«Overall, we expect the legacy or run-off market to remain buoyant.»

Deals landscape in the run-off legacy insurance market

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The (re)insurance industry is experiencing unprecedented changes e.g., regulatory developments across Europe (Solvency II) and new accounting standards (IFRS17). At the same time, (re)insurers are constantly looking for ways to simplify and enhance their businesses across the value chain. This typically involves (re)insurers looking for ways to free up capital and re-centre management's focus on their core business operations. As a result, the run-off market has seen exponential growth in recent years.

Market overview

A run-off occurs when insurers cease to write new business for specific products, business lines or portfolios. Run-off books inherently pose a significant profitability challenge. Fixed costs per policy tend to proportionately increase over time as the size of the book decreases. Many policies are still managed on inefficient legacy systems which in turn results in high administration costs per policy. To address this, insurers have the option to (1) right-size their operations as the policies run-off to ensure a stable cost ratio, (2) outsource certain administrative activities to third parties that can run these businesses more efficiently (versus keeping these in-house), or (3) divest or reinsure the closed book to a specialised consolidator, reinsurer or other interested party. The option to sell includes a variety of benefits, ranging from freeing up capital and reducing management's time and effort to removing economic and legal exposure while ensuring the policyholder is protected. This is especially the case as run-off portfolios are often sold to specialist legacy players who have a surplus of capital being backed by private equity (PE) players. The private equity model promotes the level of sophistication that these transactions are being approached by consolidating portfolios of various sizes, realising cost synergies and enhancing operational efficiency. Other potential buyers of these run-off blocks include independent insurers looking to diversify their portfolio/risk exposure.

Buyers within the run-off space will seek to acquire or merge portfolios to achieve economies of scale and decrease expenses per policy, streamlining operations and investing in new IT capabilities, digitising processes, switching to alternative less liquid and higher-yielding investments.

In this article, we aim to explore the current state of the life and non-life run-off insurance market and outlook for deals based on PwC's European Life Insurance M&A and Restructuring Outlook and the PwC 2022 Global Run-Off Survey. The surveys comprise online questionnaires that are sent to a cross section of individuals at (re)insurers, legacy business acquirers, private equity firms, investment banks, brokers, service providers and other stakeholders in both the non-life and life legacy insurance market, together referred to as the «survey respondents».

Market sizing

Life

In our recent European Life Insurance M&A and Restructuring Outlook, we highlight the significance of the European life insurance sector as being the most developed in the world, with significant legacy portfolios still expected to exist in almost all markets across Europe. Overall, we estimate that European life reserves represent approximately EUR 10 trillion. The UK insurance market remains the largest and most active in Eu-

Fig. 1: Total 39 selected key market players globally

Source: PwC, Internal Analysis; Logos are taken from the respective company websites

