INSURANCE M&A

1 Introduction

1.1 Despite Covid-19 presenting many challenges across the globe, M&A in the insurance sector picked up in the second half of 2020 and this has so far continued in 2021.

1.2 Drivers for insurance M&A include existing players seeking to access new markets, distribution channels and product lines and to broaden expertise. Technology has been an increasingly important driver in recent years, with purchasers looking for the potential efficiencies and competitive edge provided by "insurtech", including digital distribution platforms, data analytics and process automation. Non-trade purchasers such as PE houses have seen opportunities in the sector, for example in insurance broking businesses, which have the potential to offer recurring and relatively countercyclical revenues.

1.3 The ongoing pandemic has the potential to drive further M&A activity in the sector. Insurers are looking to analyse their operations and may shed non-core areas of business to boost efficiency, reduce costs and raise capital. In addition, many insurance lines have experienced what is known as a "hard market", with reductions in available cover for certain types of insurance (or providers withdrawing from markets altogether), whilst providers that remain have reduced cover for certain industry sectors and/or significantly increased premiums (this has been the case, for example, in certain property-related insurance as well as liability covers such as directors and officers insurance). The value represented by increased insurance premiums may make for an attractive investment to those looking to expand their footprint in the relevant insurance classes or to new entrants in the market specialising in specific insurance lines.

2 Insurance sector targets and deal structures

2.1 There are different considerations which apply depending on the nature of the target insurance entity (i.e. whether it is an insurer or an insurance intermediary) and the type of acquisition proposed.

Insurers

2.2 If the proposed target is an insurer (being a risk-taking underwriting entity authorised to enter into and operate insurance contracts on its own account):

- A share sale, being the most typical transaction structure, will enable the purchaser to acquire the specific underwriting entity or group in which the underwriting entity sits.
- Business purchases of specific books of policies are achieved via a portfolio transfer (which will require the purchaser, or an entity in its group, to hold the relevant insurance authorisation to accept the transferred business). For UK acquisitions, this will be effected through a court-sanctioned transfer process under *Part VII of the Financial Services and Markets Act 2000*, which can often take in excess of 12 months to be completed. It is possible to accelerate some of the economics of a portfolio transfer by entering into an interim reinsurance arrangement (with the purchaser as reinsurer and seller as cedant) which collapses at the point the transfer scheme becomes effective. This may not, however, result in a full capital release from the seller's perspective until the scheme effective date.
- For certain short-tail business lines, it is possible to achieve an acquisition through a so-called "renewal rights" deal. This involves the selling insurer granting the purchaser the right to quote and/or solicit the renewals of any relevant insurance contracts from its existing customer base, allowing new business of the relevant type to transition to the purchaser as the book churns. This type of transaction does not achieve a transfer of the back book of relevant policies (which would require a portfolio transfer).

Insurance intermediaries

2.3 Insurance intermediary acquisition targets can include insurance brokers or managing general agents (MGAs). The key difference is that a broker acts for and on behalf of an *insured* and does not typically have standing authority to bind insurance business on behalf of any insurer, whereas an MGA acts for and on behalf of an *insurer* and, depending on the arrangement, typically has authority to bind the insurer to cover specific risks up to a specified amount. As such, MGAs often outwardly appear more akin to insurers, effectively pricing and negotiating own-branded policies on its own bespoke terms (within the scope of their authorisation from the underlying insurer) and dealing with all front-of-house activities such as claims handling. MGAs may themselves distribute products via brokers.

2.4 Due to the nature of insurance distribution activities as against underwriting activities, acquisitions of insurance intermediaries are generally achieved via a share sale.

Lloyd's

2.5 One other part of the insurance sector attracting increasing interest is Lloyd's of London (Lloyd's). Lloyd's is a specialist insurance market broadly comprising insurance risk-taking entities (known as "members"), who conduct their insurance business through participating in one or more syndicates run by an agent that handles the day-to-day operations (known as a "managing agent").

2.6 Lloyd's operates an annual venture system whereby insurance business is underwritten by annually-constituted syndicates for one calendar year at a time, which enables an investor to enter the market without necessarily assuming the legacy liabilities.

2.7 Due to the nature of the business of Lloyd's and its operating structure, investments in this space are typically by share sale.

