

Europe in 2010:

Post-Crisis, Pre-Solvency II

By Fergal O'Shea and Ewa Machlarz

What is the outlook for the European insurance sector in 2010?

The year bridges two decades, and much of the activity we see today reflects fallout from the economic “boom and bust” climate of the decade just past, together with preparation for the huge regulatory upheaval that will accompany Solvency II in the decade to come.

In this article, we consider both of these aspects, starting with the actions companies operating in Europe should be considering in 2010, followed by a discussion of the effects of the recent financial crisis and the tentative recovery in the European M&A marketplace.

Preparing for Solvency II

The year 2009 saw a great deal of activity among supervisors and insurers in preparing for Solvency II. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) issued three waves of consultation papers detailing its advice to the EU Commission on Level 2 implementation measures. And many supervisory authorities began discussions with their insurance sectors, with particular regard to internal model approval for the purpose of calculating solvency capital requirements (SCR). The insurance industry associations (the European insurance and reinsurance federation, as well as national associations) and the CRO Forum actively lobbied on various key topics. Meanwhile, most insurance companies carried out gap analyses to determine their readiness for Solvency II, and some companies began to design implementation plans.

Despite this activity, there is still much uncertainty. CEIOPS and the insurance sector remain divided on such key issues as the determination and classification of “own funds” and the calibration of the standard formula for SCR. The standards for internal model approval will continue to be developed throughout the pre-application process as familiarity with best practice grows and enhancements are implemented, thus making the end goal a moving target.

Although political influences remain difficult to predict, they could be significant, as we saw in the late changes to the Level 1 text — especially where such critical topics as third-country equivalence are concerned. Against this backdrop, there have been preemptive moves by larger insurers to secure additional qualified resources and the focused support of some software providers, which calls into question the ability of other insurers to accelerate their preparations sufficiently as the Solvency II starting date approaches.

Quantitative Impact Study 5 (QIS5) will run from August to October/November 2010 and is the last opportunity for the European Commission to determine an appropriate calibration for the Pillar 1 solvency standard. Although for QIS4 most insurers used approximations and simplifications that would not be permitted under Solvency II, for QIS5 insurers should aim to be as close to Solvency II compliance as possible. Not only will this provide the EU Commission with more accurate calibration data, it will also yield useful information for each participant on its state of readiness and the likely impact on its business — by product, capital instrument and risk.

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While full participation in QIS5 should form part of every insurer's preparations for Solvency II during 2010, there are many other essential actions to help mitigate the uncertainty and ensure that the implementation of Solvency II progresses as smoothly and efficiently as possible. Some other key steps for 2010 are to:

- Determine the quantitative risk management information required and desired
- Select and implement the appropriate IT platforms
- Review and enhance the market-consistent balance sheet calculation and document the relevant internal standards
- Design and carry out training programs to mobilize resources
- Collect materials for the draft internal model approval application file
- Review the strategic actions available to gain a competitive edge under Solvency II

We consider each of these in greater detail below.

Quantitative risk management information. Time invested in reviewing the current CEIOPS-proposed disclosure requirements and in developing a template Own Risk and Solvency Assessment (ORSA) report can be invaluable in highlighting gaps both in current calculation capabilities and in more qualitative areas, such as governance arrangements. This process can also help encourage employee engagement across the business and provide the opportunity to identify additional risk information that would be useful in decision making.

Appropriate IT platforms. Solvency II requires more secure, more auditable, more frequent and faster results, so many companies may need new or enhanced IT platforms. An investment in new data warehouses, proxy modeling tools (such as curve fitting or replicating portfolios), or enterprise actuarial or risk modeling systems can pay for itself through improved analysis and decision-making capabilities. However, the selection and implementation process will take time and care to ensure full efficiency and maximum flexibility for the future.

Market-consistent balance sheet and internal standards. The market-consistent balance sheet is the foundation for all quantitative aspects of Solvency II. For some companies, market-consistent balance sheets will be new or will require extensions to cover non-life business. For others, enhancements may be

required, such as the incorporation of management action and policyholder behavior models. In all cases, greater rigor and standards of documentation will be needed — no easy task in the absence of defined European standards.