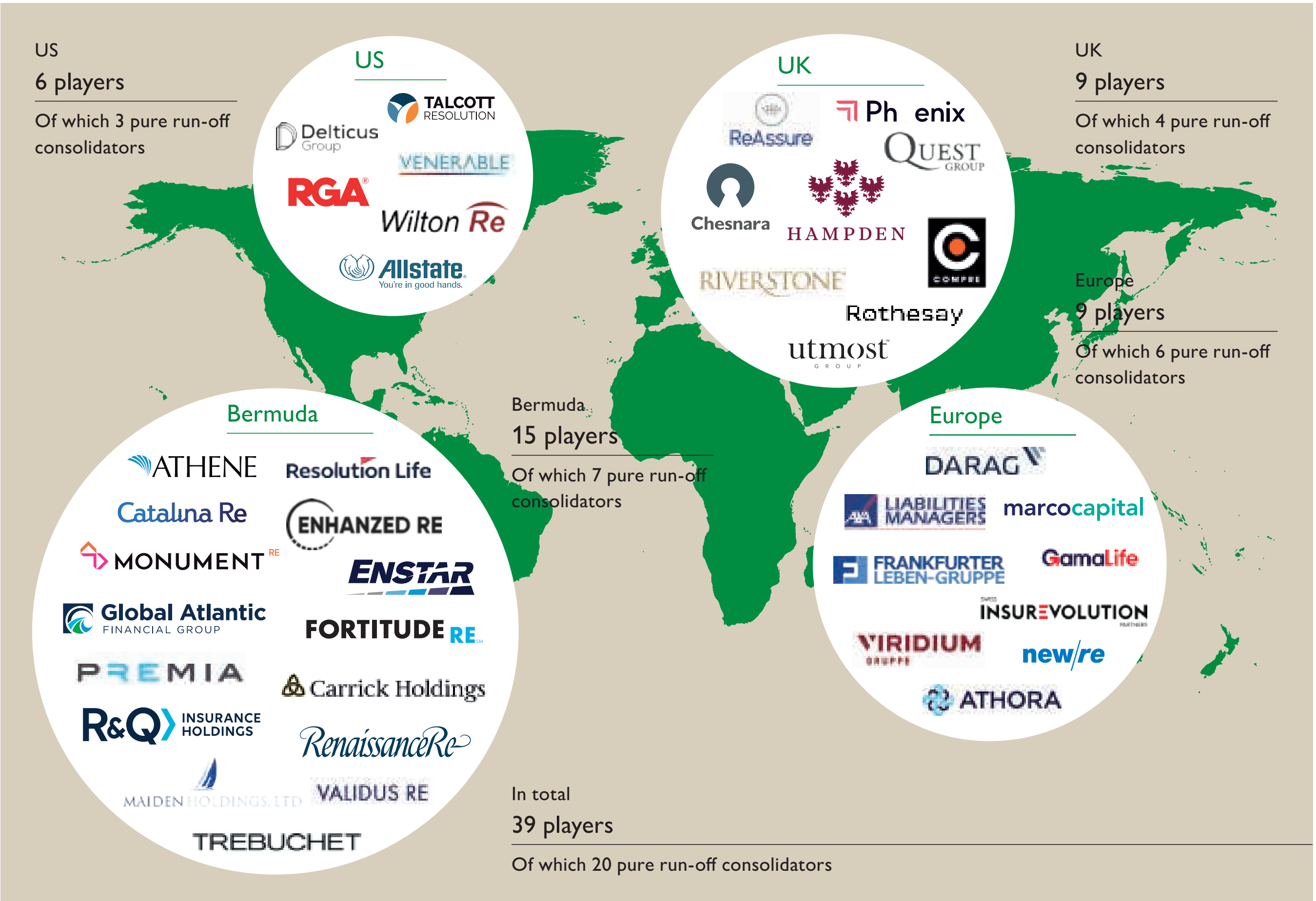
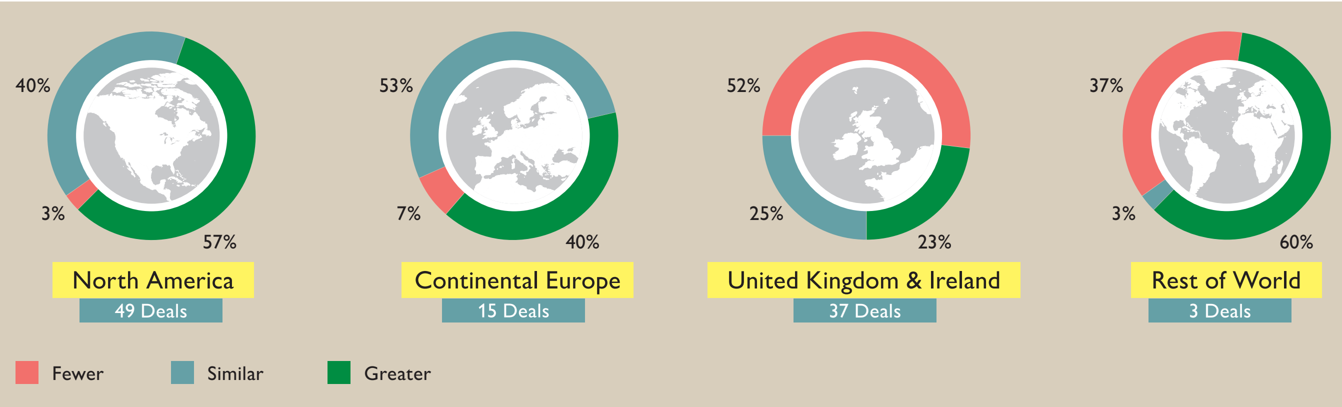


