



Acquisition activity in non-life run-off is expected to grow in advance of Solvency II. **Richard Braham*** of Barclays Bank describes how the acquisition process can be made to flow more quickly and smoothly

Until now, many companies (particularly in Europe) have been reluctant to sell their discontinued books and have simply managed them internally. However the comprehensive capital assessment enforced by Solvency II is expected to encourage companies to sell their discontinued books of insurance in order to free up valuable capital for their live business. In this regard, there is likely to be a continuing trend of higher merger and acquisition activity in the run-off market.

Bidding process

Most acquisitions are funded via a combination of equity and bank debt. Often the transaction needs to be completed swiftly, therefore understanding the information and process a financing partner would need to undertake helps to make the deal flow more quickly.

As part of the acquisition and structuring process, the run-off business will make the decision as to whether



A road map to acquisition

to self fund the purchase or request bank debt to add some gearing into the transaction. The decision will depend on the circumstance, the ability to self fund a transaction (acquisition sizes can vary from c.£1 million to c.£500 million and beyond) and the desire for debt in the group.

If a business decides gearing is desirable, it will usually be at the bidding stage that the bank is engaged to give some form of comfort, most likely through a non credit approved termsheet which adds weight to the

offer. Early engagement with the bank is useful as not only will this help the bidding process but also allows the bank to confirm legal, financial, actuarial and any other due diligence requirements that can be incorporated in the overall scope of work that will commence during exclusivity.

A seller may employ a consultant to advise, project manage and introduce the transaction to the market. Our view is that the role of the consultant can be beneficial, especially for a relatively new seller, in order to aid the

process and introduce the deal to the most relevant parties given the type of business classes involved.

To start a bidding process, potential suitors after an initial review will produce a structure for the acquisition to show the viability of their proposal. An acquirer, although they do not have to, will likely use a newly established special purpose vehicle (SPV) set up to take on the assets of the transferring business (Figure 1).

Typically, the holding company will be established to complete the acquisition. This approach is cleaner than transferring the acquired business into an existing company as it ensures there is no co-mingling of reserves. From a bank's perspective, this would be the preferred route for an individual purchase, as the due diligence required can focus on the transferring assets, the associated cashflows and their ability to repay a facility. However, an alternative structure may be applicable if a counterparty requires a corporate facility based on the group's cashflow and activity rather than the individual legacy purchase.

As the market has progressed, the structures to effectively acquire business have become more sophisticated. As well as seeing outright purchase and transfer of companies or portfolios, innovative structures are being used to provide reinsurance contracts for a particular book.

As a result, there will be times that a company or portfolio will not physically transfer until a later stage. I believe that creative structures will benefit and enhance the market, as the ability to not rely on a particular exit mechanism to ensure resolution will, over time, take away some of the uncertainty that currently exists in the market.

Choosing the appropriate bank is an important decision, firstly in adding gravitas to the bidding process but then more importantly to the acquirer, providing the ongoing requirements that the business will need. As well as providing leverage for the transaction,

the bank will be able to provide operational and cash management capabilities as well as asset management. The ability to achieve better returns for the cash and cash equivalents within the investment portfolio is critical and is often a good way to reward your debt provider for balance sheet support.

Exclusivity period, due diligence

The majority of transactions we have reviewed have been bought at a discount to net asset value, providing a buffer to absorb any potential future reserve deterioration, but there will be some instances where a premium will be offered. This may be the case, for example, where the seller is aware of particular reserve redundancies or maybe anticipated commutations that will shortly impact the portfolio.

The bank will need to understand all potential upcoming savings on the business, both the expected and those created by the synergies of the purchase. This will give guidance as to the ability for capital releases that will likely be the source of repayment to a debt facility.

Comprehensive financial, legal and actuarial due diligence is a must and usually the agenda for all parties involved will be included to ensure a relevant scope of work is assembled. The due diligence will look to assess the classes of risk underwritten, adequacy and volatility of reserves, quality of investment portfolio, value/quality of the reinsurance receivables and the size of the unallocated loss adjustment expense (ULAE).

A bank would expect at least the following financial profile assessment to ensure the correct synergies for the

