European Insurance Industry Observations

April 2017

Non-life

Natural catastrophes globally and severe flooding in the U.K. and Europe in FY16 gave rise to significant claims against insurers. The combined impact of severe weather in Europe gave rise to c.$5.5 billion of economic losses ($3.4 billion insured), making it the third largest economic loss event in FY16 and largest in Europe. Wildfires in Canada, earthquakes in Japan and Ecuador, severe storms in Texas, major flooding along the Yangtze River in China and forest fires in Canada were some of the global events impacting European insurers. Munich Re estimate total insured losses to be c.$27 billion, which was above the inflation-adjusted average for the last 30 years, but below the average for the last 10 years.

Pricing continues to present challenges for both U.K. and European non-life companies, even though volumes improved in FY16 on the back of improving economic conditions in some countries. Market analyses indicate that commercial pricing declines may be reaching a plateau, although further renewal cycles will bear this out better.

Prior year reserve releases: There was no direct evidence that prior year reserve releases as a percentage of combined operating ratio (COR) declined in FY16 amongst the large cap European P&C insurers, although Generali is an outlier amongst peers and has the lowest contribution from prior year development (there was reserve strengthening in 1H16). We note, however, that in July 2016 the U.K. PRA instructed the Lloyd's market to carry out a detailed reserve review of syndicates citing concerns about sustainability of reserve releases.

Reported Solvency II capital positions for the larger P&C insurers appear healthy, with Zurich the only insurer reporting a sub-130 percent (Economic Solvency) ratio. As with life insurers, a visible trend was around the volatility of the Solvency II ratio, which declined for most insurers in 1H16 as a result of unfavourable market movements, before improving by the end of FY16.

Legacy: A number of insurers are bringing their legacy books to the market – recent examples include The Hartford's U.K. business, QBE, Aviva, RSA, and Generali among others. After years of generating low returns and consuming considerable capital, larger insurers are taking more urgent action to dispose of their legacy businesses in order focus on core business. Focus on core activities also saw a number of players dispose of live underwriting operations with limited scale and/or low profitability (e.g. RSA, Generali).

Cyber insurance continues to develop strongly in Europe driven by tighter regulations (including fines of up to 4 percent of worldwide revenues for companies that seriously mishandle data breaches). However, underwriters are facing a struggle due to the lack of data and loss history needed to make reliable actuarial calculations about exposure.

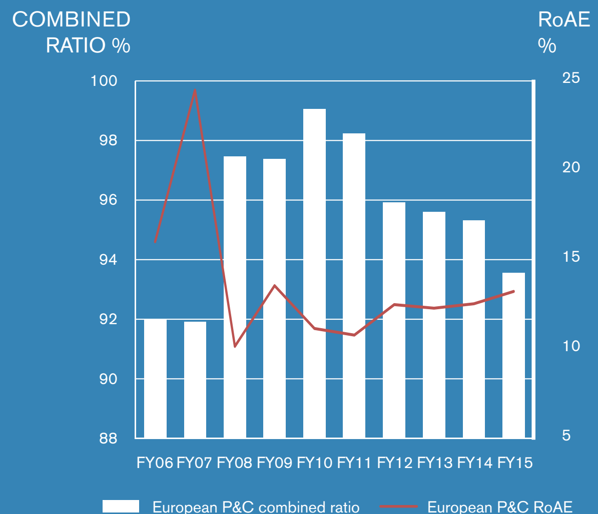
Fintech is playing a larger role in expanding market reach as well as making buying insurance easier for consumers. Insurers also invested in fintech start-ups with Allianz's funding of MoneyFarm, a digital wealth manager; Munich Re's partnership with Trov, which is developing a range of on-demand insurance products; and AXA backing Gasolead, which is creating a virtual assistant to help insurance agents generate more digital leads. The digital agenda and big data are now firmly embedded in most insurers' long term strategy, but a number of insurers continue to focus on streamlining back office IT (including outsourcing of back office activities) along with developing/investing in front office digital infrastructure.

