European Life Insurance Mergers, Acquisitions and Restructuring Outlook 2023

January 2023

Foreword

Welcome to PwC's European Life Insurance Mergers, Acquisitions and Restructuring Outlook 2023, which has been produced against a backdrop of increasing levels of activity from across much of the sector. The results of our survey suggest that the appetite for mergers and acquisitions ("M&A") is unlikely to be diminished, despite significant economic uncertainty across much of Europe.

This report looks at some of the drivers of M&A and restructuring activity across the European market, with a particular focus on some of the larger markets, where activity has been on the increase, and the specific challenges faced in each of these markets. The report also includes our latest views on deal pricing and how the changes in the regulatory and accounting landscape are likely to affect deals.

The UK market has remained the most active in Europe and continues to have significant deal activity, which I believe will be driven by portfolio deals as insurers look to simplify product offerings and reduce complexity in their operations.

The German and Italian markets have seen increased levels of transaction activity in the life insurance sector. The recent portfolio deals in Germany involving AXA and Zurich are likely to herald a real change for the industry, with the market opening up to complex deal structures. Italy is also expected to remain an active market for deals, driven by bancassurance distribution agreements approaching renewal dates, insurers prioritising exits from capital-intensive legacy portfolios and higher yields on Italian debt putting insurers' solvency under pressure.

Looking forward, whilst the economic environment of high inflation and interest rates is a clear challenge for the industry, deal activity in the key markets across Europe is unlikely to see any real slowdown, given the focus from insurers on cost reduction and business transformation combined with the high degree of buyer interest in the sector.

The disposal of complex legacy portfolios, which attract high capital charges, offers insurers the opportunity to reduce costs, improve capital efficiency and redeploy capital to core activities, whilst offering specialist consolidators the ability to drive economies of scale.

The higher interest rate environment may also lead to some insurers returning to offer guaranteed products across Europe, which could drive growth in new business volumes across the industry where premium volumes have stagnated for some years.

We are extremely grateful to everyone who has participated in this survey and contributed their insights. Please reach out to any of the PwC team if you have any questions or would like to discuss the survey or the life insurance market in general.

Finally, I'd like to pass on my own thanks to everyone across the PwC network for all their efforts in pulling together the findings and contributions for this year's survey.

Steve Harrison
Director
Risk Modelling Services
PwC UK

Although every country has its product specifics and nuances, the life insurance industry remains highly attractive for investors across Europe. The sector offers the opportunity to deploy capital at attractive rates, with a wide range of levers in an insurer's arsenal to create value for shareholders and policyholders.

Our views and the headlines

The uncertain economic environment has not impacted appetites to invest in the life insurance sector. High levels of deal activity continue to be expected in all of the active markets across Europe and will emerge in countries where there has been less activity to date.

Deal activity

Increasing assets under management is a key M&A driver for acquirers with asset rich insurance businesses. Life insurance provides a significant opportunity for asset redeployment (especially into illiquids) and increasing asset-side economies of scale.

Drivers of M&A

Economies of scale are a key driver of M&A, providing a source of growth in an environment where organic growth is suffering from strong headwinds, and offering a lifeline for struggling insurers.

Drivers of M&A

Flat new business volumes and lower margins have driven many insurers away from writing certain products, in particular those with high guarantees. This may be set to change in a world of higher interest rates.

New business

Regulatory changes across Europe may open up the opportunity for capital optimisation and transaction activity.

Regulatory changes

Higher interest rates are impacting territories in different ways, be that through systemic solvency issues or driving changes in appetites for particular product types.

Economic environment

Acquirers of life insurance portfolios are targeting rates of return within the range of 10% p.a. to 15% p.a., offering an attractive pricing environment for new investors.

Deal pricing

Sellers continue to focus on cash generation and returning cash to investors via share buybacks and higher dividends.

This is somewhat paradoxical when compared to the appetite of private equity buyers who continue to seek to invest in the market.

Shareholder value and return

A seller's environmental, social and governance ("ESG") strategy has become a standard part of an acquirer's due diligence scope.

Environmental, Social and Governance

Dividends, cash generation and Solvency II own funds are the key metrics used in determining and articulating the value of a transaction to an acquirer. The introduction of IFRS 17 is not expected to change this.

Deal pricing

2022 saw the acquisition of Aegon Netherlands by A.S.R., a mega deal (€4.9bn deal value) which indicates there is still appetite for transformational deals within the European life insurance market.

Deal size

Portfolio deals are anticipated to be a key feature of future M&A activity, offering sellers and acquirers an opportunity to achieve their strategic aims, be that capital deployment or optimising operations.

Deal size

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Key findings

The past 18 months have been an exciting time for life insurance M&A activity across Europe. The survey results support our views that deal activity across continental Europe is unlikely to see any real slowdown.

Figure 1: Over the next 18 months, please indicate for each territory whether you believe there will be a fewer, similar or greater number of deals compared to the previous 18 months

57%
29%
14%
UK and IoM

70%
20%
10%
Ireland

56%
22%
22%
Germany

67%
0%
33%
Italy

90%
10%
0%
Benelux

89%
0%
11%
Spain and Portugal

56%
11%
33%
France

67%
22%
11%
Central and Eastern Europe

100%
0%
0%
Scandinavia

Fewer Similar Greater

Source: PwC

Josh Baah
Risk Modelling Services
PwC UK

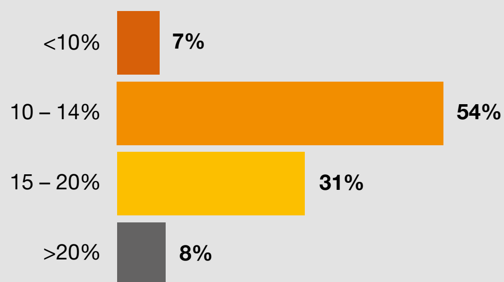
The vast majority of survey participants expect deal activity in the next 18 months to remain at similar levels across all territories. Notably, France, Germany and Italy have been identified as key markets for greater activity in the near term, while more mature markets, such as the UK, are expected to continue to experience high levels of activity.

Rates of return

92% of survey participants expect to price life insurance transactions at a target internal rate of return ("IRR") between 10% p.a. and 20% p.a., with the majority of participants selecting figures in the range of 10% p.a. to 14% p.a.

While variability among responses is expected, these target returns are consistent with our experience of investors' return expectations. Such high returns and long time horizons present an attractive opportunity for investors.

Figure 2: At what target IRR percentage (i.e. total return on capital), do you see the pricing of a life insurance transaction?



Source: PwC

M&A and restructuring activity

Our survey suggests that participants are more likely to engage in M&A activity than any other restructuring activity over the next 18 months. The majority expect to be involved in acquisitions, with reinsurance and hedging activities also being high up on the agenda.

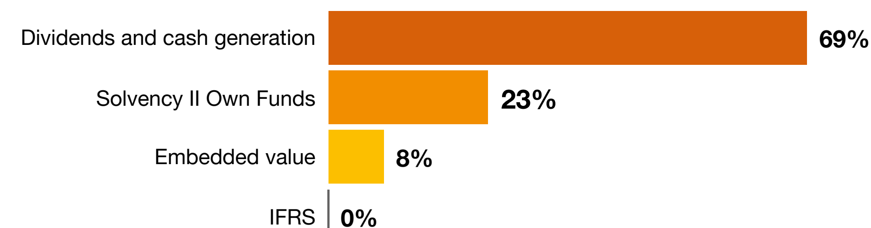
This is not surprising given the challenging macroeconomic environment in recent years and the level of uncertainty going forward. It is possible that market participants are looking to maintain or improve shareholder value through generating economies of scale and efficient deployment of capital.

Figure 3: M&A and restructuring activities survey participants have been involved in over the past 18 months and their intended activity in the next 18 months

Source: PwC

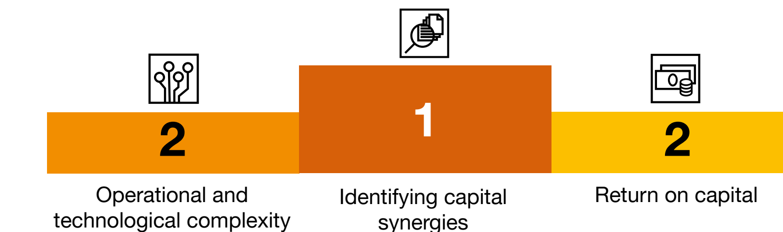
Deal pricing

Figure 4: What key metric would you expect to use in determining the price of a life insurance transaction?



Source: PwC

Figure 5: When involved in a life insurance transaction, what are your top 3 areas of focus?

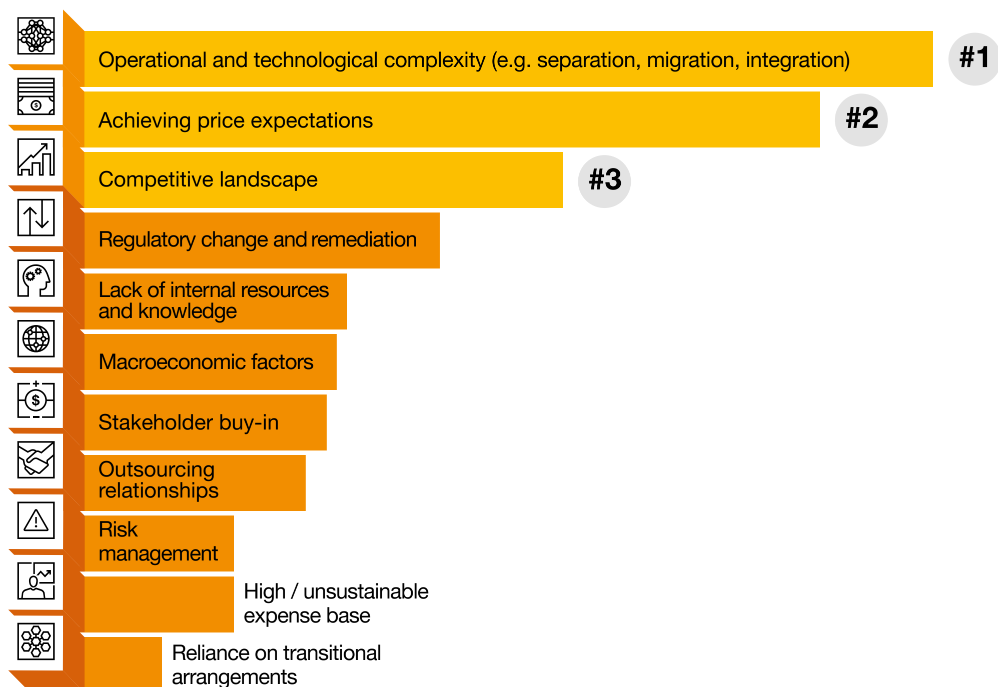


Source: PwC

Transaction challenges

Survey participants were asked to rank the top three challenges they have experienced when completing a transaction. Operational and technological complexity, achieving price expectations and the competitive landscape were identified as the top three, with 22% of participants choosing operational and technological complexity.