3 Diligence considerations

3.1 Where the target insurance entity is an insurer, some of the key areas in which purchasers/investors will be most interested may include:

3.1.1 **Capital and reserves:** the policy liabilities of insurance companies are, by definition, to some extent uncertain (as they depend on the ongoing claims experience). An insurer is subject to detailed regulations requiring it at all times to hold assets at least equal to a conservative valuation of its estimated future insurance liabilities (its so-called "reserves") along with a suitable capital buffer on top to enable it to survive unexpected shocks. UK insurers are subject to the UK's Solvency II prudential regulation regime and the related provisions in the PRA Rulebook which specify rules for the determination of the reserves and the level of the required capital buffer (being the Solvency Capital Requirement, "SCR"), along with requirements as to the "quality" of the capital held to meet this requirement. Any assets held in excess of these amounts, to the extent not needed as additional buffer consistent with the insurer's risk appetite, potentially represent surplus which may be available for distribution.

3.1.2 **Valuation of reserves**: The inherent conservatism built into the level of reserves maintained by insurers in respect of an existing book of business in accordance with accounting and regulatory requirements can represent significant latent value for purchasers. Resolving the liabilities over time for less than the reserved amount, particularly for closed legacy books of insurance business, can result in profit being released as the reserves run off. However, determining this value is not straightforward given the nature of projections and different cashflow modelling each insurer uses to calculate its reserving requirements.

3.1.3 **Outwards reinsurance programme**: how much risk an insurer passes on by way of reinsurance is an indicator to an investor or purchaser as to the target's risk profile. Separately, insurers can take regulatory credit for its reinsurance contracts it has entered into (provided such contracts meet the Solvency II risk transfer requirements), allowing such contracts to be included in the valuation of the assets held to meet the insurer's future liabilities.

3.2 Where the target insurance entity is an insurance intermediary, some of key areas for consideration include:

3.2.1 **Commission arrangements**: as well as charging a fee for arranging and advising on insurance contracts, brokers may also benefit from profit commission arrangements with

insurers for the business they place. These arrangements can be subject to "claw-back", whereby commission paid to the broker up-front on the placement of business may need to be repaid at a later date if the relevant business does not perform as expected (e.g. if it is subject to high lapse rates or high levels of claims making the business unprofitable). Claw-back liabilities can sometimes be a significant factor in valuing an intermediary target.

3.2.2 **Material contracts**: an investor/purchaser will want to understand the matrix of contracts which apply in an insurance broking arrangement. For example, there will be contractual arrangements between the broker and each insured (i.e. standard terms of business agreements) as well as between the broker and the insurer (setting out, for example, the commission arrangements). For MGAs, it will be important to understand what the authority agreements between the MGA and insurer allow the MGA to do and the period of time in which the MGA is permitted to bind business on behalf of the insurer.

3.2.3 **Client money**: insurance brokers often receive premium payments from insureds for the policies they arrange, meaning that they hold the relevant amounts for a short period prior to them being paid onward to the insurer (usually net of commission). In addition, insurance claims are sometimes paid via the broker, meaning the relevant amount will be held by the broker pending payment to the insured. A broker can hold such insurance monies: (i) under a "risk transfer" arrangement with an insurer which allows the broker to hold such money on the insurer's behalf (and at the insurer's risk): or (ii) as "client money" under CASS 5 (part of the Client Assets section of the FCA Handbook). Holding insurance monies as client money is highly regulated so it is important to understand the target's compliance with the FCA requirements.

3.3 Where the target insurance entity is a Lloyd's vehicle, some of the key areas of consideration include:

3.3.1 **Tenure rights**: in order to assess the value of a Lloyd's member, it will be necessary to understand the tenancy arrangements (i.e. a member's right to participate on a syndicate) in order to identify any limits or controls to the usual perpetual participation of a member on a syndicate. For example, knowing the tenure rights of any third-party Lloyd's Corporate Members will assist in determining the ability to increase underwriting participation.

3.3.2 **Reinsurance to close** (**"RITC"**): this is the mechanism by which an underwriting year at Lloyd's is closed by reinsuring the estimated outstanding liabilities as at the date of closure, in consideration for a premium, to a subsequent year of account of the same or another syndicate. An understanding of an underwriting syndicate's RITC arrangements will inform an investor/purchaser as to the potential exposure to legacy liabilities.

3.3.3 **Profit Commission**: if the deal involves the acquisition of a Lloyd's managing agent, an investor should understand the entity's profit commission arrangements (including any claw back) based on the underwriting performance of the relevant underwriting syndicate(s).