A&M view

"UPTICK IN VOLUMES, BUT MUTED PRICING GROWTH, AND STREAMLINING AND MAKING OPERATIONS EFFICIENT ARE KEEPING MANAGEMENT TEAMS BUSY"

For many non-life insurers faced with intense competition, excess capital and muted macro growth conditions, **the ability to grow the top-line continues to prove challenging**. Volume growth is a key priority for non-life insurers, given a benign rating environment across most lines of business. Whilst the cost of disasters has racked up in recent periods, there is no evidence yet that these are sufficient to push up rates, given excess capital in the market chasing (increasingly) lower returns. This has put added pressure to selectively grow volumes and maintain cost discipline.

In this environment, **consolidation amongst P&C (re)insurers will likely continue in the medium term, as scale, business line and geographic diversification, and synergies, play a central role in determining the 'winners'** – those with stable, profitable growth – from the 'laggards' – those with limited growth in key markets, and lack of the requisite scale and diversification needed in current market conditions. We see the Lloyd's market as poised for consolidation given the increasing number of syndicates with sub-optimal underwriting and expense ratios. Whilst demand for a Lloyd's platform remains strong within the overseas insurance community, there are signs that the market is losing some of its historical capital advantages from pricing pressures and rising costs. We see the market for outsourced insurance services – claims management, infrastructure & IT, and, increasingly even front office underwriting via specialist MGAs – as continuing to grow rapidly as capital/balance sheet management, underwriting returns and top line growth occupy Management teams' agendas.



We also see non-life run-off as a continued major growth area as insurers are no longer be able to maintain costly legacy books that yield limited diversified returns. Given the challenges faced within 'live underwriting' there are additional pressures to release capital tied up in clunky blocks of legacy reserves. Non-life run-off is a potential investment opportunity for private equity sponsors, as has been done within life closed-block transactions. **Private equity backed non-life run-off acquirers such as Catalina have seen significant growth in profitability and net asset value** from acquiring and efficiently running-off legacy reserves. A key challenge is identifying and backing the right management team with experience of acquiring and managing run-off businesses.

Over the longer term, the increasing likelihood of anything but a 'hard Brexit', together with the adverse economic impact from Sterling weakness, will potentially have a detrimental impact on economic growth and adversely impact insurers' U.K. business. U.K. insurers will closely monitor negotiations and have already developed contingent plans for their EU operations.

Life

A number of life insurers are **focused on improving new business margin** and reducing new business sales in lower margin products, particularly in mature markets. Generali has been the most prominent in its restructuring, reducing GWP by 4 percent and new business annual premium equivalent (APE) by c.7%, but growing new business value by c.15 percent in FY16. AXA reduced new business sales by 5 percent in mature markets but improved new business margin by 2 percentage points; the opposite was true for 'high growth' markets where new business sales improved but new business margin fell. Similarly, Allianz has focused on repricing, increasing the share of 'capital-efficient' products, and changing the business mix by reducing savings and annuities.

The above developments in FY16 are part of broader longer term **efforts by life insurers to overhaul their businesses**, through disposals, operational improvements and digitising the business value chain, given market conditions, and in order to deliver target risk-adjusted returns. Standard Life's sale of its Canadian and Singapore operations, Aegon's sale of its U.K. annuity books, and Generali's restructuring of its Italian and German operations are a few examples of life company disposals and we expect this to continue over the next 12-15 months.

Life insurers continue to focus on **driving up the volume of AuM** inflows and on growing fee-based business. Aviva, Allianz, Standard Life all saw strong growth in AuM and fee based revenue, whilst AXA was an outlier, with AuM for both AXA Investment Managers and Alliance Bernstein showing reduction in AuM in FY16. Standard Life's acquisition of Elevate from AXA and Aegon's acquisition of Cofunds from L&G were the big transactions in the platform market and makes both companies leaders in this market. The U.K. platform market is set for further consolidation in the near term. Standard Life's own subsequent recent merger with Aberdeen Asset Management was a clear signal towards scale and consolidation in the asset management industry.

Adverse market conditions and market volatility led to a reduction in most European life insurers' Solvency II ratios in FY16. Some insurers saw a reduction in available capital and an increase in required capital – not surprising given that the risk-based nature of Solvency II can lead to this compounding effect in times of adverse market conditions and volatility. However, based on published ratios, most of the large life insurers appear to be well capitalised. Investment portfolios, while undergoing selective reallocations, remain conservative. Interest rate movements in FY16 led to an increase in unrealised gains for a number of insurers.