Figure 6: Please rank the top three challenges you've experienced when completing transactions



Source: PwC

The role of ESG in transactions

ESG is fast becoming a consideration for life insurance transactions, particularly given the long-term nature of investments underpinning insurance portfolios. Participants identified ESG as a new focus in diligence, ensuring that there is alignment with the acquirer's own strategies. While ESG is currently featuring as an area for diligence focus, it is also likely that ESG factors will begin to take a more prominent role in the pricing of transactions.

Figure 7: Please describe the current status of the life insurance M&A market.

Source: PwC

Figure 8: What will be the key features of life insurance transactions over the next five years?

Source: PwC

A common theme across responses is that the market will continue to be hot, with a steer 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.

Europe outlook

The European life insurance sector is the most developed in the world. Many of the largest global insurers call Europe their home, and significant legacy portfolios of savings and protection business exist in almost all markets across Europe.

The European economy has faced challenges on multiple fronts over 2022; principally the fallout from the COVID-19 pandemic and geopolitical instability following Russia's invasion of Ukraine. As a result, energy prices have risen to unprecedented levels, causing the level of inflation and interest rates to soar.

These challenges are having a marked impact on the insurance industry, leading to significant falls in asset values and the share price of listed insurers falling 30% over the first nine months of 2022 vs an overall market fall of only 12%.

Despite the issues presented by the economic and political climate, the landscape for life deals is still optimistic, with European deal activity continuing to be observed. The majority of our survey participants are expecting deal volumes to remain relatively unchanged and participants are continuing to look for portfolios in excess of €1bn.

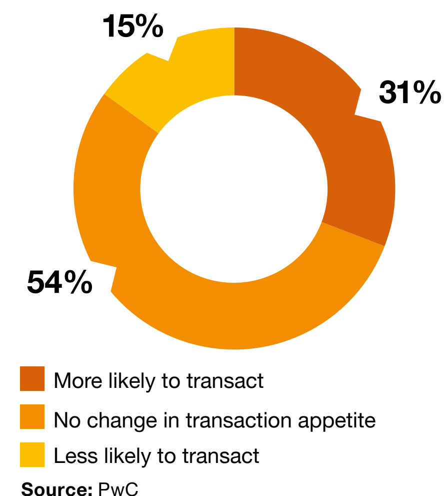
We expect to see high volumes of transactions across all markets in Europe, driven by both push and pull factors. Investors are seeking growth through increased economies of scale and greater levels of diversification. The adverse economic environment is a driver for insurers to:

- focus on their core markets;
- examine capital deployment; and
- reduce leverage and simplify operations.

These objectives can be achieved from a combination of disposals, portfolio deals; and restructuring activities such as reinsurance.

We expect deal activity to continue at pace across all of the core markets in Europe, with portfolio deals highly likely in the UK and Belgium, consolidation activity continuing in Germany and Italy, and the French market opening up to consolidators in the medium term.

Figure 9: The impact of market volatility on M&A appetite according to survey participants



Source: PwC

Matt Moran
Partner
EMEA Insurance Deals & Value Creation Leader
PwC Luxembourg

Steve Harrison
Director
Risk Modelling Services
PwC UK

We expect continued elevated activity across Europe as insurers seek to build scale, simplify operations, change risk profiles and restructure balance sheets. We believe transactions will increasingly take place across a diverse set of M&A and reinsurance formats as attention also turns to sub-portfolios and carve-outs from larger legal entities.

Henrik Matsen, Group Head of Growth, Athora Holding Ltd

Figure 10: Geographical breakdown of Solvency II Gross Technical Provisions for life obligations (net of transitional measure on technical provisions ("TMTP")) and the number of life insurance companies* at year-end 2021

1 UK**
79
Number of life insurers
2,630
Total life technical provisions (€bn)

2 France
212
Number of life insurers
2,237
Total life technical provisions (€bn)

3 Germany
81
Number of life insurers
1,576
Total life technical provisions (€bn)

4 Scandinavia
75
Number of life insurers
982
Total life technical provisions (€bn)

5 Italy
41
Number of life insurers
852
Total life technical provisions (€bn)

6 Netherlands
24
Number of life insurers
391
Total life technical provisions (€bn)

7 Ireland
37
Number of life insurers
374
Total life technical provisions (€bn)

8 Belgium
25
Number of life insurers
260
Total life technical provisions (€bn)

9 Luxembourg
32
Number of life insurers
232
Total life technical provisions (€bn)

10 Spain
64
Number of life insurers
199
Total life technical provisions (€bn)

11 Central and Eastern Europe***
149
Number of life insurers
131
Total life technical provisions (€bn)

12 Portugal
16
Number of life insurers
40
Total life technical provisions (€bn)

Figure 11: Number of deals (2017 - Q3 2022)

Number of deals based on publicly announced transactions at the time of writing (excludes Switzerland)

Source: AM Best – Best's Financial Suite – Solvency II, EIOPA, PwC

*Number of life insurance companies includes composite entities
**Excludes Isle of Man
*** Countries included are: Austria, Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia

Inflationary pressures

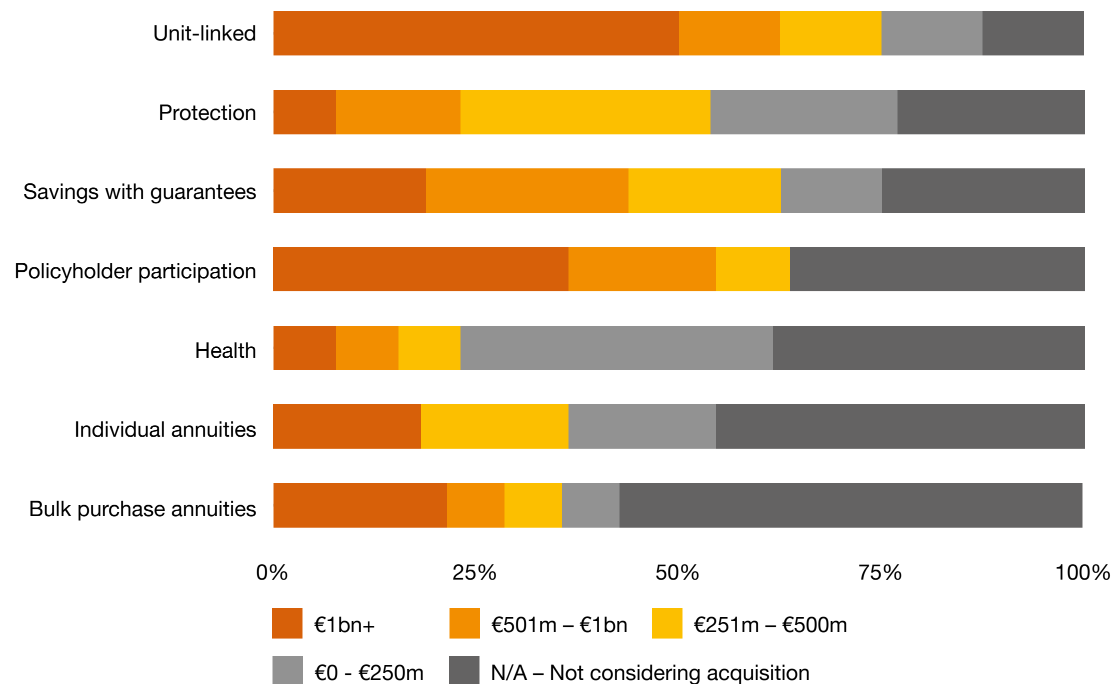
Higher inflation is an issue facing every economy and represents both an opportunity and a threat to the industry.

With rising wage demands and a lack of skilled personnel across the industry, coupled with significant costs associated with accounting (IFRS 17) changes and regulatory reforms (Solvency II), insurers are expected to focus on accelerating cost reduction exercises and simplifying operational processes.

Whilst inflation is widely expected to return to more normal levels of between 2% p.a. and 3% p.a. in most developed economies by 2024/2025, under the current inflationary environment, consolidators offer the opportunity to insurers to offload complex portfolios and simplify their businesses. Such disposal can act to reduce operational, IT and administrative costs to help manage short-term pains for insurers, whilst enabling consolidators to replenish their heritage portfolios that are quickly running off.

The impact on insurers is not only cost-related. Where insurance companies have written index-linked liabilities (including index-linked bulk purchase annuities), their long duration means that high and uncertain inflation will increase capital requirements. However, the actual impact on solvency will depend on existing hedging strategies with some insurers better protected than others. This is another driver for strategic reviews, where transactions, also offering cost benefits, may take a higher place up the agenda.

Figure 12: Survey participants' ideal portfolio size (by total assets) to acquire



Source: PwC

Swap rates which underpin the risk-free rate used by European insurers to value their liabilities have increased substantially over 2022. However, the yields on government bonds across many territories have outstripped these swap rate rises. This has resulted in winners and losers in the insurance sector, particularly amongst those insurers who have not sought to hedge the market.

Interest rate environment

A rise in interest rates is generally a positive for savers. Increasing interest rates could trigger a resurgence of traditional savings products in Europe and a rebirth of annuities in the UK, which have taken a back seat in recent years due to capital-light alternatives.

In contrast, increasing interest rates and depressed asset returns are likely to materially impact insurers' solvency positions. Insurers may therefore be more incentivised to streamline their businesses, particularly if they can achieve an attractive price from an improved negotiating position.

If inflationary pressures do subside, interest rates may fall to lower levels, more consistent with those over the previous decade, increasing insurers' liabilities. Investors therefore need to consider this risk when assessing the value of companies or portfolios in transactions.

EUR denominated liabilities

The risk-free rate defined by the European Insurance and Occupational Pensions Authority ("EIOPA") to value EUR denominated liabilities is calculated using a basket of assets, irrespective of the country of the liabilities. This results in a mismatch between liability and asset values as government yield curves differ from the EIOPA curve.