Fig. 2: Expected change in number of run-off transactions over the next two years

Source: PwC, Global Insurance Run-off survey, September 2022



rope with technical provisions that have increased by GBP 389 billion (21%) to GBP 2.2 trillion over the past four years, while the number of insurers has fallen by 11% over the same period. The UK is expected to remain the largest and most active run-off market in Europe. But France, Germany and Italy are expected to see increased levels of deal activity in the near term.

Non-life

Our 2022 Global Run-Off Survey estimates that the global non-life run-off reserves have increased from approximately USD 864 billion to USD 960 billion, an 11% increase compared to the 2021 Survey. Although this is a staggering amount, it represents only one-tenth of the estimated life run-off market. North America continues to dominate the global non-life run-off market with reserves of USD 464 billion, up from USD 402 billion or 15% year-on-year growth. The UK and continental Europe markets have combined reserves of USD 319 billion, up from USD 302 billion or 6% year on year. Our estimates of the reserves in other key territories, including Asia, the Middle East and South America, have also increased to USD 177 billion or 11% year on year.

The global growth in estimated run-off reserves reflect several factors including the fundamental underlying growth in insurance business being transacted globally, with the consequential knock-on effect for policies entering run-off and inflation also playing its part.

In the last two years, 15 non-life run-off deals have been publicly disclosed in continental Europe with estimated gross liabilities of USD 684 million transferred. This represents a realised potential of only 0.3%, when compared to the estimated volume of non-life run-off reserves in the region of USD 241 billion, over half of which emanate from Germany and Switzerland.

Key market players

Globally, the run-off market is dominated by several players concentrated in specific geographies. In total, we highlight 39 selected key players mainly in Bermuda/US, Continental Europe and the UK. (Figure 1)

Macro-economic factors

Supply chain disruptions that are still being felt off the back of the COVID-19 pandemic and are further exacerbating global circumstances, like the impact of the war in Ukraine, have put inflation levels under severe pressure. We've seen inflation increase most in the first world economies globally over the past two years, and it's generally expected to remain relatively high in the near term with considerable uncertainty over the future. As a result, we expect the run-off market to also experience pressure, however, consider it unlikely that we'll see any real slowdown, given the focus of re(insurers) on cost reduction and business transformation.

Deal activity – Non-life

The non-life sector has seen consistent growth year on year in run-off liabilities. This, combined with new capital as well as new players entering the market, has resulted in high levels of deal flow and pricing pressure. Sophisticated run-off consolidators have been able to effectively manage these liabilities and their underlying assets and could extract significant value from run-off books, seeing returns well above market average with IRR expectations of 10% to 17% in certain scenarios.

It's estimated that approximately USD 10 billion of new capital has entered the non-life run-off space over the past three years alone, and the survey respondents expect legacy deal activity to remain buoyant. Outside of the UK and Ireland, over 93% of the survey respondents estimate similar or greater levels of deal activity in the next two years. (Figure 2)

The survey respondents also indicated that they expect the sector's biggest areas of opportunity to feature Lloyd's legacy deals and disposals of non-core business lines following M&A activity in the live' (i.e. regular traditional non-run-off) insurance market. The survey respondents selected general liability, property and casualty (P&C) and workers' compensation as the lines of business likely to attract the most interest, broadly in line with what's been seen in recent years. Motor and financial lines make up the top five chosen by the survey respondents, reflecting the growing appetite for younger exposures. (Figure 3 and 4)

Deal activity – Life

We expect to see high volumes of life run-off transactions across all markets in Europe, as insurers seek to build scale, simplify operations, change risk profiles and restructure balance sheets. Our survey suggests that participants are more likely to engage in M&A activity than in any other restructuring activity over the next 18 months, with consolidation playing a key feature of life insurance transactions over the next five years. Indeed, a common theme across responses is that the market will continue to be hot, with a shift toward portfolio transactions. Survey participants anticipate a greater focus on operational simplification. This may trigger further disposals of non-core businesses to support capital generation.