Insurers are continuing to explore management actions based on the internal model, in order to tailor and improve their risk adjusted returns and improve Solvency II own funds position – examples include further matching adjustment (MA) portfolios and extending the MA application to include additional liabilities; investing in new asset classes (infrastructure, commercial real estate and using securitised structures to adapt certain inefficient assets for MA); optimising credit portfolios, etc. Life insurers are now firmly established in infrastructure lending, commercial real estate and 'direct investments' more generally, as they continue to expand their search for higher (and stable) long term investment yields. L&G, PIC and others took further action in FY16 to expand into long dated infrastructure debt and equity.

A&M view

"GROWTH OPPORTUNITIES EXIST, BUT CAPITAL AND RISK-RETURN DRIVEN RESTRUCTURING CONTINUES TO DRIVE STRATEGIC SHIFTS"

From a market perspective, **Europe still presents a huge growth opportunity for European life insurers**, given the sheer size of the market for savings and retirement products, the demographic, and the pension funding gap in most markets. As Government-backed pension schemes and defined benefit schemes continue to dwindle in importance, individual savers and company-sponsored defined contribution schemes have taken centre-stage, and it is this market that presents a big growth opportunity for life insurers. At the same time, the derisking of existing defined benefit schemes by corporates continues to present opportunities for providers of 'bulk annuity' solutions. However, Solvency II has meant that a number of the 'old-world' products (e.g. guaranteed rates) are less economically viable. **Capital strength and efficiency, and cash generation,** together with the desire to reduce reliance on low interest rates and spread margins, is leading European life insurers to rethink their overall strategies.

Many European life insurers are still in the 'restructuring phase' of their operations, and M&A activity is expected to continue as a consequence – mainly as non-core and/or capital intensive businesses or businesses not meeting internal risk-adjusted return targets continue to be offloaded. Private equity sponsors have already been active in the life insurance market (particularly closed block), and will continue to opportunistically do so; however, cost of capital constraints mean that strategic acquirers with large balance sheets and the ability to drive diversification benefits will likely continue to be behind the bulk of the bigger ticket deals.

As Solvency II reporting and the implications of different Solvency II ratios across insurers continues to evolve, investors are increasingly focused on balance sheet and capital volatility of life insurers and the extent of diversification of risk and earnings streams. As there is still considerable disparity across local Solvency II application across countries, however, investors are skeptical of comparing ratios across insurers. **For M&A transactions,** this will mean that unpeeling the Own Funds and SCR to understand any inherent risks to the capital ratio will become increasingly important.

While it is still not clear what Brexit will mean for U.K.'s application of Solvency II, it is very clear what U.K. life insurers' preference will be. It is likely that the PRA will allow for certain compromises to be struck post Brexit, without being seen to compromise on capital adequacy more fundamentally.

A corollary of Solvency II has also been life insurers' increasing the proportion of their overall revenues derived from fee-based businesses. This is also **leading to beefing up of investment management businesses,** and, in the U.K., consolidation in the platform asset administration market. We see this trend as continuing, given the longer term requirements for individuals to manage their own pensions and investment assets.

A longer term opportunity that we note is around the 'socialisation' of investments, built upon some form of a social media platform. With younger investors increasingly savvy about saving and investing, but recognizing that direct investments into markets are fraught with risks and with odds stacked against them, there is a clear opportunity to attract younger savers into the market for investments, built upon a low margin/high volume platform. Investment platforms have historically been focused on the older, high net worth segment or the 'active trader' segment; but with spreads under pressure from this bracket, we expect an increasing push by insurers and platforms into the volume driven (albeit potentially higher churn) younger age bracket.

Insurance distribution

The insurance broking market has **continued to invest in its IT platform** to improve efficiencies and business scalability, and provide new products and services. As legacy IT platforms have become a big burden on brokers, demand for improved IT capability has become a necessity, even at the smaller end of the spectrum. In addition, a number of broker-MGA platforms are investing in analytics capability to improve pricing and service delivery to the market.

Market conditions remained difficult for non-life brokers, in FY16 as with their (re)insurance counterparts. With the U.S. market performing well in HY16, the majority of U.K. brokers reported strong results from their U.S. branches, while favorable foreign exchange movements delivered additional significant gains for brokers with U.S. businesses. The U.K. broking market also saw improved volumes and profitability in 2H16, but pricing pressures in the market, in particular within energy and aviation, have continued to impact brokers. According to estimates by JLT, upstream energy gross written premiums (GWP) fell from $1,786 million in FY14 to $530 million in FY16.