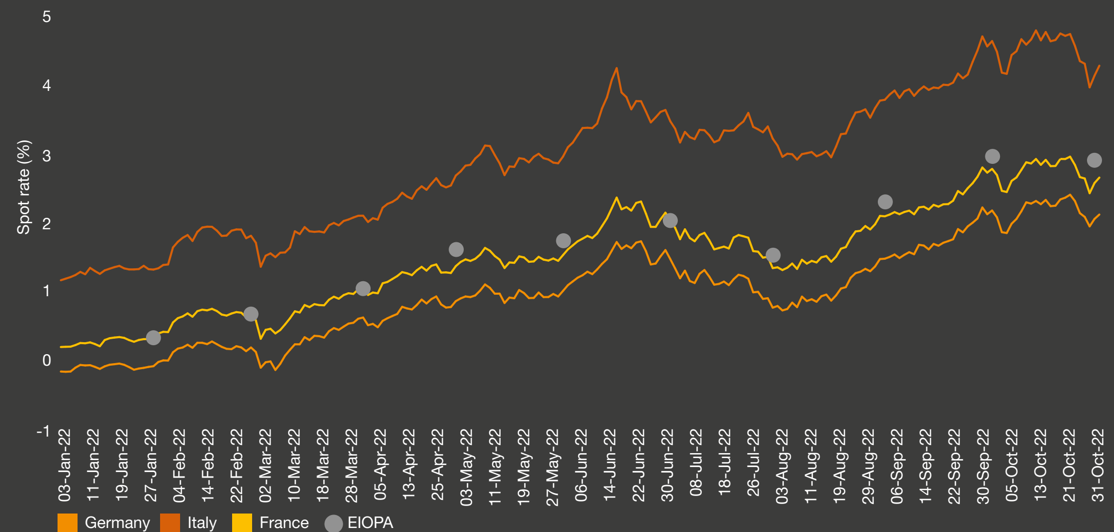
The mismatch has been felt the most by insurers with high levels of Italian and other Southern European sovereign debts, such as Greece, where government debt spreads have widened by a greater amount than the corresponding increase in the EIOPA risk free rate.

This explains why the solvency of some insurers in Southern Europe with high levels of exposure to these markets are facing challenges.

The changes in the calculation of the volatility adjustment ("VA") described in the regulatory focus section of this document are designed to remove some of this volatility.

Across all markets, the reduction in the risk margin ("RM") and solvency capital requirement ("SCR") will provide some relief against this. However, management actions such as mass lapse reinsurance to reduce the SCR further and shore up balance sheets are likely to be attractive to some in the industry.

Figure 13: 10-year risk free rate – EIOPA Solvency II vs Government bond yield



Source: Eikon from Refinitiv

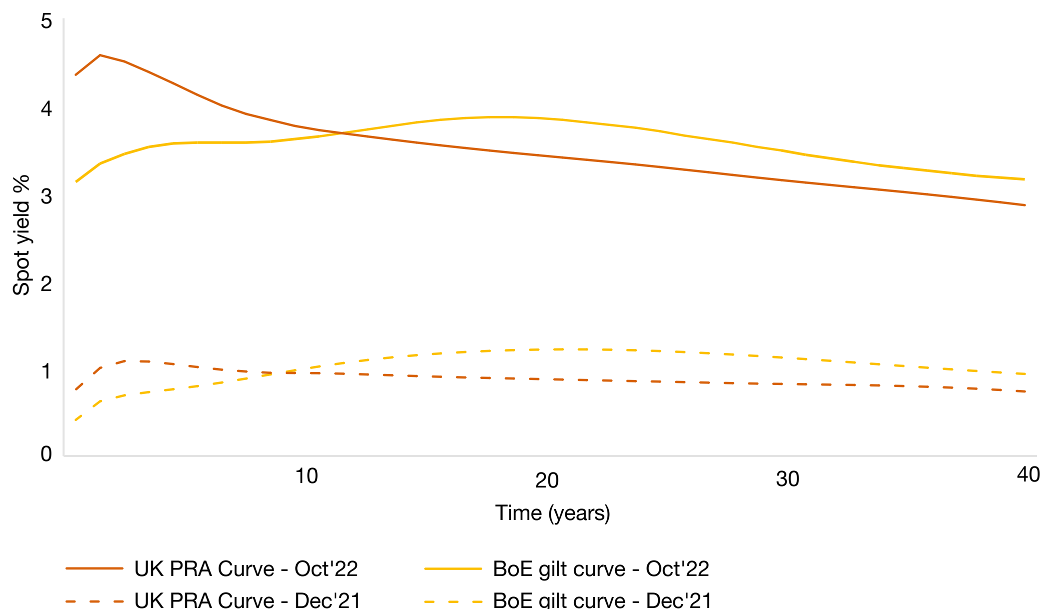
GBP denominated liabilities

Recent interest rate volatility has caused the UK gilt curve to diverge significantly from the SONIA curve (used by the Prudential Regulation Authority ("PRA") to derive the risk-free rate). This is particularly noticeable over the first 15 years, where the spread between the curves has increased by as much as 88 basis points over 2022.

The market perceives UK Government bonds as now being more risky, however, the true driver is more likely to be the current economic uncertainty and concerns about the level of UK debt. The fact that UK insurers invest heavily in GBP denominated assets, the high degree of hedging strategies (on a solvency basis) and the high utilisation of the matching adjustment, broadly means most insurers should be well matched. This explains why the solvency coverage ratio of many of the large UK insurers are likely to have increased as a result of the market movements.

Whilst balance sheets and solvency surplus have contracted in absolute terms, the future levels of cash generation should be largely unchanged where assets are held to maturity, with future changes in the solvency regime and further restructuring likely to be key for insurers to continue to generate incremental returns for shareholders.

Figure 14: UK spot yield curve – PRA Solvency II vs Bank of England Gilt curve (nominal)

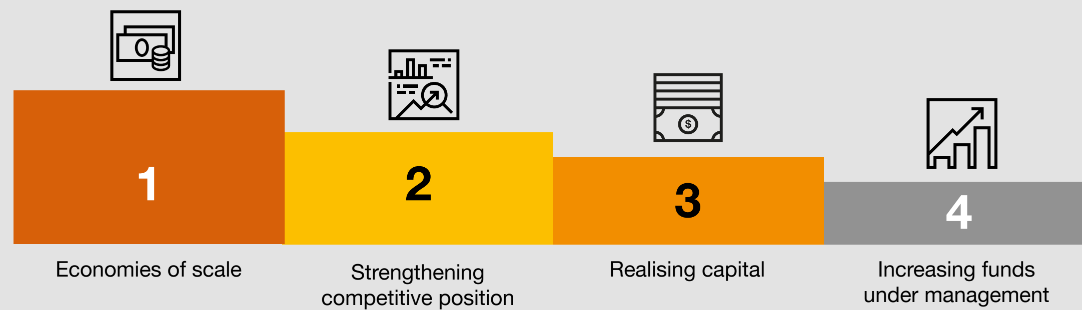


Source: Prudential Regulation Authority

The absence of organic growth, combined with inflation and many businesses effectively being in run-off means that a significant number of insurers will have to use M&A to survive. Cost pressures won't allow them to continue without action.

Brian Purves, Partner, PwC UK

Figure 15: What are your top three drivers for entering M&A and restructuring activity?



Source: PwC

The key drivers of deal activity as identified by our survey are likely to remain the same as those over the last five years. Principally driven by portfolio rationalisation and simplification to achieve a combination of:

- Economies of scale
- Strengthening of competitive position; and
- Capital efficiency.

Economies of scale

Consolidators have a role to play in every jurisdiction across Europe. Whilst they have been seen negatively in some countries, there can be a huge positive for policyholders, shareholders and the industry, through:

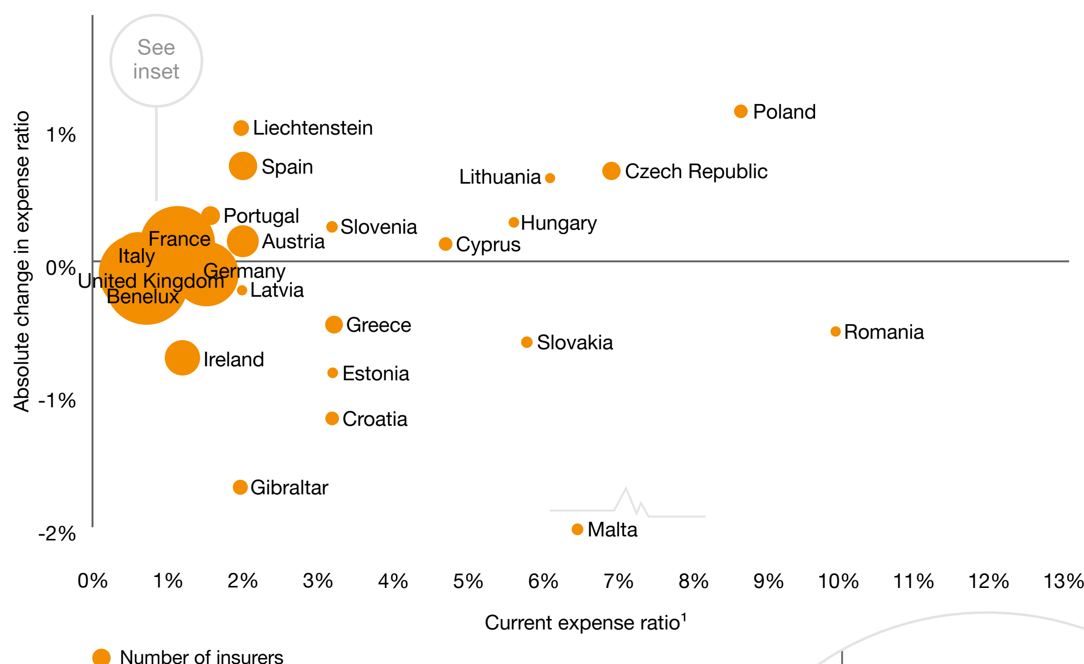
- improved customer experience and outcomes as a result of increased efficiency;
- investment in IT; and
- better investment returns – this is particularly true for legacy portfolios that are "unloved" by their current owners.

Participants identified that achieving economies of scale continues to be one of the most important drivers of deal activity. This is not surprising given the high levels of inflation, but also the growing business model of a number of insurers across Europe focused on consolidation.

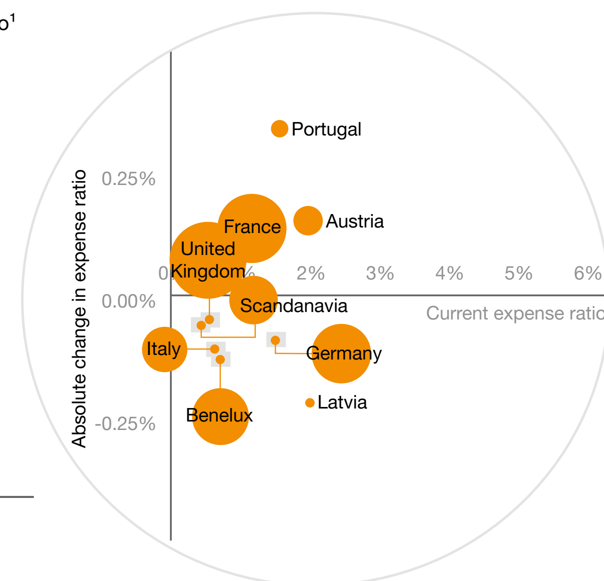
Achieving cost savings of between 20% and 50% are not uncommon for insurers when consolidating portfolios, largely as a result of efficiencies arising from the removal of duplicate functions. An increasing number of highly motivated buyers, typically funded via third-party capital, are offering sellers attractive pricing for portfolios that had previously been uneconomical to acquire in order to achieve scale and generate cost savings.