It's estimated that during the last five years, Europe witnessed 189 deals, primarily in Benelux, UK and Italy. The vast majority of the survey respondents expect deal activity in the next 18 months to remain at similar levels across all territories. Most notably, France, Germany and Italy have been identified as key markets for greater activity in the near term, while more mature markets, like the UK, are expected to continue to experience high levels of activity. The recent portfolio deals in Germany involving AXA (EUR 19 billion, assets under administration, acquired by Athora) and Zurich (EUR 21 billion, assets under administration, acquired by Viridium) are likely to herald a real change for the industry, with the market opening to more complex deal structures. (Figure 5)

Fig. 3: Expected biggest areas of opportunity for the non-life run-off market

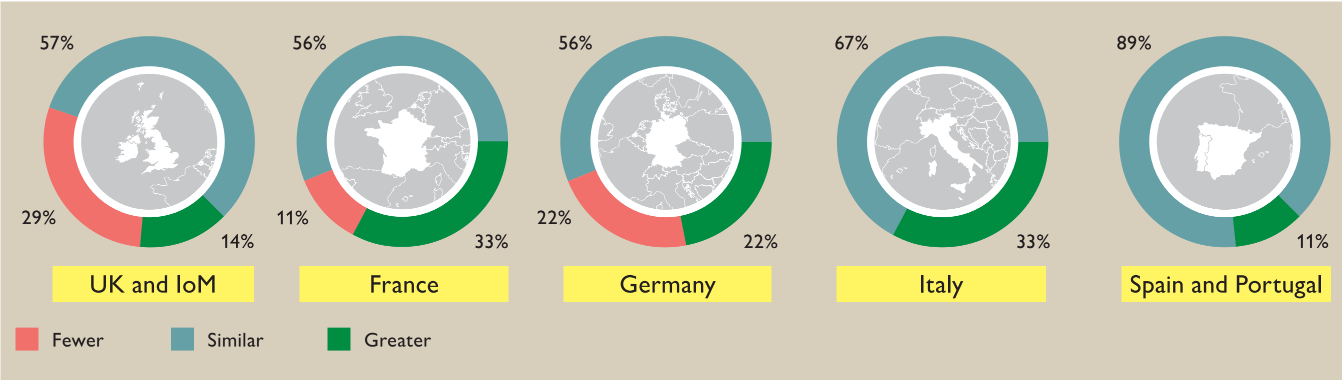
Source: PwC, Global Insurance Run-off survey, September 2022

Fig. 4: Lines of business expected to attract the most interest

Source: PwC, Global Insurance Run-off survey, September 2022

Fig. 5: Expected change in number of run-off transactions over the next two years

Source: PwC, European Life Insurance Mergers, Acquisitions and Restructuring Outlook 2023, January 2023



In Switzerland, larger life insurance transactions are also gaining momentum with a CHF 4 billion legacy portfolio reinsurance deal of individual life insurance being ceded by Allianz Suisse to Resolution Re in September 2021.

While inflation is widely expected to return to normal levels of between 2% and 3% p.a. in most developed economies by 2024/25, under the current inflationary environment, consolidators are offering insurers the opportunity to offload complex portfolios and simplify their businesses. Such disposals can act to reduce operational, IT and administrative costs to help manage short-term challenges for insurers, while enabling consolidators to replenish their heritage portfolios that are quickly running off. (Figure 6)

The recent focus of life insurance companies has been upon:

- unit-linked savings products, whether through writing new business or encouraging customers to convert their existing traditional products, and
- protection business, particularly through the bancassurance channel where it's associated with mortgages or loans, given the high profitability obtained in this particular segment.