3.4 Some general considerations which apply generally across insurance M&A include:

3.4.1 **Regulatory**: regulatory due diligence is often key for transactions in this sector. This will frequently involve a review of correspondence with regulators over a number of prior years, as well as a review of any specific investigations, visits, inspections, reports and/or interventions by the regulator could be carried out with a lookback period of 5-10 years in order to assess the target/target group's compliance with its regulatory obligations.

3.4.2 **Distribution and claims:** it will be important to understand how insurance business is conducted and distributed in the target as well as how claims are handled. Although insurance distribution activities and claims handling are now often carried out digitally and through automated services, the need for human resource has not been eliminated. Over recent years the FCA has conducted several reviews into the sale of insurance products (including the sale of annuities and general insurance) and how such products are distributed in order to ensure that customers are being treated fairly. A review of the target or target group's systems and controls could be carried out and an assessment of the level of claims and how those claims are handled (e.g. to identify whether there is any mis-selling risk).

3.4.3 **Incentivisation/retention arrangements**: these arrangements, including any employment agreements and restrictive covenants, will need to be reviewed and bolstered as appropriate.

This may be particularly important where the business model relies on specialist underwriting talent (which may be the case, for example, where the target is an MGA).

4 Regulatory considerations

UK insurers are regulated by the Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**), whereas insurance intermediaries are solely regulated by the FCA.

Change of controller

4.1 When a regulated entity is to be acquired (directly or indirectly) by another person, depending on the level of control being acquired, consent from the regulator for a "change in control" may be required. For a UK insurer target, approval of the PRA and/or FCA (depending on which are relevant to the target) will be required for any person who (whether acting alone or in concert): (a) acquires 10% or more of the shares in an insurer or in a parent undertaking of insurer; (b) holds 10% or more of the voting power in the insurer or parent; or (c) holds shares or voting power in the insurer or parent enabling it to exercise significant influence over the management of the insurer. Further PRA/FCA approval will be required on each occasion that the holding of shares and/or voting power passes through a 20%, 30% or 50% threshold.

4.2 An assessment of where the target or target group is to be placed in the buyer's group needs to be undertaken at an early stage, as each new "controller" of the regulated entity will need to submit an application and notifications of any entity which ceases to be a controller will need to be provided.

4.3 If there is a planned reorganisation after the initial acquisition which would result in the regulated entity being moved within the acquiring group and thereby becoming controlled by different controllers, then that reorganisation will need to be included in a change of control application and applications submitted for each controller (whether they are controllers in the initial acquisition structure or reorganised structure).

4.4 Although a single application can be submitted for multiple controllers of the same regulated entity, an assessment of all the directors of each controller will be undertaken and there are a number of "fitness and propriety" questions that need to be answered for each director and a CV submitted. Collating this information for change in control applications can take time, so early engagement with the process is advised.

4.5 The timetable for obtaining regulatory consent to a change in control needs to be factored into the overall deal timetable, including the maximum time periods in which the regulator can "stop the clock" and ask questions about the application. The PRA and FCA are open to having pre-submission discussions about what is required for a given change in control application and having these discussions can help with submitting a "complete" application to the regulators. If an "incomplete" application is submitted, the assessment period will not start until a "complete" application is provided.

4.6 For changes in control concerning a Lloyd's business, purchasers/investors will also need to keep in mind the timetable for "coming into line" for syndicate participation in the next Lloyd's underwriting year (which takes place in November each year).

Regulatory capital/potential for future dividends

4.7 An insurer's dividend paying capacity may be influenced by:

4.7.1 the calculation of its SCR from time to time under Solvency II (as this will determine the amount of free capital in excess of its SCR from which it can pay dividends); and

4.7.2 PRA guidance, which states its expectation that insurers "consider whether the level of their capital resources held following payment of a planned dividend would be in line with the insurer's risk appetite" and seek advance approval from the PRA for a dividend "which would take a firm close to risk appetite" and that it may review the sustainability of dividend policies as part of its regular supervision.

4.8 The PRA may (as regards the insurance market as a whole at times of abnormal systemic risk, or as regards a particular insurer in distress) recommend the cancellation or deferral of dividends and exercise its supervisory powers to compel an insurer to comply with this recommendation (on the basis that non-compliance indicates a breach of the requirement to have in place an "effective system of governance which provides for sound and prudent management of its business").

4.9 Although these potential restrictions on dividends are unlikely to be a concern in the short to medium term in a typical PE leveraged buyout structure, due to the prohibitions on paying dividends imposed by the terms of the acquisition debt facilities, they could have an impact on any plans for a future dividend recap.