Figure 16 illustrates many Western European insurance markets operate with an expense ratio of less than 2%, demonstrating how closely expenses are managed amongst these territories to maintain competitiveness and deliver investor returns. This is achieved in some of the most mature markets, such as the UK, through the adoption of an outsourcing model. Conversely, expense ratios amongst Eastern European markets are much higher. Administration and acquisition expense ratios are between 300% and 800% greater than those observed in Western Europe, with almost twice the allocation of expenses to acquisition. This appears to be a result of the much smaller scale of the life portfolio and highlights the scope for increased cost optimisation and value creation.

Figure 16: The change in average expense ratio over five years across Europe



Source: AM Best – Best's Financial Suite – Solvency II



Achieving cost savings of between 20% and 50% are not uncommon for insurers when consolidating portfolios, largely as a result of the removal of duplicate functions.

1 Expense ratio has been defined as the ratio of total expenses incurred to technical provisions (for life obligations)

Strengthening of competitive position

Strategic reviews have been a common phenomenon for many insurers across the sector in recent years. This has often been linked to examining the profitability and capital efficiency of their businesses across different jurisdictions in Europe which can trigger: investment and a need to buy to strengthen market position; organic growth to achieve scale; new product entry; or a market exit altogether.

For those insurers with a focus on new business, the drive to grow new business volumes continues to be a challenge, with a focus on increasing the share of customer wallets or capturing a greater share of the value chain. Acquisitions have been commonplace to achieve either approach, which has seen insurers buying asset management and advice capabilities, acquiring businesses for additional product development and investing in claims management infrastructure.

Alternatively, an exit maybe on the cards. Exits from territories deemed 'non-core' are likely to continue, such as Aviva's exits from various markets across Europe and around the world. Similarly, a refocus on a key product set may see certain product offerings closed to new business or divested.

For those insurers with a focus on new business, the drive to grow new business volumes continues to be a challenge, with a focus on increasing the share of customer wallets or capturing a greater share of the value chain. Acquisitions have been commonplace to achieve either approach.

Capital efficiency

Capital management on an economic basis is widespread across Europe today, with early adoption of realistic balance sheets in 2006 in the UK, and the introduction of the Solvency II regime in 2016 being a catalyst for the rest of Europe. However, the adoption of economic capital management measures has been slower than expected due to the immediate relief offered by Solvency II transitional measures, which are heavily adopted in countries such as Germany, Portugal and the UK.

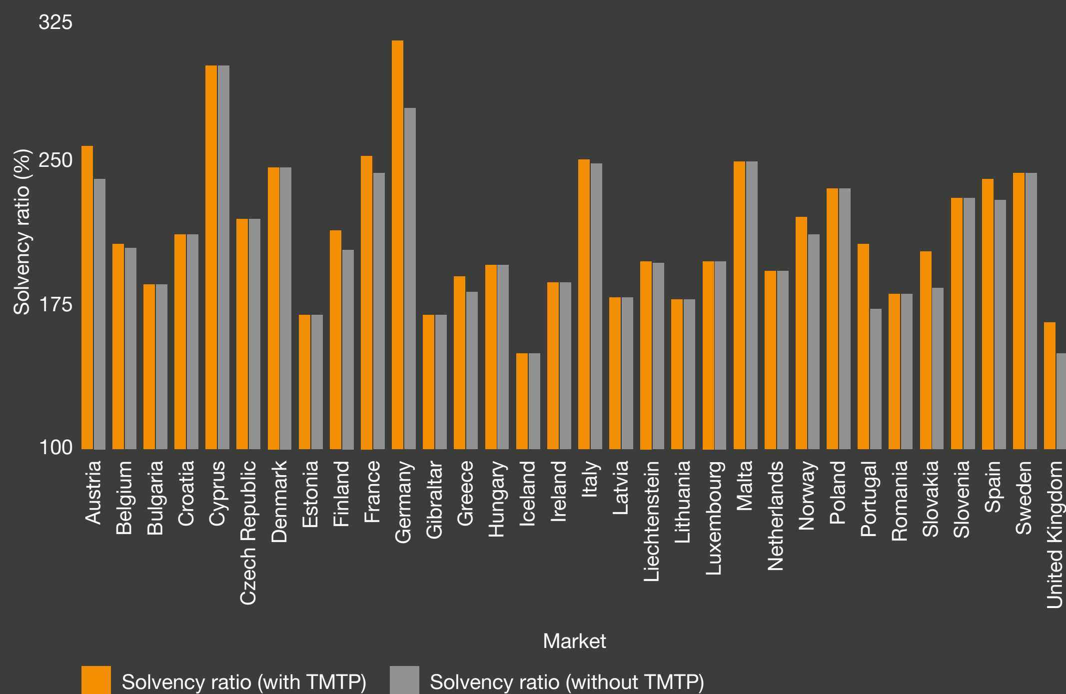
Six years into the run-off of transitional measures, and with Solvency II now fully embedded in the European insurance industry, European insurers appear to give an increasing degree of focus to an economic balance sheet.

Average solvency ratios at the end of 2021 across Europe continued to show the strength of the industry (see figure 18), however, the radical change in the economic outlook has recently impacted solvency ratios and this is likely to continue to develop in the short-term and focus insurers' minds on managing short-term capital efficiency.

At a time when investors are demanding a return of over 10%, there are a large number of actions that can be taken quickly to improve returns and reduce volatility including:

- Changes in investment strategy and hedging;
- Management actions in the SCR;
- Intra-group reinsurance; and
- External reinsurance covering biometric and lapse risks.

Figure 17: Average solvency coverage ratio with and without transitional arrangements across Europe



Source: AM Best – Best's Financial Suite – Solvency II

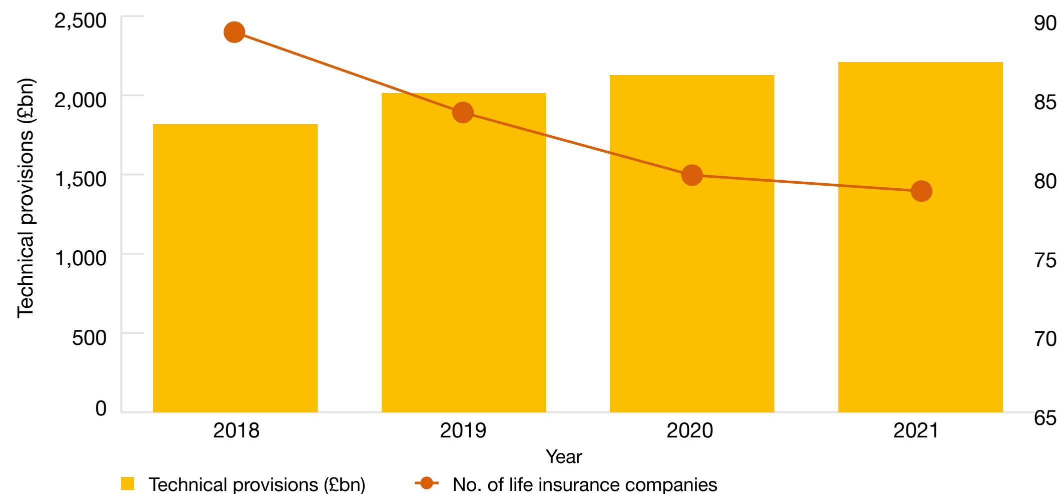
UK

The UK market has been in a state of consolidation over the last three decades. With shifts in strategic focus, there is a greater push for insurers to streamline their businesses and reduce complexity, which is likely to trigger further portfolio deals across the UK.

The UK insurance market remains the largest and most active in Europe with technical provisions[1] amounting to over £2,208bn for life obligations. This has grown by £389bn (21%) over the past four years, whilst the number of insurers has fallen by 10 (11%) over the same period.

The UK insurance market is characterised by a wide variety of players, with the majority focused on the UK exclusively. This includes small mutuals, monoline annuity writers and large listed organisations, each with differing goals and strategies.

Figure 18: The number of life insurance companies[2] and total technical provisions[3] (for life obligations) held



Source: Prudential Regulation Authority, AM Best – Best's Financial Suite – Solvency II

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1 GBP: EUR exchange rate of 1:1.19 for year-end 2021.
2 The number of life insurance companies include 'life composites' only and does not include non-Solvency II firms.
3 Technical provisions for life obligations only, includes all composite entities.

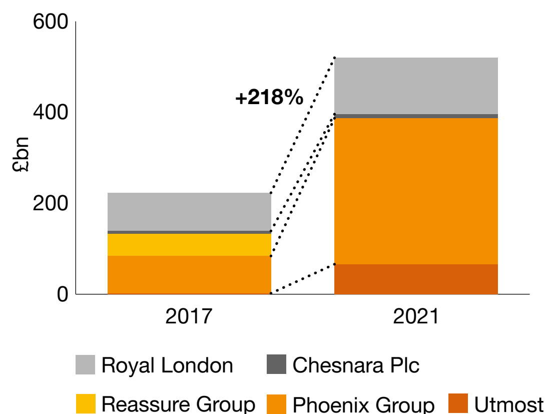
Consolidation

To date, the UK has had a strong track record in consolidation relative to continental Europe. This was most likely due to the large number of insurers, the rise of the outsourcing model, together with the capital and tax synergies that consolidators have been able to take advantage of.

Although it could be argued that the UK is heavily consolidated, there remains considerable demand from consolidation specialists for back books to achieve economies of scale, with Chesnara's acquisition of the £2.9bn Sanlam Life and Pensions UK business and Phoenix's acquisition of the £10bn Sun Life of Canada's UK operations yet further examples.

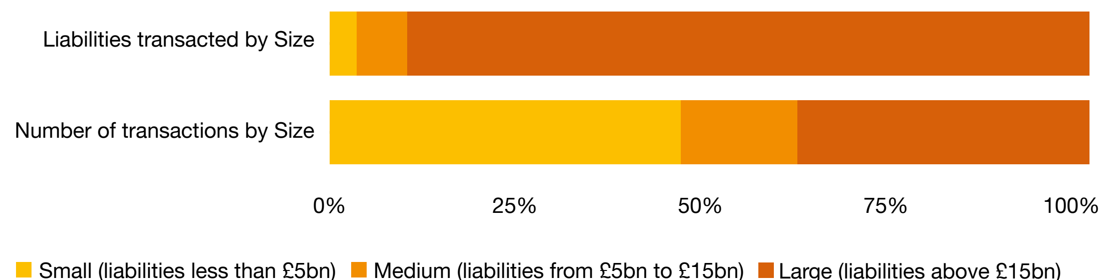
However, the maturity of the consolidation market signals a scarcity in the future volume of company acquisitions, with the exception of potential "mega-deals".

Figure 19: Balance sheet growth (by total assets) of UK consolidators



Source: PwC

Figure 20: UK consolidation activity (2016 – 2022 YTD)



Technical provisions for life obligations only, data based on publicly announced transactions at the time of writing

Source: PwC

Activity is therefore likely to be dominated by a growing trend in portfolio-level acquisitions, as some market participants redefine their business models and shift their focus to becoming product specialists or refocus on other sectors including wealth management.