Insurers have been actively analysing solutions for traditional legacy savings portfolios with high guaranteed rates, including through reinsurance and portfolio sales. Only a limited number of transactions have been announced to date, primarily due to differences in price expectations between buyers and sellers, as well as regulatory challenges.

Deal value levers

The survey respondents indicated data and systems integration/adequacy as a common operational challenge faced when working in the non-life and life run-off market. Followed closely by data cleansing and operating model integration/transformation, reflecting the technological challenges the market is keen to address. We've identified four key value levers to address the operational and profitability concerns:

1. Asset optimisation:

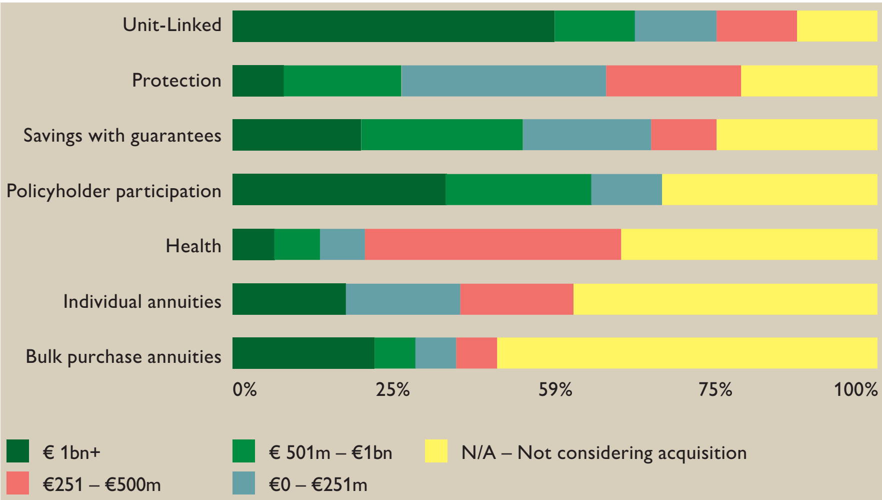
Sellers should aim to optimise current investment management fees and assets under management (AuM) to meet investor expectations. Investors are looking to gain access to a greater asset pool to drive down fees by investment managers and drive margins on AuM. This would also include investment charges currently levied on policyholders and competitiveness. In preparation of a contemplated sale, moving to or identifying a market-consistent strategic asset allocation (SAA) through the re-allocation of investments to different asset classes, would showcase potential upside in returns to buyers and hence drive a higher valuation.

2. Technical liability excellence:

Sellers should focus on identifying any potential value pockets in the solvency valuation basis. Assessing persistency assumptions, contract boundaries and any leftover legacy «manual» reserves through a detailed review of reserve assumptions is critical in reparation of a sale process. In addition, companies validating pre-sale capital optimisation techniques will gain a considerable advantage by showcasing the ability to optimise capital requirements through hedging strategies, use of internal model versus standard formula, additional diversification, and use of transactional measures. Realisation of synergies and diversification with existing operations

Fig. 6: Survey respondents' ideal portfolio size (by total assets) to acquire

Source:: PwC, European Life Insurance Mergers, Acquisitions and Restructuring Outlook 2023, January 2023



and the utilisation of optimisation tools to provide access to solvency are two additional relevant factors that can contribute towards maximising valuations.