Executive remuneration

4.10 PE investors also need to consider potential regulatory implications of the reward package offered to executives in the business to the extent that it constitutes "remuneration" which is subject to the requirements of Solvency II relating to remuneration policy and structuring. It is a requirement under Solvency II that an insurance firm's remuneration policy and practices incorporate measures aimed at avoiding conflicts of interests. Additionally, where any "Solvency II Staff" (being Senior Managers and others with significant levels of responsibility in risk management, compliance, actuarial and internal audit functions) receive variable remuneration, the regulator requires in most cases that a substantial portion of that variable remuneration (i.e. at least 40%) is deferred for a 3-year period and can, during that 3-year period, be reduced if appropriate. This should not apply however to a typical sweet equity structure, where the executives acquire shares in the group at market value.

Group supervision and capital requirements

4.11 Under Solvency II, regulatory supervision of the individual insurance companies within an insurance group is supplemented by supervision of the insurance group as a whole. The group must also meet Solvency II regulatory capital requirements at a group level. Capital is required to have suitable characteristics so that it remains permanently available as a "buffer" to cater for adverse shocks. As such, for example, pure debt finance would not count as capital for a regulated insurance group – including where it is injected at a higher level within the insurance group (as it is defined for group solvency purposes) and pushed down the group into the regulated entities themselves as share capital. In addition, since the activities of an (unregulated) parent holding company can affect its subsidiaries, even a holding company not subject to specific regulation is subject to the regulatory corporate governance and "fit and proper" requirements if it falls within the insurance group for group supervision purposes.

4.12 Under Solvency II, the insurance group consists of one or more insurance undertakings and their direct and indirect parent and subsidiary undertakings – a parent undertaking being defined as an entity having (directly or through other subsidiaries) majority voting rights, the right to appoint the majority of the management body, or "dominant influence" of an undertaking. In addition to (re)insurers (i.e. "insurance undertakings"), the group may include "insurance holding companies" (a parent undertaking whose main business is to acquire and hold participations in insurance undertakings), "mixed financial holding companies" (a parent undertaking holding participations in undertakings in multiple different financial sectors which constitute a financial conglomerate), and "mixed-activity insurance holding companies" (a parent undertaking of at least one insurance undertaking but which is not an insurance undertaking, insurance holding company or mixed financial holding company).

4.13 The perimeter of the insurance group is defined under Solvency II by identifying an "ultimate parent undertaking" – i.e. the highest parent undertaking within the group for the purposes of group supervision and/or calculating group solvency. Since the UK's exit from the European Union, group solvency is calculated under UK Solvency II at the level of the ultimate parent undertaking which is a parent insurance undertaking, insurance holding company or mixed financial holding company (but not a mixed activity insurance holding company) and which has its head office in the UK or Gibraltar.

4.14 Purchasers and investors, particularly in highly leveraged deals, should consider the structuring of their acquisition vehicles (including which entities may be deemed to be a parent undertaking of entities in the insurance group, and the jurisdiction in which those entities are located) to establish whether they fall within the regulatory group supervision and/or group solvency capital requirement of the insurance group in the UK and/or EEA, and the implications for the regulatory treatment of those undertakings and for the capital treatment of the acquisition funds.

5 SPA considerations

Set out below are some key areas where the sale and purchase agreement ("**SPA**") will need to be tailored to factor in some of the points discussed above:

5.1 **Regulatory conditionality**:

5.1.1 As noted above, the regulatory change in control timetables need to be factored into the wider transaction timeline and closing should be conditional upon those regulatory consents being given.

5.1.2 In addition, if it is proposed that individuals from the purchaser's group or individuals from investors are to be put on the board of a regulated entity as an executive director (or will otherwise be carrying out any "Senior Management Functions" under the Senior Managers Regime), such persons will need to be approved by the regulator as a Senior Manager before they can assume that role, and a "statement of responsibilities" setting out what they are responsible for will need to be drawn up as part of that approval process. This application process has its own timetable which will need to be factored in and conditionality included in the SPA. Any individuals who are proposed to become Non-Executive Directors are not subject to regulatory pre-approval as Senior Managers unless carrying out certain roles which are Senior Management Functions (but will nonetheless become subject to a "fit and proper" requirement, criminal record checks and regulatory references).