With inflationary pressures high on the agenda for many firms, we expect cost synergies to be a significant driver of consolidation and divestiture activity moving forward.

Restructuring and M&A activity across all product portfolio types is likely to continue, but we anticipate activity in the UK to have a particular focus on:

- With-profits business;
- Mutual sector; and the
- Annuity market

The inflationary environment will make it more difficult for owners of smaller back books to manage their costs down in line with the run-off. The market for Heritage M&A remains significant at c.£470bn of AUM and we think Boards will continue to re-assess their strategic appetite to retain capital-intensive heritage businesses. This may become a trigger for more M&A transactions in the closed back book space.

Anna Franekova, Corporate Development Director, Phoenix Group Holdings plc

With-profits business

The with-profits sector represents a significant portion of legacy business within the UK. Over the past decade, the industry has seen a steady decline in the number of companies willing to take on the management of this type of business. This is due to regulatory complexity, lack of transparency and the challenge of meeting guarantees while operating in an era of low interest rates.

With new business levels declining significantly, insurers have found it challenging to write sufficient volumes of profitable business, resulting in many with-profits funds closing. However, closure also presents further challenges, namely expense diseconomies and ensuring equitable distribution of any inherited estate.

This has led to some insurers divesting parts of their with-profits business and, in some cases, making strategic decisions to exit the with-profits market completely. Such opportunities enable insurers to redeploy the capital released into core operations. For example, Canada Life's sale of its closed with-profits book to Scottish Friendly has accelerated its shift to focus on core products.

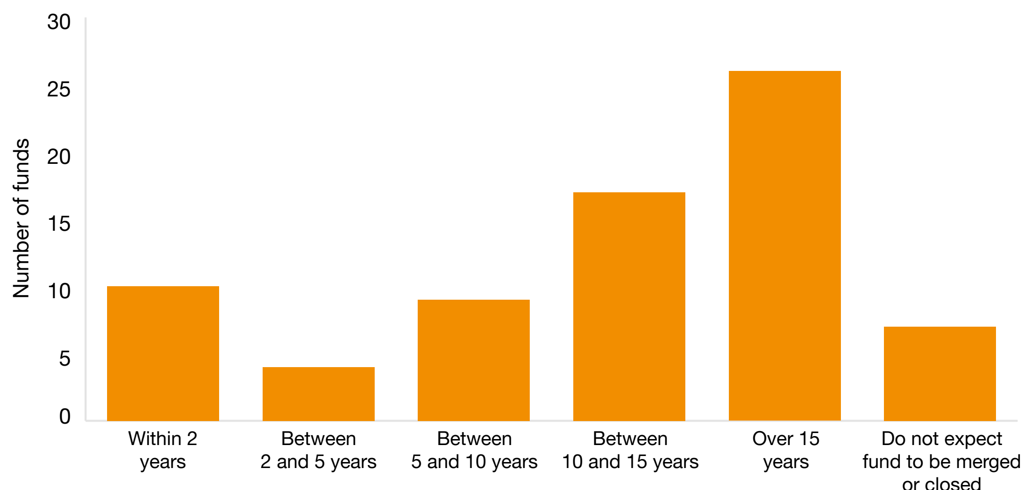
In contrast, some insurers do continue to have a strategic focus on with-profits and may be looking towards consolidative solutions to generate better policyholder outcomes. For these insurers, we are seeing the adoption of one or a combination of the following strategies:

- Fund rationalisation – an increasing number of insurers with multiple with-profit funds are restructuring to streamline their business and benefit from operational efficiencies.

  For example, Royal London and Aviva Life & Pensions UK Limited have consolidated several closed with-profits funds.

- Acquisition – providing an opportunity to grow scale. This operational driver is commonplace in the mutual sector.

Figure 21: The number of funds expected to be merged or be closed in the future



Source: PwC With-Profits Survey 2021

The results of our *PwC With-Profits Survey 2021* highlight the end-state solution for with-profits will vary by fund and by firm. There are currently 70 closed with-profits funds in the UK market[1], however, responses from this survey demonstrate the majority of funds expect to merge or be closed in the future.

The ongoing regulatory burden over run-off plans and the triggering of sunset clauses suggests the restructuring of with-profits funds will become more common throughout the next decade. We anticipate this to trigger further M&A activity, particularly in the mutual sector.

1 The participants captured in the PwC With-Profits Survey 2021 are estimated to represent c.99%, in monetary terms, of closed with-profits funds in the UK market.

Mutual solutions

The concept of mutuality in insurance dates back to the 18th century. Since the late 1980s, widespread demutualisation has contributed to a shrinkage of the sector, with fewer than 65 mutual insurers (including friendly societies) operating in the market.

Mutuals have shown resilience to market volatility, however many in the sector are sub-scale and are often constrained in their ability to grow organically due to limited capital. Rising regulatory costs and increases in their cost base exacerbate the need to scale up in order to remain competitive and demonstrate financial strength. These push factors serve as a catalyst for deal activity in the mutual marketplace, with Oddfellow's acquisition of Kingston Unity being a recent example.

The terminated takeover of Liverpool Victoria highlights demutualisation still represents a challenge in the UK, particularly given the high thresholds required for member votes. However, with the market becoming increasingly dominated by larger players; the increasing costs of compliance and regulation; and challenges for mutuals to distribute capital, the future viability of the mutual business model continues to be called into question.

What is the future of the mutual sector? The marketplace, over time, has bifurcated into scale players and niche players with an affinity to a specific profession or product. The success of mutuals will therefore likely rely on their boards' reviewing their future strategy and taking actions to ensure they remain relevant for their customers.

For those that choose to follow a niche sector, an ability to cut costs and recognise efficiencies through restructuring may provide a competitive edge. Whilst those that wish to grow through scale will need to consider refining product offerings and creating more efficient operating models.

The marketplace, over time, has bifurcated into scale players and niche players.

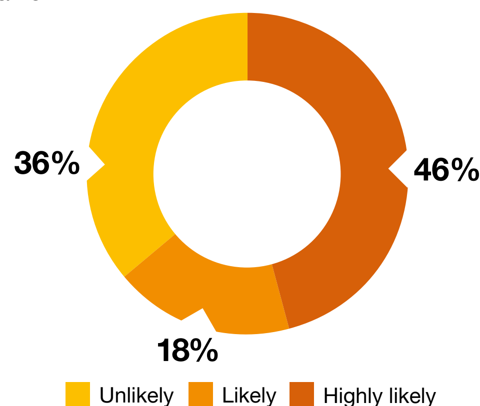
UK annuity markets

The decline of Defined Benefit ("DB") pensions and increased focus on risk management has created a demand from scheme sponsors and trustees for de-risking or exit solutions.

This has led to increased activity in the pension-risk transfer market with the volume of bulk annuity transactions reaching £12bn in H1 22 showing no signs of slowing down.

We expect the demand for bulk purchase annuities ("BPA") to continue, with new opportunities also opening up in Europe, such as the c.€1.5 trillion BPA market in the Netherlands. Consistent with this outlook, 64% of survey participants indicated they are either likely, or highly likely to engage in pension transfer activity over the next 18 months.

Figure 22: Survey participants' future appetite in the pension risk transfer market*



Source: PwC
*Note, responses are not specific to the UK

Germany

With a flurry of deals, changes to new business strategies and rising interest and inflation rates, the German life insurance market is going through a period of change. Facilitated by a change in regulatory outlook, European market participants have found a way to make the acquisition of German portfolios an attractive proposition through cost optimisation and sophisticated asset strategies, with further portfolio deals on the horizon.

The German market is sizeable at over €1.6trn of life technical provisions, serviced by c.80 insurance companies and characterised by legacy portfolios with high policyholder guarantees (up to 5%).

Legacy portfolios

There are two primary strategic options being deployed by German insurers:

1. To retain legacy portfolios and optimise asset strategies to meet onerous guarantees while streamlining costs, or
2. To dispose of legacy portfolios to one of the growing number of consolidators across the market.

Both of these strategic standpoints suggest there is a demand for consolidation, however to date consolidation remains slow. The number of German insurance companies has reduced by 20% from 2000 to 2010 and subsequently by 15% from 2010 to 2020. The reduction in the last decade has been partially eclipsed by the setting up of internal specialty insurance companies (e.g. sustainable life insurance companies).

After a period whereby only portfolios with a volume of up to c.€5bn assets under administration ("AuA") were the subject of external run-off transactions, a large-volume transaction was carried out for the first time in 2018 with the sale of 89.9% of Generali Leben to Viridium. In this context and for the first time, BaFin made its requirements for the sale of life insurance portfolios public, covering in particular the reliability of the potential acquirer, its business model and structures, and its operational ability to adequately manage the acquired portfolio.

The announcements within one month of each other of the sale of the German life portfolios of Zurich (€21bn AuA acquired by Viridium) and AXA (€19bn AuA acquired by Athora), both subsidiaries of listed companies, show that consolidation on the German market is once again gaining momentum. Several insurance companies are now actively looking to dispose of their high-guarantee legacy portfolios providing an opportunity for European market participants who are seeking access to greater pools of assets under administration.

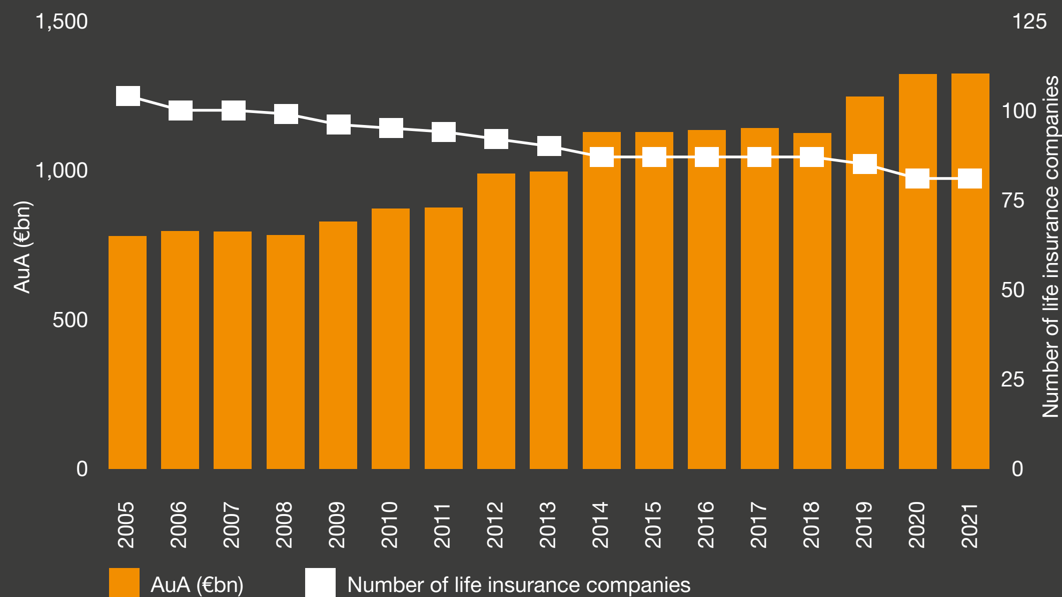
With rising risk-free interest rates, additional interest rate reserves peaking at their all time high-levels, a prudent accounting regime and a broad collective profit sharing mechanism for all risks arising from investment and technical sources of income, the German market has been, and remains, a very attractive market for investors.