3. Expense base optimisation

Over the years, investors have focused on gaining scale to enable their fixed overhead to be spread. A detailed analysis of baseline unit costs (including stranded costs from previous transactions) together with the identification and quantification of cost synergies will be pivotal to a successful cost base integration. addition, companies validating pre-sale capital optimisation techniques will gain a considerable advantage by showcasing the ability to optimise capital requirements through hedging strategies, use of internal model versus standard formula, additional diversification, and use of transactional measures. Realisation of synergies and diversification with existing operations and the utilisation of optimisation tools to provide access to solvency are two additional relevant factors that can contribute towards maximising valuations. 3. Expense base optimisation Over the years, investors have focused on gaining scale to enable their fixed overhead to be spread. A detailed analysis of baseline unit costs (including stranded costs from previous transactions) together with the identification and quantification of cost synergies will be pivotal to a successful cost base integration. Sellers are expected to showcase their view of expected valuation upside from the integration, such as expected overhead synergies, by taking advantage of assumptions on market observable outsourcing costs as a proxy for the costs likely to be incurred by an acquirer on a marginal basis.

4. IT and operational entanglement and separation

It's important to define standalone capabilities required for day one (being the first day after completion of the transaction) and post-day one operations including replace, maintain, buy vs. build as well as fully costed plans, from as-is to standalone. This translates into a multi-step formula: 1) Identify key business processes and interactions between the Group and third parties, 2) plan the separation of core IT systems, legacy systems and end user-developed apps, 3) extract data within the perimeter, including where data is co-mingled with the Group. In addition, both parties should work towards a day one readiness plan, covering critical topics like transitional service agreements («TSA»), regulatory approvals and transfer of required resources. Through the definition of service agreements, sellers can identify areas of separation complexity or areas where the buyer can't provide a replacement capability and determine whether a TSA can be offered.

Future growth

Non-life

North America continues to be seen as the most likely region to experience growth in transaction activity, with 57% of the survey respondents predicting a greater number of transactions in the future and a further 40% expecting a repeat of current volumes. Continental Europe remains relatively close behind North America in terms of forecast deal activity.

Innovation in deal structuring is becoming more prevalent in the non-life run-off market with a wider range of transaction structures being used year on year. While the use of different structures is expected to continue and grow, the majority of survey respondents expect reinsurance structures such as adverse development covers (ADCs)[1] and loss portfolio transfers (LPTs)[2] to dominate in the next two years, with Lloyd's Reinsurance to Close (RITC) deals and US insurance business transfers (IBTs) also expected to feature.

Life

The increase in interest rates may redirect attention towards the sale of portfolios and revive transactions that weren't completed due to differences in price expectations. Companies that have clearly defined savings businesses as non-core will be more proactive in the disposal of these portfolios, while others that had left these businesses on standby, may prefer to reintroduce this product as part of their core offering.

What's more, higher interest rates may encourage insurers to write new traditional savings products with the opportunity to earn attractive returns on assets backing these products. But insurers will need to move away from sovereign debt to meet guarantees, which will increase exposure to credit risk and in turn increase insurers' cost of capital.

Rates of return

Life and non-life players can maximise opportunities to boost returns and efficiently manage investment risk by making use of the expertise of sponsors invested in the market.

Survey respondents across both life and non-life mainly believe that legacy acquirers are pricing legacy deals at target internal rates of return (IRRs) of between 10% and 17%, with the majority selecting figures in the 10% to 13% range. While we note that different market players will make vastly different assumptions when pricing deals, the expectation that most acquirers are targeting returns around the low to mid-teens is consistent with recent market history. Most importantly, despite all the private capital dry powder searching for targets, we've seen a real emphasis on maintaining pricing discipline.

Our survey highlights the growing maturity of the run-off market and competition for targets, with the «above average» returns in early market years much harder to come by. This is being further challenged by the current combination of price and claims inflation.

Overall, we expect the legacy or run-off market to remain buoyant. The current inflationary environment represents both a threat and opportunity to the industry. We consider it unlikely that we'll see any real slowdown in the market.

For further details on the run-off market outlook, refer to the 2022 Global Run-Off Survey and European Life Insurance M&A and Restructuring Outlook.

Notes

1 Adverse development cover (ADC) works as a stop loss on net loss and LAE reserves, covering the risk of having insufficient reserves (reserving risk).

2 Loss portfolio transfer (LPT) works as a quota share on loss and LAE reserves, covering the risk of an acceleration of expected claims pay-out (timing risk) and asset/liability duration mismatches (investment risk).

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