine synergies, and then focus on creating an efficient, integrated unit. That is best achieved when businesses make considered and realistic assessments of the strategic and cultural fit between the firms involved and the hurdles to be overcome.

# Appendix

Abnormal returns compare actual returns with expected returns had the M&A not occurred.

Short-horizon measures consider abnormal returns a few days around the time the merger or acquisition is announced.

Longer-term measures review how far returns to investors who stayed invested after the acquisition outperformed a benchmark portfolio or index.

Standard statistical tests can be used to assess the overall significance of abnormal returns.

But any statistical inference is conditional on the model for expected returns...

...as well the assumed distribution from which the sample of abnormal returns is drawn.

## Testing for abnormal stock market returns

Abnormal returns refer to how far, following an event such as a merger, actual returns on firms' securities vary from expected or normal returns had the event not taken place. Empirical researchers use a variety of different models to estimate abnormal returns. One simple approach is to assume that, had the merger or acquisition not occurred, a firm's stock returns would have been expected to evolve in line with an overall market/sector index (ie the benchmark index), where allowance is made for past correlation with the benchmark return series. Formally, the abnormal return of firm  $i$  around an M&A event at date  $t$  ( $AR_{it}$ ) can be calculated as:

$$AR_{it} = R_{it} - E(R_{it}|\Omega_t)$$
$$E(R_{it}|\Omega_t) = \alpha + \beta R_{Mt}$$

where  $R_{it}$  is the daily stock return of firm  $i$  at the time the M&A is announced and  $R_{Mt}$  is the daily return of a corresponding benchmark index in the same period,  $\alpha$ ,  $\beta$  are linear regression parameters and  $\Omega_t$  refers to the information set at time  $t$ .

### Length of horizon

If financial markets are efficient, the effect of an M&A on the firms' future prospects ought to be fully reflected in stock prices at the time that the deal is announced. But the transaction could have been anticipated and so the effects could show up earlier, or it may take a little while for the implications of the merger or acquisition to be completely digested. For both reasons, most researchers tend to look at abnormal returns a few days either side of an announcement and aggregate the effects over time to derive the cumulative abnormal return (CAR):

$$CAR_{i(\tau_1, \tau_2)} = \sum_{t=\tau_1}^{\tau_2} AR_{it}$$

To the extent that markets are not efficient so that the effects of the merger or acquisition show up only slowly in stock prices, some researchers advocate looking at long-term measures of equity price outperformance. In addition to CAR over a longer time horizon (eg, a year), the buy-and-hold abnormal return (BHR) is commonly computed. BHR is defined as the difference between the realised return from holding the shares of the firms involved in the M&A and that achieved if the investor had invested in a benchmark portfolio or market index:

$$BHR_{i(\tau_1, \tau_2)} = \prod_{t=\tau_1}^{\tau_2} (1 + R_{it}) - \prod_{t=\tau_1}^{\tau_2} (1 + E(R_{it}|\Omega_t))$$

### Statistical tests

By comparing CAR or BHR across firms it is possible to evaluate whether the effect of M&A on firm stock performance is statistically significant. In practice it is common to consider simple *averages* of CAR/BHRs – often labelled CAAR and BHAR – and exploit standard statistical tests to examine how likely it is that the estimated sample mean abnormal return was drawn from a population with a mean of zero.

### Some caveats

Any assessment of the size and significance of an M&A is conditional on using an appropriate normal return model, which cannot be assured. That the problem is likely to increase with the length of the assumed investment horizon is an unresolved issue in the literature.

Even if the expected component of returns is well captured, the statistical tests may be unreliable if the underlying distributional assumptions about abnormal returns are invalid. In particular, if unexpected returns associated with the M&A are correlated across firms, statistical tests tend to over-reject the hypothesis that the M&A had no impact on performance.