Training programs. The fundamental concepts of Solvency II must become second nature across the entire senior management team, and traditional attitudes must be changed through engagement and dialogue. Skilled Solvency II resources are already at a premium, and preparing staff for the new regime (with such new issues as the required balance sheet format and product segmentation) will be a major challenge. This will take time and must be supported by a comprehensive training program.

Internal model approval. Many supervisory authorities, including the U.K. and the Netherlands, will begin the internal model approval pre-application process in 2010. Experience from Basel II indicates that incomplete documentation is a major threat to securing internal model approval. Early action to gather the necessary documents can help identify any omissions and provide sufficient time to remedy the situation.

Review strategic action. Not all activities should be focused on compliance. All firms should be considering how their risk appetites and business models might change under Solvency II. Simple actions to enhance capital efficiency under Solvency II, such as product redesign or changes in investment strategy, are available to all insurers.

Although some aspects of Solvency II remain uncertain, many insurers will be better informed and better prepared than others for any pending changes. Finding time to prepare for change amid the pressures of business as usual is difficult, but insurers that act decisively now are likely to be the real winners under Solvency II.

European M&A Activity in 2010

The financial crisis of 2008 caused a significant slowdown of M&A activity in the European insurance sector. Though the overall level of M&A transactions has not yet returned to that of 2007 and early 2008, there have since been some signs of renewed activity (mostly notably and recently the sale of ALICO to MetLife, the Pru's acquisition of AIA as well as the Delta Lloyd, and the imminent PZU and

planned Talanx IPOs). The economic situation seems to have stabilized since the end of 2008, but uncertainty persists, and it is difficult to predict the prospects for M&A business in the coming year. Some of the following factors are likely to affect insurance M&A opportunities in 2010.

Changes in the Regulatory Environment

As might be expected, Solvency II is already having an impact on M&A activity, and its influence will only increase. Although there is still uncertainty about the final details of Solvency II, as noted in the first half of this article, companies are starting to appreciate the implications of this regime on their business and, in particular, the likely effect on regulatory capital requirements.

Capital pressures under Solvency II may lead to an increase in merger activity among smaller firms or even complete closure to new business. Larger entities are likely to be better positioned to benefit from diversification and the resulting reduction in capital requirements. Furthermore, larger firms are likely to be better able to support the development of internal models to more closely reflect their actual levels of risk.

Clearly, the extent of Solvency II's impact on M&A activity will depend on what the final Solvency II standard formula factors are. These factors have not been finalized, and so the overall impact on required capital, and the related effect on M&A activity, remain uncertain.

Financial Crisis: Changes in Supply and Demand

Before the 2008 financial crisis, one strategic driver of M&A activity had been the search by companies in mature markets for good opportunities in emerging markets as a way to expand their global coverage. They sought the higher growth and yields expected in insurance markets such as Russia, Turkey, and Central and Eastern Europe. The 2008 crisis caused many of these companies to pause and reconsider their access to capital, their position in each of their markets and (once again) their business strategy.

The impact of the crisis on group balance sheets and available capital, and the reduced availability and increased cost of funding, have also tempered demand. At the time of the crisis, several pending

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deals were put on hold as companies tried to assess the extent to which they would be affected by the turmoil. At present, buyers still seem somewhat cautious and risk-averse. This clearly has demand-side impact, although it is uncertain how long this “stall” will persist as national economies stabilize and, in general, resume growth.

There has been some evidence in recent months of a pickup in demand, particularly for high-growth and high-yield investments in developing markets (for instance, the AXA buyout of EBRD's minority share in the ex-Winterthur CEE business, and the MetLife and Pru acquisitions of ALICO and AIA, respectively), and this may indicate increased buyer confidence. Some recently completed and pipeline IPOs (notably, Delta Lloyd, PZU, AIA, Chartis and Talanx) also point to increased market confidence and likely buyer demand.