Carsten Horst, Partner, PwC Germany

Christopher Sur
Partner
Global Financial Services Deals Leader
PwC Germany

Carsten Horst
Partner
German Life Insurance Leader
PwC Germany

Figure 23: The number of life insurance companies and total assets under administration (AuA)

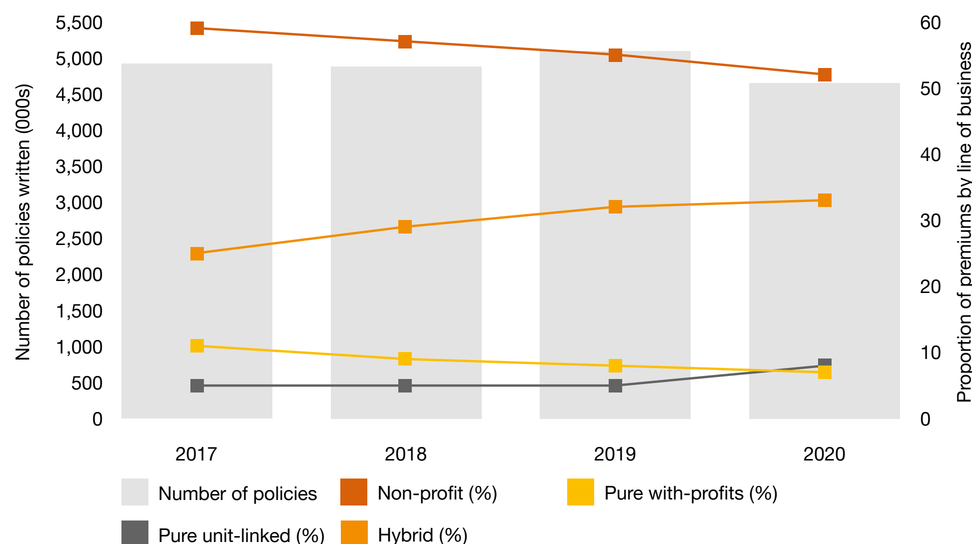


Source: German Insurance Association ("GDV")

New business

Whilst the nuber of policies written has remained steady (as shown in the figure below), premium volumes saw a depression over 2020, likely as a result of COVID-19, following growth over 2018 and 2019 (premium volumes increased by 11% on in-force portfolios and 20% from new policies). Growth has been driven by a shift from new business writers towards more capital-light products offering lower guarantees. However this is a more gradual transition relative to other countries due to a slower uptake by policyholders.

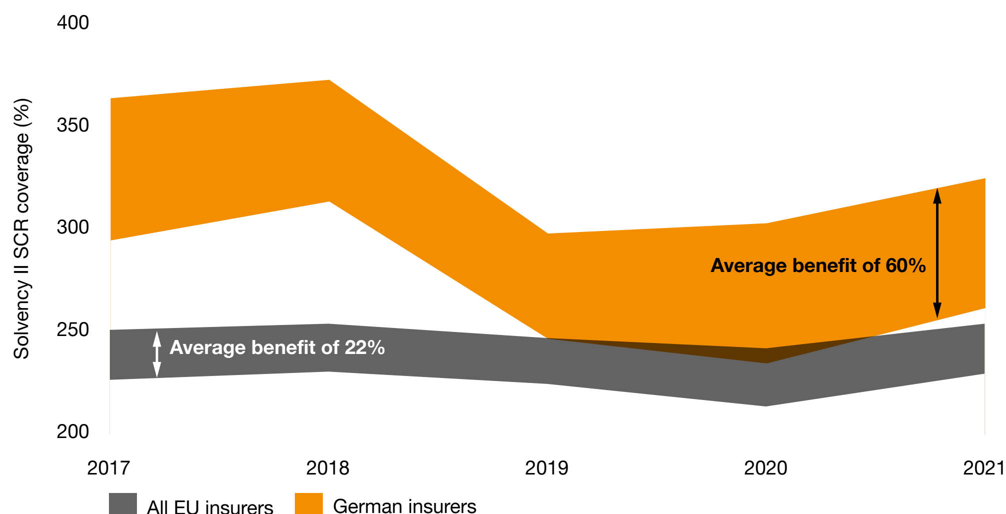
Figure 24: The number of new policies written and split by line of business



Source: GDV

The German business model is characterised by a highly regulated policyholder participation mechanism, part of which is eligible as own funds under Solvency II.

Figure 25: Impact of TMTP on German insurers and all EU insurers*



Source: EIOPA

*Includes both life and non-life insurance companies.

Capital headwinds

Figure 25 demonstrates the significance of TMTP within the German market. When the ultimate forward rate ("UFR") is also taken into account, it is clear that there is a material reliance on regulatory capital relief within insurers' existing Solvency II balance sheets. This capital relief is not indefinite as the TMTP will be fully amortised after a transition period by 2032 and the magnitude (and hence benefit) of the UFR is under review as part of EIOPA's wider Solvency II review.

The German business model is characterised by a highly regulated policyholder participation mechanism, part of which is eligible as own funds under Solvency II. However, an economically value down funds would be lower, as recourse to these eligible own funds is only possible in adverse scenarios and is subject to supervisory approval.

These factors are important considerations which introduce headwinds for incumbents and new entrants into the market.

Italy

The Italian life industry, managing over €1trn of assets, has undergone significant consolidation in recent years, with many smaller life insurers being acquired by their larger competitors. Much of the consolidation in the industry has taken place. However, the market is likely to see further deals with a particular focus on legacy portfolios as Italian insurers follow the growing trend across Europe of optimising capital deployment.

In the immediate term, the need to optimise capital is likely to be exacerbated by the reduction in the solvency of some Italian insurers. Bancassurance agreements continue to be key to both growth and creating value, meaning these are fiercely contested.

Davide Glavina
Partner
Insurance Strategy and M&A Leader
PwC Italy

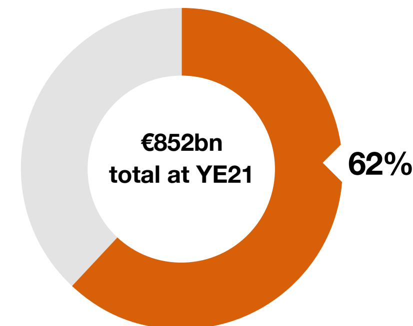
The Italian insurance industry continues to be a market dominated by a small number of large insurers, with the top 4 insurance groups (Generali, Intesa Sanpaolo, UnipolSai and Poste Vita) representing 62% of the market by technical provisions and with a market share of 55% by gross written premium ("GWP").

Recent consolidation activity in Italy has seen a reduction in the number of life insurers, with the bigger insurers acquiring market share and distribution, for example Generali's acquisition of Cattolica. This acquisition reinforced Generali's position as the largest insurer (both life and non-life) in Italy and provides substantial opportunities for cost savings.

Given the level of consolidation, the next steps for the market are most likely to be focused on portfolio disposals from some of the larger insurers.

Given the level of consolidation, the next steps for the market are most likely to be focused on portfolio disposals from some of the larger insurers.

Figure 26: Total technical provisions (for life obligations) held by the top 4 insurance groups



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Based on the submissions of solo entities domiciled in Italy

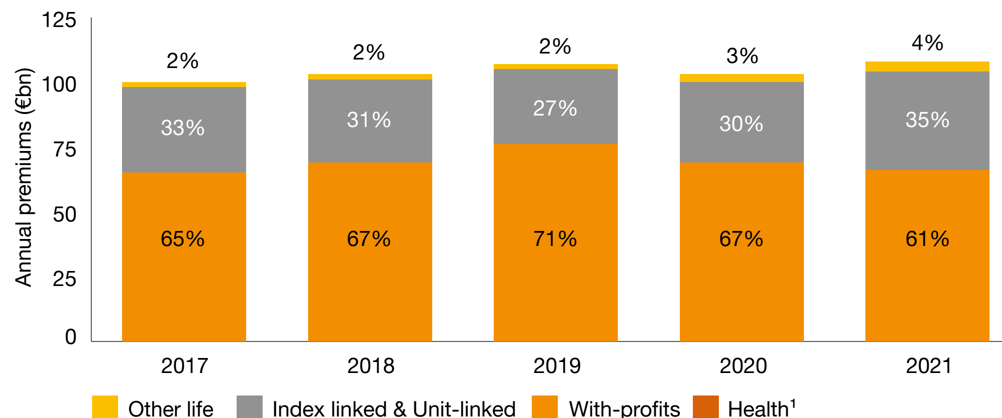
New business

Annual Italian GWPs have been relatively static over recent years, with an annual increase of only c.2%. This is partly a function of the COVID-19 pandemic, but primarily due to much of the reported new premiums written arising from a recycling of maturing policies, with distributors and advisors seeking to entice customers to reinvest proceeds into new products.

The market continues to be heavily dominated by guarantee products, but unit-linked and Multi-Ramo (hybrid products offering both unit linked and guaranteed elements) products are a growing proportion of both new business and in-force books (c.23% of GWP at year-end 2021). Much of the shift in product design and innovation has therefore been focused on hybrid products, driven by insurers looking for less capital-intensive products while still providing some level of guarantees, rather than a result of customers demanding equity exposure.

With one of the highest life penetration rates of any market across Europe, the return of higher interest rate environments and lower equity markets may be a driver for insurance companies to sell products with guarantees. However, the lower disposable income levels associated with higher living costs are likely to dampen consumer demand, at least in the short-term.

Figure 27: Total gross written premiums (for life obligations) split by line of business



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Based on the submissions of solo entities domiciled in Italy

The market continues to be heavily dominated by guarantee products, but unit-linked and Multi-Ramo (hybrid products offering both unit linked and guaranteed elements) products are a growing proportion of both new business and in-force books (c.23% of GWP at year-end 2021).

1 Health business accounts for less than 1% of total gross wirtten premiums.

Bancassurance led distribution

Distribution of life insurance products remains focused on the bancassurance model, with approximately 1 in 2 sales being through a bancassurance relationship.

Several relationships with the important bancassurers (both life and non-life) have been up for renewal in 2022, principally ICCREA and BPM, which have been hotly contested amongst insurers in the industry.

There have been some new entrants to the market, for example, Net Insurance Life S.p.A who are seeking alternative routes to distribute via digital platforms. However, the continued dominance of the bancassurance channel underlines the importance and value of strategic partnerships and joint ventures with bank distributors in the insurance market.