5.2 **Warranting reserves**:

An investor or purchaser of an insurer will be concerned to understand the insurance reserves (discussed above in section 3.1.1). However, given the subjective nature of the calculation of insurance reserves, it likely that the seller will resist any form of warranty, as this would amount to underwriting the future profitability of the business. A purchaser/investor may seek access to any independent actuarial report to assist with making its own assessment of the insurance reserves. There may be scope to negotiate limited warranties with regards to the preparation of the report.

5.3 **Warranties – general**:

In addition to including more typical warranties concerning material agreements, employees, pensions, litigation, regulatory and compliance warranties (e.g. licences, permissions, regulatory returns) and so on, warranties around the systems, controls, distribution and processes of the insurance entity should be considered, as well as, potentially, warranties on customer relationships and reinsurance programmes.

5.4 **Split exchange/completion**:

There will generally need to be a period of time between exchange and completion of the SPA (as a result, for example, of regulatory conditionality) and so the SPA will need to include obligations on the seller regarding the conduct of the target insurance entity during such period. This is of particular importance with a "locked box" deal structure where risk essentially passes to the investor/purchaser at signing. The obligations placed on the seller and the influence of the purchaser during this period of time will, however, need to be considered carefully to ensure that the purchaser does not acquire "control" prior to regulatory approval for a "change in control" being granted in respect of the transaction.

6 Debt financing considerations

Set out below are some key areas to consider when structuring a debt financing package taking into account some of the points discussed above:

6.1 **Regulatory issues**:

Regulatory regimes often impose restrictions on the scope of security and guarantees available to be granted by a regulated business, and on the ability of lenders freely to enforce security and guarantees from and over regulated businesses, which means that they will be focused on the regulatory due diligence work in order to understand those potential constraints. For example:

6.1.1 *Change of control*

A secured lender's primary route to enforcement is via a single share charge at the top of the lending group structure, over the borrower or its immediate parent (the so-called "single point of enforcement"). Lenders will want to understand the applicable regulatory change of control regime, since this will also apply to any such enforcement (which would typically occur on a sale of the business by the lenders).

6.1.2 *Guarantee and security package; cash management*

6.1.2.1 Regulated entities, including unregulated members of a regulatory consolidation group, may be prevented from granting any guarantees or security because, if they were to be enforced by a lender, the relevant regulated entity could be deprived of the financial and non-financial assets and resources required to carry out its regulated business. This feature of regulated businesses is well-known to lenders and is commonly accepted, but they will nevertheless want to understand the financial and structural position fully as part of the design and calibration of the collateral package capable of being provided by the target group.

6.1.2.2 *If a regulated business is holding client monies, trust monies or similar, or is required to maintain* segregated regulatory capital or other segregated amounts, it will be important to identify any such amounts and ensure they are excluded from any guarantee or security package. This may mean using segregated trust bank accounts and, potentially, sweeping any amounts flowing into such accounts that actually belong to the business on a regular basis into bank accounts that can be subject to lender security.

6.1.3 *Material contracts*

Lenders will also be focused on understanding the matrix of contracts which apply in an insurance broking arrangement and otherwise in the business, in particular where a change in control on an enforcement and sale of the business would give rise to termination rights of the counterparty. Where such contracts are fundamental to the business, for example authority agreements between an MGA and insurer, a lender may want to explore directly with the insurer the possibility that the insurer may pre-agree a “white list” of potential transferees. More likely, however, given that the insurer will wish to preserve its freedom to contract, is the possibility that the insurer and lenders may agree a “roadmap” of consultation as part of an enforcement process on which all parties will be aligned in wanting to preserve value in the business.

6.2 **Split exchange/completion**:

Given the gap between signing and completion under the SPA, which features where regulatory consent is required for the change in control, any related facilities agreement will need to be drafted on a ‘certain funds’ basis. Broadly, this means that almost all conditions precedent to funding are satisfied at signing of the facilities agreement (and the other financing documents) concurrently with SPA signing. Those left outstanding to be satisfied ahead of drawdown for closing are either within the control of the borrower to fulfil, or are related to the satisfaction of SPA conditionality, e.g. evidence of fulfilment of the regulatory consent condition. This requires front-loading the financing workstream, including agreeing and documenting arrangements with third party lenders to the target group for the release of any incumbent debt which is to be repaid. Finally, given that the timing for receipt of regulatory consents cannot be pre-baked, and particularly if a bidder’s debt provider is a credit fund, it is important to ensure that the timeline for completion following receipt of the consent adequately permits for debt drawdown since credit funds will frequently require a longer notice period than a bank lender, in order to draw down from their funds.

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