To counter tougher market conditions, larger brokers have been devising various ways to increase commissions and fees earned from insurers. Broker market facilities such as the Aon Client Treaty continues to disrupt smaller market participants and will allow larger brokers to take some form of block commission on deals (and further squeeze (re)insurer margins). The regulatory environment for brokers remains high on the list of priorities, with Financial Crime and Sanctions, CASS 5 and Conduct Risk all keeping brokers busy. The FCA is expected to include Conduct Risk in their Thematic Review Plan for FY17. Conduct Risk has also meant brokers investing in training and IT development to allow them to better measure and monitor performance.

A key product that has seen growth is M&A insurance as a number of carriers and brokers seek to take advantage of rate hardening, given the increasing demand for the product. Entrants to the market in FY16 included Berkshire Hathaway Specialty Insurance, CFC Underwriting, and Hyperion-owned managing general agency (MGA) DUAL.

Consolidation in the U.K. market, particularly within the commercial, specialist segment has continued. With a large number of regional businesses ripe for consolidation, PE sponsors or PE-backed platforms have been active in the market. Carlyle-backed PIB Insurance and Penta-capital backed Global Risk Partners are the two key broker-consolidators in the U.K. market. Both businesses have been actively acquiring niche commercial regional brokers/MGAs, taking advantage of what is a hugely fragmented market at the lower end of the insurance broker market. At the same time, the U.K. market has seen a number of smaller MGAs sprouting up to take advantage of commercial niches which are costly or inefficient for insurers to maintain in-house.

In the U.K., **The Insurance Act 2015** has replaced principles set out in the Marine Insurance Act 1906. The changes include a different basis for disclosing material information, amended remedies for breach of contract and a new way to establish which pieces of information represent warranties. Knowledge held by brokers is included within the scope of what an insured either knows or ought to know. This means that brokers must be careful to share appropriate information with clients.

A&M view

"BROKER MARKET CONSOLIDATION, BACKED BY PRIVATE EQUITY CAPITAL, IS EXPECTED TO CONTINUE OVER THE MEDIUM TERM"

The European insurance broking market, led by the U.K., continues to evolve, and is increasingly seen by the insurance industry as an agent of change and risk management for insurers. In this environment, **we see the need for brokers, in particular at the mid to lower end of the market, to continue to improve their business operations and systems, governance and financial management processes.** These are all areas where brokers have historically been weak, but market dynamics, not least the increasing trend towards consolidation and a larger number of smaller brokers increasingly in the spotlight, is putting more pressure on brokers to modernise the way their businesses are run.

We expect regulatory pressures on the broking market to continue and the regulatory burden will continue to force the industry towards scaling up, as it is costly and inefficient for smaller brokers to invest time and money in the required systems and people to meet market standards.

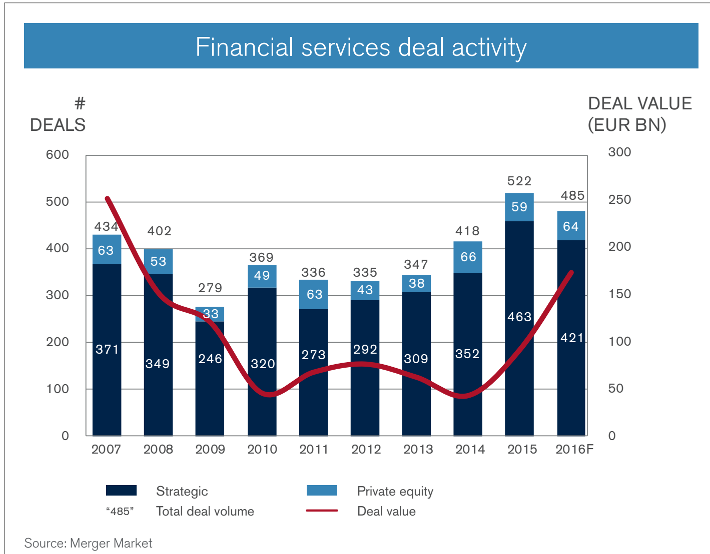
Market conditions – muted pricing, challenges from big ticket insurer-broker facilities – **are expected to remain challenging for brokers,** and this will imply that product innovation, and strong MGA capabilities, will continue to be the focus for a number of brokers. A key challenge for brokers will be cost management, and demonstrating that investment in IT systems and processes will lead to expected efficiencies and value for investors.