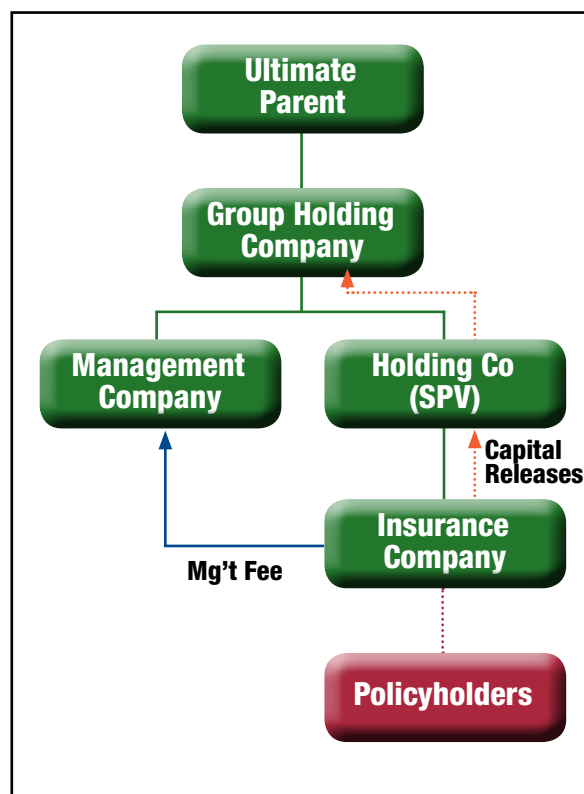


Figure 1. Structure of the acquisition

acquiring company exist:

- Liabilities: assess the confidence that the reserves will be sufficient to cover the liabilities.
 - o The actuarial report will give a picture of historical volatility by examining the gross ultimate losses over, say, a five year period. It will also likely include estimates of reserves at the 95th or 99.5th percentile of certainty to demonstrate the impact of substantial reserve deterioration in a stressed scenario.
 - o They must have a full understanding of the diversity of the portfolio and all classes of business underwritten which will ensure they have the specialist skills to manage the book.
 - o The regulatory jurisdiction in which the assets and liabilities are domiciled should be analysed and reviewed to provide the relevant comfort that a necessary transfer of business can take place.
- Investment portfolio: assessment of the quality of the current

investment portfolio is essential to ensure it fits the strategy of the acquiring business (ie. the percentage split across rated securities is in line with current investment programme). Analysis of how the incoming investment portfolio will immediately impact the existing portfolio mix will be important. For example, a fairly conservative business that prefers to invest in AAA/Government bonds and may have c.70 per cent of its portfolio in AAA investments or better would be concerned if this was to substantially drop due to the seller's investment strategy to chase yield. As to be expected, from a bank's perspective the more conservative an investment strategy (within reason), the more credibility can be assumed for the business. If some of the investments are to be used as a type of security for a bank facility, it is worth noting there would be different haircuts applied given the different rating.

- Reinsurance receivables: if the reinsurance asset is sizeable, this can have a significant impact on the business. A review of the external rating on the reinsurance companies involved will be a good estimation of the quality, availability and ability to collect these assets. If the reinsurers are deemed not to be of high quality this should form a part of the negotiations for agreeing the purchase price.
- Exit options: clear business strategy as to the goal for the portfolio, whether this will be run off to maturity or whether they are reliant on a successful scheme of arrangement, for example to ensure finality. If it is the latter, the acquirer will need to understand what the likelihood of a successful scheme completion will be as to ascertain if the purchase will be the right decision.
- The acquirer would usually be



expected to build a cashflow model to show anticipated capital extractions which again would be a good indicator of the strategy for the business.

- Legal due diligence should be completed to review any outstanding litigation or jurisdictional issues.

All transactions involving the acquisition of insurance companies cannot be completed without the approval of the regulator, which they would look to approve if they are satisfied that the insurance company will be properly managed and has sufficient resources to meet all future liabilities. From our experience, the Financial Services Authority (FSA) has been efficient and understands the run-off market when compared to regulators of other jurisdictions. We have seen regulators from other European jurisdictions significantly hold up cross border transactions and request more stringent and burdensome requirements on a specialist business than that required by the FSA.

Given the likely increase in cross border transfers, it will become even more important to understand what requirements need to be fulfilled by the different regulators within different jurisdictions. The requirements will significantly differ from one region to another and could impact original proposed timeframes for a particular transaction without the foresight to gain such clarity.

Extracting value/cashflows

The rationale for an acquisition will likely be the synergies created by purchasing similar pools of legacy business. From what we have seen, the current economic climate has lent itself to accelerated commutations, due to the certainty of cash upfront rather than waiting for the duration of a policy. As soon as the due diligence, final negotiations and a potential acquisition are complete, the acquirer will commence its business strategy to generate significant savings on the legacy portfolio and ultimately capital extractions (with agreement from the regulator) to benefit the new owner.

Conclusions

The market and most specialist run-off participants are witnessing a higher volume of legacy portfolio opportunities to acquire both from within the UK and Europe. As discussed earlier, a large contribution to the increased focus on selling discontinued business will be due to the new regulation and the increased capital this would consume. Selling would alleviate this problem and allow the focus to shift back to core business. As a result and as we can see, many opportunities will arise and the key will be understanding which purchases will create the best synergies that suit a niche player's business strategy.

Early engagement with key parties to an acquisition, including the bank, will ensure a more successful bidding process and ensure all areas of due diligence will be complete during the exclusivity period. The bank will be able to help with the structure of the acquisition as well as support the ongoing business on a day to day basis, so choosing the correct partner will be a factor in the ultimate success of an acquirer. ●

** Richard Braham is relationship director, non-bank financial institutions, with Barclays Corporate*