Solvency

The recent fall in the value of Italian government bonds combined with equity market falls has led to some material reductions in the solvency of Italian insurers, putting them under pressure to take management actions to boost solvency ratios in the short – term. Much of this is driven by the mismatch between the change in the EIOPA interest rates and asset values, which introduces additional balance sheet volatility.

There is a range of solutions available to insurers with many focused on optimising capital positions. Liability side actions (such as buying out guarantees) are more common in the Italian market and mass lapse reinsurance solutions are attracting interest. However, reinsurance solutions involving a transfer of assets and risk outside of Italy are less common.

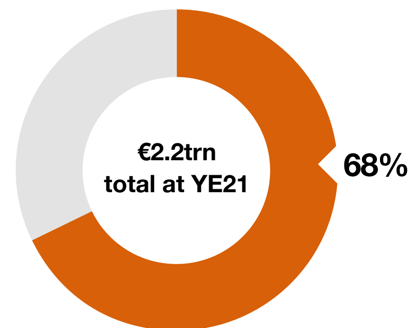
France

France has the second largest life insurance market in Europe, dominated by large bancassurance groups and a vibrant mutual sector. However, with over 200 insurers operating across the market, there has been far less consolidation than in other European markets. Complex employment laws have been prohibitive to consolidators entering the market.

Recent transactions have involved external investors in the French market making strategic decisions to exit (such as Aviva). Future transactions are likely to be driven by other overseas investors seeking routes to exit the market or portfolio disposals aimed at releasing capital. Until a new entrant with a mandate to drive change enters the market, sales to local insurers are the easiest way to achieve either.

Whilst there has been some consolidation of the industry amongst the domestic insurers, with over €2.2trn of life insurance provisions, it is surprising that the European consolidators have not yet entered the market. In part, this is driven by the strength of the French bancassurers who dominate much of the sector through their own insurance businesses, with no sign of any imminent change as these remain core to their operations in France.

Figure 28: Total technical provisions (for life obligations) held by the top 10 insurance companies



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Based on the submissions of solo entities domiciled in France

With over €2.2trn of life insurance provisions, it is surprising that the European consolidators have not yet entered the market.

Antoine Grenier
Partner
Corporate Finance Deals Leader
PwC France

Beyond the domestic market, French insurers continue to grow their operations globally. Covea's acquisition of PartnerRe for €7.9bn and CNP's acquisitions in Italy (including Aviva's operations) and Brazil demonstrate the strength and reach of French insurance groups.

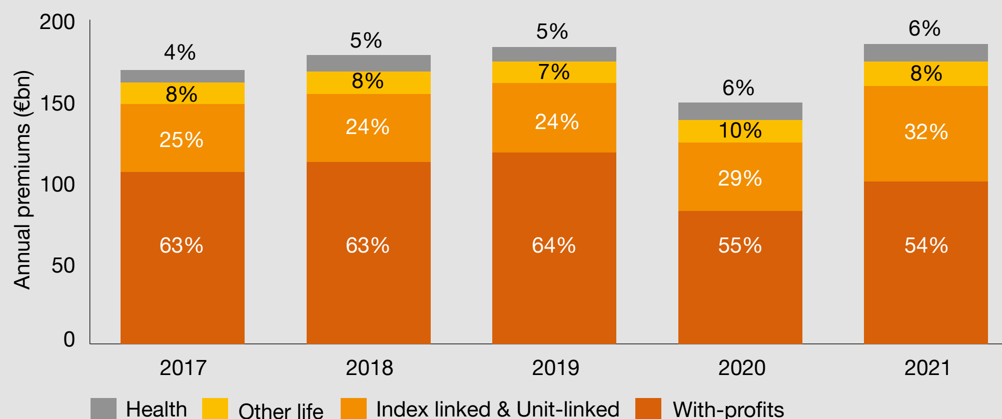
Gross written premiums have grown year on year, with the exception of 2020 where the impacts of COVID-19 led to a substantial drop. Volumes rebounded in 2021 which has continued over 2022.

New Business and distribution

Distribution through bancassurance is the primary sales method across France, with brokers and work-based arrangements making up the rest. Despite this, there is an increasing focus in the sector on InsurTechs such as Acheel, Alan and Seyna who are entering the market and providing digital platforms.

Business partnerships between insurers and household names are also a growing feature of the French market.

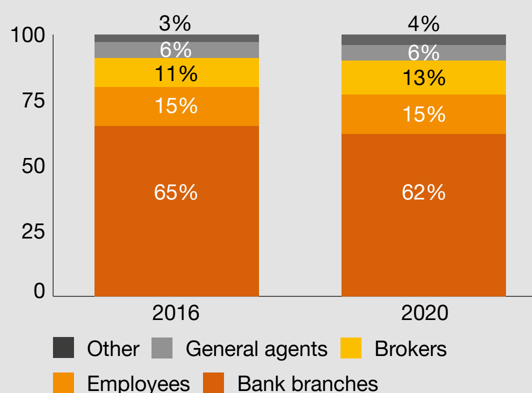
Figure 29: Total gross written premiums (for life obligations) split by line of business



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Based on the submissions of solo entities domiciled in France

Figure 30: New business sales by distribution channel



Source: PwC

The continued difficulty for run-off business in the market

The French market remains dominated by three core groups of participants, namely bancassurers, insurers and mutuals. Many of the large French insurers contine to be well capitalised and seek opportunities to grow into new markets, whilst local employment laws are perhaps providing a real barrier to entry for consolidators.

- Bancassurance remains core to the French market, which appears core to the strategy of many banks.
- Larger international insurers such as AXA, Allianz and Generali have significant operations in France. Public statements and recent deal activity show that these insurers are continuing to look at optimising their legacy life portfolios. Whilst not identifying France as a market, it's clear that these significant legacy portfolios could offer opportunities to buyers.
- The mutual sector and insurers offering products to affinity and trade groups continue to represent a large part of the market. Whilst many of these businesses are small, the strength of customer loyalty within the affinity group is the clear differentiator which allows these businesses to continue to grow and cross-sell to their client base. The acquisition of Aviva's French operations by Aéma Groupe showed the mutual sector in France remains strong and able to compete on a big scale and compete at the highest levels.

France is likely to see continued consolidation, but whether this extends to the levels seen in the UK or starting to be seen across Germany and Italy is yet to be seen.

Netherlands

The Dutch life insurance market is a mature market which has undergone significant consolidation in recent years, attracting external capital. Future consolidation opportunities are likely to be through portfolio transfers, driven by the larger Dutch insurance groups seeking to generate capital to deploy into alternative markets.

Competition for new business remains fierce, with pricing pressure affecting both individual life and traditional group life products, continuing to push down profitability for these products.

Within the Dutch life insurance market the top five insurers generate more than 80% of the gross premiums written.

To achieve growth, Dutch life insurers have focused on product innovation and international expansion to increase revenues (including diversification with non-life product lines), cost reduction programmes and consolidation to drive operational synergies. This focus on growth has resulted in greater profitability achieved in the market.

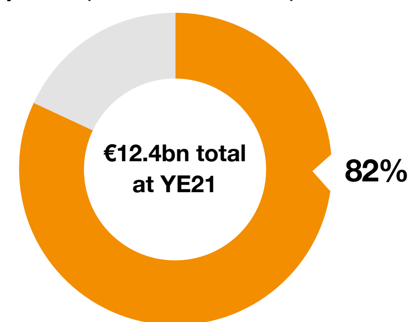
Increasing costs

In addition to the cost drivers observed across Europe (i.e. IFRS 17 and increasing inflation), the Dutch market is seeing an increase in costs due to KYC/AML requirements which have transferred into the life insurance sector from banking.

Higher costs are continuing to put pressure on the cost-effective management of closed book life insurers, necessitating highly efficient business models with an emphasis on digitalisation and outsourcing. To address increasing costs, life insurers have adopted one or a combination of strategies:

- Outsourcing of administration and/or legacy IT systems to third parties such as that implemented by ASR and NN;
- Cost reduction programmes, process standardisation and data quality improvements, especially relevant for closed book life insurance portfolios managing their operations through internal dedicated business units;
- Disposal of legacy portfolios to remove costs (with specialist acquirers achieving economies of scale).

Figure 31: Total gross written premiums (for life obligations) written by the top 5 insurance companies



Source: EIOPA

Based on the submissions of solo entities domiciled in the Netherlands

Figure 32: Profitability in the Dutch market*

Source: PwC

* Profitability defined as net revenue divided by written premium, based on top 15 insurers

Manoël De Goeij
Partner
Valuations
PwC Netherlands

Ronald Doornbos
Partner
People & Organisation
PwC Netherlands

Pensions Reforms

The upcoming pension reforms in the Netherlands, expected to come into force on 1st July 2023 (postponed from October 2022), will have a major impact on all organisations as the nature of pension provisions will need to change.

All future accrual will shift away from defined benefit plans and be replaced by two defined contribution arrangements: a collective and a more individual/flexible arrangement.

Pensions are currently provided by an employer sponsored pension fund, Premium Pension Institution ("PPI") or a life insurer, with the changes in regulations leading to a significant structural change in the industry.

For employer sponsored pension funds, the changes are likely to offer an opportunity to de-risk. At the same time, participants in the individual/flexible defined contribution arrangements will have the choice to transfer their accrued pension benefits to an insurer at their retirement date.

These changes in pension provision could therefore drive a new €1.5 trillion market opportunity in bulk pension transfer to both incumbent insurers and new entrants.

Transaction activity

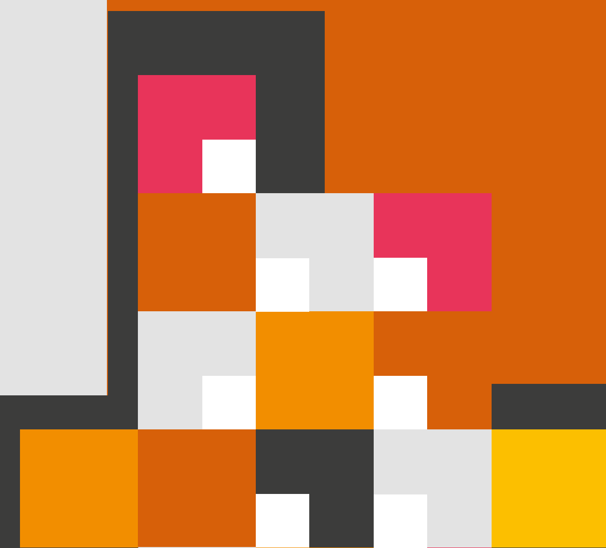
Transaction activity in the Netherlands has been focused on consolidators, with ASR, Athora, Chesnara (through Waard Leven), De Goudse and Lifetri all active in acquiring businesses and portfolios.