Market consolidation, led by private equity, will continue in the insurance broking market (and the insurance services market in general). The current broking and services market – including, among others, the BPO and the claims management industry, the insurance/broking software market – is seeing growth as a result of insurers themselves having to focus on cost management, leading to increased outsourcing. Given the need for the broking and service industry to modernize and access bigger markets for continued growth, private equity sponsors are a natural fit; although valuation expectations for sellers continue to defy logic in many instances. The broker-MGA model is attractive because of the higher commission/profit share basis, and we this model as gaining further importance in the near term.

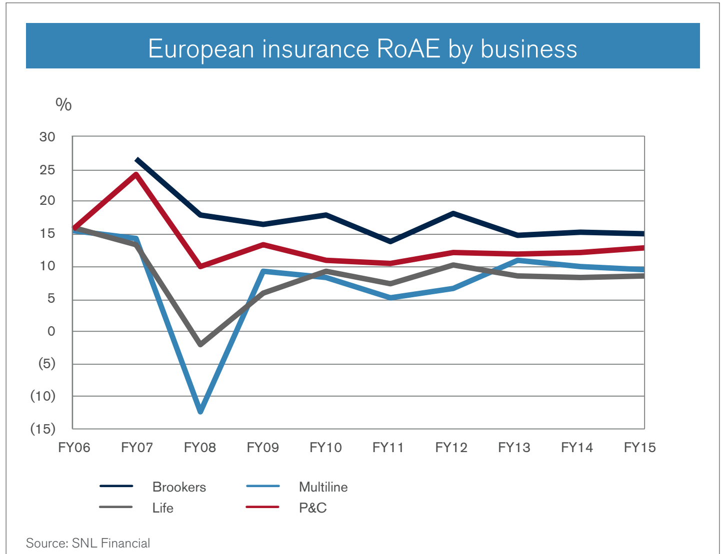
A key headwind to consolidation in the insurance broker and services market is the ability to find and back the right management teams with previous experience of successfully executing a 'buy-and-build' strategy. While private equity can naturally help in such a strategy, the right management team will command a significant premium given the relative scarcity of teams with a track-record of successful deal execution and integration.

The Insurance Act 2015 will result in significant changes to the procedures brokers follow. A more comprehensive search for disclosure material will take additional time, as will arranging this in a format that meets the requirement for reasonable clarity. Brokers will face slightly higher risks under the new regime, as they are being given additional responsibilities which will increase liability. To protect themselves, brokerages will need to revisit their contractual terms and clarify the role of the broker and client and specify key responsibilities.