## Appendix

	Abnormal returns for:	Short term (-1D to +1D)		Short term (-5D to +5D)		Long term (52 weeks)			
		CAAR (ppt)	Sample size	CAAR (ppt)	Sample size	CAAR (ppt)	BHAR (ppt)	Sample size	
<b>Overall sample</b>									
	Acquirer	0.26	1205	0.43	1205	6.18*	7.02	1206	
	Target	1.08*	784	1.09*	784	3.10	-2.86	781	
<b>Pre and post crisis periods</b>									
2003–2007	Acquirer	0.10	603	0.07	603	5.18*	14.64	603	
	Target	1.12*	318	1.06*	318	-1.57	-2.69	315	
2008–2013	Acquirers	0.43	584	0.83	584	7.27	-1.26	603	
	Targets	1.06*	458	1.12	458	6.43	-2.99	466	
<b>Type of integration</b>									
Consolidation	Acquirer	0.39	572	0.90	572	5.68*	17.60	572	
	Target	1.27*	313	1.66*	313	2.70	-0.09	312	
Vertical integration	Acquirer	0.44*	173	0.26	173	4.43*	1.93	173	
	Target	1.00*	57	2.19	57	0.48	0.70	57	
Convergence	Acquirer	-0.27	261	0.03	261	-0.91	-8.49*	261	
	Target	1.05*	323	0.40	323	4.06	-5.41	322	
Diversification	Acquirer	0.43	196	-0.23	196	18.59	0.92	197	
	Target	0.56	90	0.75	90	2.17	-6.02	89	
<b>Domestic vs non-domestic deals</b>									
Domestic	Acquirer	0.45*	767	0.90	767	8.82*	11.47	767	
	Target	1.19*	481	1.14	481	4.68	-3.17	479	
Non-domestic	All	Acquirer	-0.07	438	-0.39	438	1.52	-0.86	439
		Target	0.81*	290	0.90	290	0.72	-1.87	289
	Same region	Acquirer	-0.22	237	-0.44	237	-1.16	-2.75	238
		Target	1.45*	165	1.27	165	-1.76	-3.85	164
	Cross-regional	Acquirer	0.12	201	-0.34	201	4.82*	1.48	201
		Target	-0.04	125	0.41	125	4.00	0.73	125
<b>Acquirers involved in multiple deals</b>									
Two to three	Acquirer	0.16	301	0.12	301	14.75	29.50	301	
	Target	0.92	158	0.53	158	0.59	-4.50	158	
Four and above	Acquirer	0.28	436	0.19	436	2.30	-0.49	437	
	Target	1.41*	180	2.59*	180	3.03	-2.32	180	
<b>Transactions by size of deal</b>									
Small (< USD 100mn)	Acquirer	-0.21	263	-0.35	263	11.87	0.26	264	
	Target	0.87	176	1.93	176	9.22	-5.56	176	
Medium (> USD 100mn and < USD 1bn)	Acquirer	0.86	220	2.36	220	7.61	40.42	220	
	Target	1.58*	159	1.00	159	6.70	2.03	158	
Large (> USD 1bn)	Acquirer	0.33	57	-0.64	57	-1.90	-6.26	57	
	Target	0.25	50	-0.29	50	0.57	-3.61	50	
<b>Transactions by geographic location of target and acquirer</b>									
Both acquirer and target from advanced markets									
	Acquirer	0.45*	882	0.80	882	7.78*	10.20	882	
	Target	1.47*	503	1.56*	503	3.31	-3.47*	503	
Both acquirer and target from emerging markets									
	Acquirer	-0.22	150	-0.79	150	-2.24	-6.01*	150	
	Target	-0.30	153	-0.82	153	1.55	-4.58	151	
Acquirer from advanced market and target from emerging market									
	Acquirer	-0.30	164	-0.60	164	3.80*	-0.09	165	
	Target	1.01	106	1.38	106	6.39	4.60	105	

Notes:

\*Results are statistically significant at a 95% confidence level.

The sample of firms is based on deals where an insurance company is an acquirer.

CAAR: Cumulative average abnormal returns in ppt; BHAR: Buy and hold average abnormal return in ppt.

Abnormal return is defined as the difference between actual return on the stock and a model-based expected return, which itself is derived using a national benchmark index.

Short term refers to the interval either one day or five days before and after an M&A announcement (-1D to +1D or -5D to +5D). Long term refers to the period 52 weeks following an M&A announcement.

Qualitatively similar results were obtained for median analysis using the Wilcoxon rank-sum test.

Source: Swiss Re Economic Research & Consulting.

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