We believe the key supply-side factors supporting future deals include:

- The trend toward the disaggregation of the insurance value chain and the move away from manufacturing on the part of distributors (in particular, in the bancinsurance sector)
- A refocus on core activities leading to divestiture of noncore assets, especially where these are capital-intensive and are not essential to the main activities or core competencies of the group
- The phenomenon of the “reluctant shareholder” — that is, government-owned or supported banking and insurance entities — wherein the support of the financial institutions in question has been a necessary but temporary expediency, and the public ownership is, in most cases, not consistent with public policy
- The situation regarding government-supported entities will also be influenced by the EU Commission's requirement for group restructuring (meaning, for some companies such as ING or RBS, significant asset disposals) as the quid pro quo for derogation from EU state aid restrictions

Although these factors could increase the supply of potential deals, the demand-side difficulties remain. However, our sense is that while companies are less expansionist than in the recent past, many remain committed to a territorial diversification strategy, with particular focus on high-yield, high-growth developing markets that offer scale opportunities. One positive effect of the financial crisis may be an increased supply of such transactions.

Financial Crisis: Effect on Prices

Before the financial crisis, the effect of high demand for, and a limited supply of, suitable target enterprises in many developing markets was a strong factor in bidding up transaction prices. But while the limited supply of suitable transactions may have inflated pricing levels, the financial crisis has had a greater impact on prices to date. There remain significant differences between bid and offer valuation expectations, and they are inhibiting the completion of deals. The bid/offer expectation gap is one of the most significant issues affecting deal supply. We have seen some solutions to this, such as price earn-outs, but a substantial flow of completed deals is unlikely to occur unless and until the price expectations of both buyers and sellers are more closely aligned than they have been recently.

To date, it appears as if the majority of insurers have withstood the recent financial crisis somewhat better than their banking peers. On the general insurance (P&C) side, most insurers tend to employ prudent investment policies, with the bulk of their assets being invested in cash or cash equivalents. (There were some exceptions to this, and those companies typically suffered investment losses.)

The life sector has been affected more directly by the financial crisis, as the fall in yields and many asset values has reduced the spread margins earned on investment-style products. The economic downturn has also damaged retail consumer confidence and put a squeeze on retail funds available for investment. This has led to an erosion in appraisal values related to lower new business volumes, as well as a significant deterioration in policyholder persistency. On the asset side, there have been some notable write-downs, particularly for companies with U.S. exposures and in structured instruments such as CDOs and ABS.

For the developing markets such as Turkey, prices for deals hit their peak just before the financial crisis. Some deals were then put on hold as prices dropped in reaction to market uncertainty. While no specific deals have been resurrected to date, there has been speculation. However, we cannot see

transactions progressing on previous multiples in the absence of significant conditioning through earn-outs or some other delayed compensation or risk-sharing mechanism.

European M&A: Final Thoughts

Over the past year, the continued influence of supply-side drivers such as regulatory and divestment strategy has emerged among noncore market participants. These factors support an increase in transaction activity. On the demand side, although most participants believe the worst of the financial crisis may have passed, buyers still seem cautious both in their outlook and in the prices they are willing to pay, perhaps mindful of a possible further economic dip in 2010. Compared with this time in 2009, however, firms are more actively considering acquisition opportunities. The key determinant of activity remains the offer and bid expectations of buyers and sellers, respectively, and the extent to which these can converge in such an uncertain business environment.

Conclusion: A Common Theme

The two areas explored above, Solvency II and the M&A market, may appear to constitute a somewhat arbitrary pairing of subjects — but they share an important common theme: that of change presenting opportunities. The notion that change presents opportunities may be thought of as a cliché beloved of consultants, but it is true in general, and definitely true in these two contexts.

Those insurers that prepare best for Solvency II, and take the opportunity it presents for a potentially very beneficial overhaul of their enterprise risk management philosophy and systems, are likely to be the firms that prosper over the decade just starting. Similarly, those insurers looking to expand profitably, whether geographically or in new business lines (or both), should find that the post-turmoil nature of the insurance sector in 2010 presents several opportunities that would not have arisen in the more stable years of the past decade and may not repeat themselves in later years of the decade to come.

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