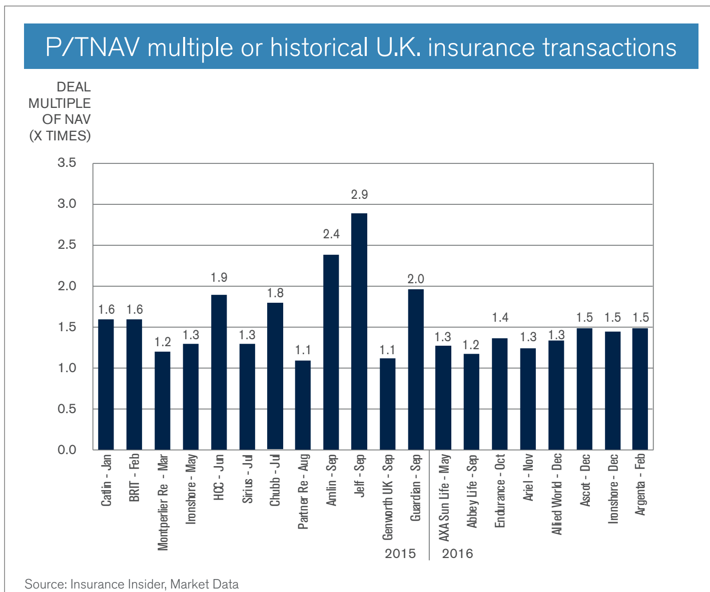
European insurance observations



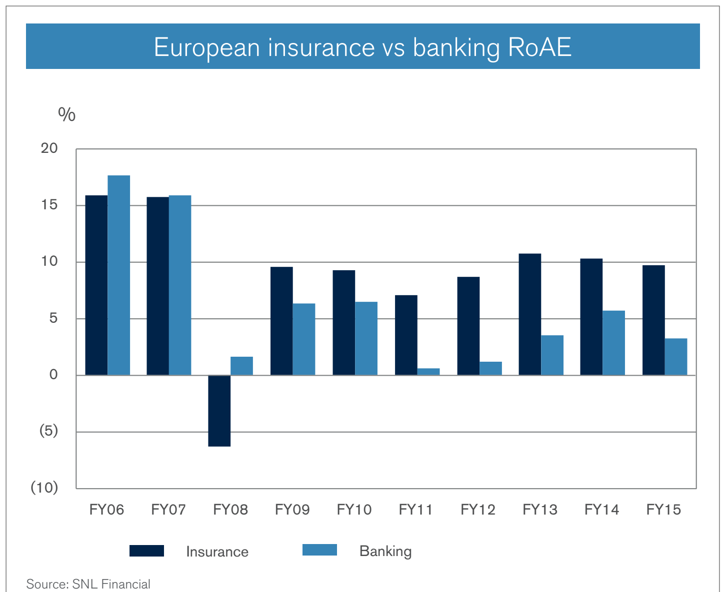
Source: Merger Market



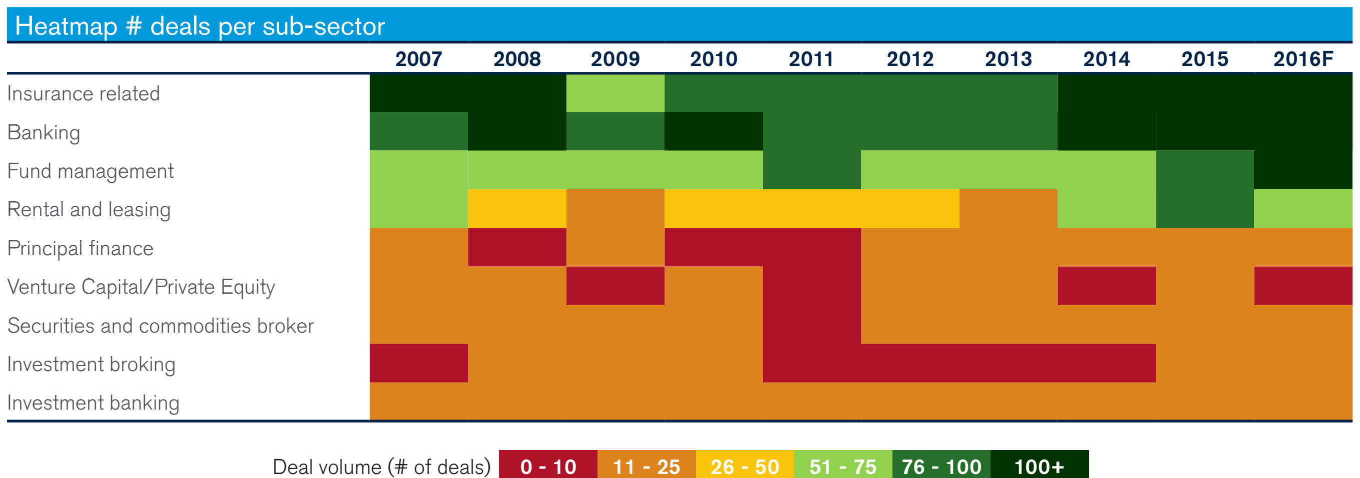
Source: SNL Financial



Source: Insurance Insider, Market Data



Source: SNL Financial



Source: Merger Market

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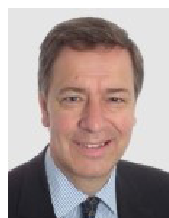

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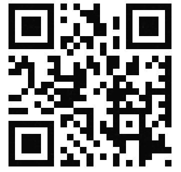

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