In FY22, Aegon and ASR reached an agreement to combine its Dutch operations (pension, life and non-life insurance, banking, and mortgage origination activities). This combination is a real landmark deal for the sector, creating the second largest insurer in the Netherlands. Chesnara also made its seventh Dutch acquisition when it announced it was buying the bankrupt Conservatrix business and the market leader NN Group also acquired its life insurance joint venture with ABN Amro Verzekeringen, further solidifying its leading position in the Dutch life insurance market.

Given the large number of participants actively looking to acquire closed books in the Dutch market and the level of consolidation to date, future consolidation is likely to be focused on portfolio deals, unless the recent ASR / Aegon deal drives further mergers amongst the smaller insurers as they look to manage their costs and achieve greater scale to be able to compete.

The ASR-Aegon deal once again illustrates the need to consolidate life books in order to manage them profitably in the medium to long run.

Manoel de Goeij, Partner, PwC Netherlands



Spain

Spain is the 11th largest insurance market across Europe with insurance companies managing €199bn of life insurance technical provisions. Consolidation across the insurance industry has been limited, with Elliott-backed Med Vida being the key player driving back book transactions. The majority of other transactions have been a consequence of deals in the banking sector, where many banks have their own captives.

The top 5 life insurers have a market share of 58% measured by premium volume (with a similar share when measured by technical provisions), with Vidacaixa the clear market leader with a 35% market share.

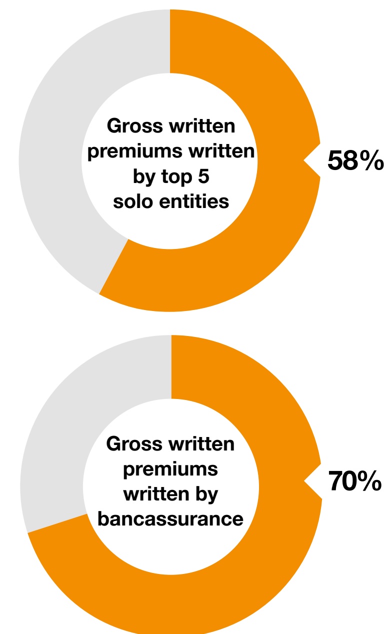
Life insurance premiums in the Spanish market totalled €23.6bn in 2021, equating to 38% of the total insurance market and a 8% increase relative to 2020. The majority of premiums are linked to savings products (c.80%) with the remainder being protection. However, the market is still well below 2019 premium levels as a result of the lower level of traditional savings premiums being written. The impact of COVID-19 on GDP levels and increasing inflation has diminished the attractiveness of life insurance products.

Bancassurance is the dominant distribution sector, with 70% of premiums distributed in this way, despite some upturn in the agent and broker networks.

Changes in interest rates and increased regulatory pressure on consumer protection will drive changes in the life insurance sector.

Pablo Martínez-Pina,
Partner, PwC Spain

Figure 33: Total gross written premiums (for life obligations) written by the top 5 solo entities and by bancassurers



Source: PwC

Pablo Martínez-Pina
Partner
Financial Services Deals Leader
PwC Spain

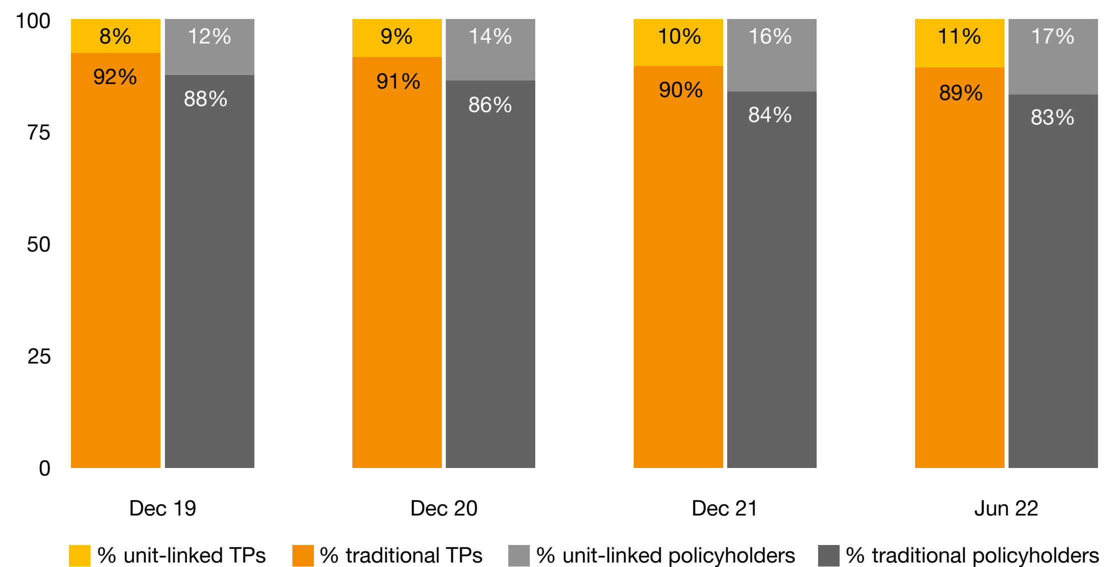
Recent trends

The recent focus of life insurance companies has been:

- Unit-linked savings products, be that through writing new business or encouraging customers to convert their existing traditional products; and
- Protection business, particularly through the bancassurance channel where it is 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.

Figure 34: The split of technical provisions and policyholders by line of business



Source: PwC

Outlook and key challenges

The recent increase in interest rates is a game changer for the industry but also introduces a new set of challenges.

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

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

Recent market movements could also open up insurers to reputational damage. For example, where unit-linked policyholders are facing material losses in their portfolios after having been encouraged to switch from guaranteed products, and in respect of surrender values of guaranteed products which are linked to the market value of the underlying assets.

From a tax perspective, many of the savings incentives offered by insurers for individuals have been eliminated in favour of collective employment savings programs, reducing demand for insurance products.

Transaction activity

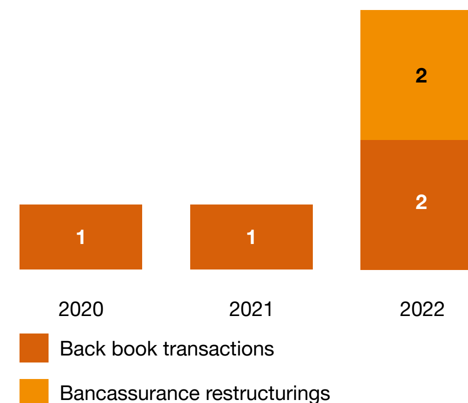
The increasing M&A activity seen in 2021 and the final six months of 2022 is expected to continue into 2023. The market remains a seller's market, with a strong appetite for inorganic growth from market participants and a scarcity of opportunities. The bancassurance market is mature, with M&A being driven by activity in the banking sector, renewals of agreements and agreements with Tier 3 banks (regional banks or with relatively low customer base).

Back book consolidation has gained some momentum, with MedVida announcing two transactions (CNP and Metropolis). However, with only one key participant, the market remains challenging. Future consolidation will depend on the successful completion of these transactions and how established consolidators react to the current economic climate.

In the broker space Spain is facing a similar pattern to the rest of Europe, with significant M&A activity from established players and consolidation of small brokers by PE-backed entities.

M&A activity in the life insurance sector is expected to be at the same level as that observed recently across all of the sectors in the Spanish insurance market. This deal activity is likely to be driven by international entities reconsidering their position in Spain and by smaller insurers / mutuals looking for a safe haven in light of the current environment.

Figure 35: The number of bancassurance restructurings and back book transactions



Deal pricing

There has been significant variability in the pricing of life insurance companies over recent years due to more sophisticated pricing techniques and a maturing life insurance M&A community.

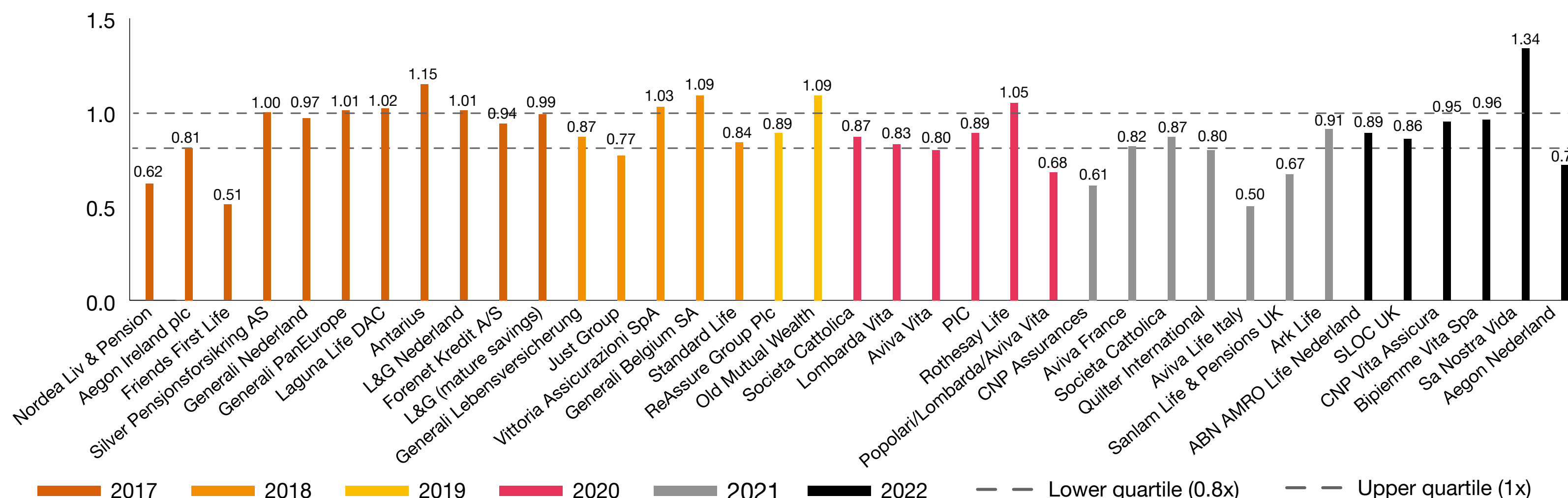
Own funds multiples from transactions over the past five years show a wide range, from as low as 0.5x to as high as 1.3x. Some transactions are outliers but with the upper and lower quartiles still showing a range of c.20%, variability in pricing is not uncommon. This reflects the economics of the underlying insurance portfolio, value opportunities identified by acquirers and also the success of the deal cycle.

With such significant ranges in transaction multiples, it is clear that there is no 'one size fits all' for life insurance companies and the merits of one company may be the deficiency of another. There are many quantitative drivers for the differences in the valuation of insurance companies, in addition to other qualitative factors, such as the strategic importance of an asset to the acquirer, which influence the final price agreed as part of any commercial negotiations.

Own funds multiples from transactions over the past five years show a wide range, from as low as 0.5x to as high as 1.3x.

Martin Watson
Associate Director
Risk Modelling Services
PwC UK

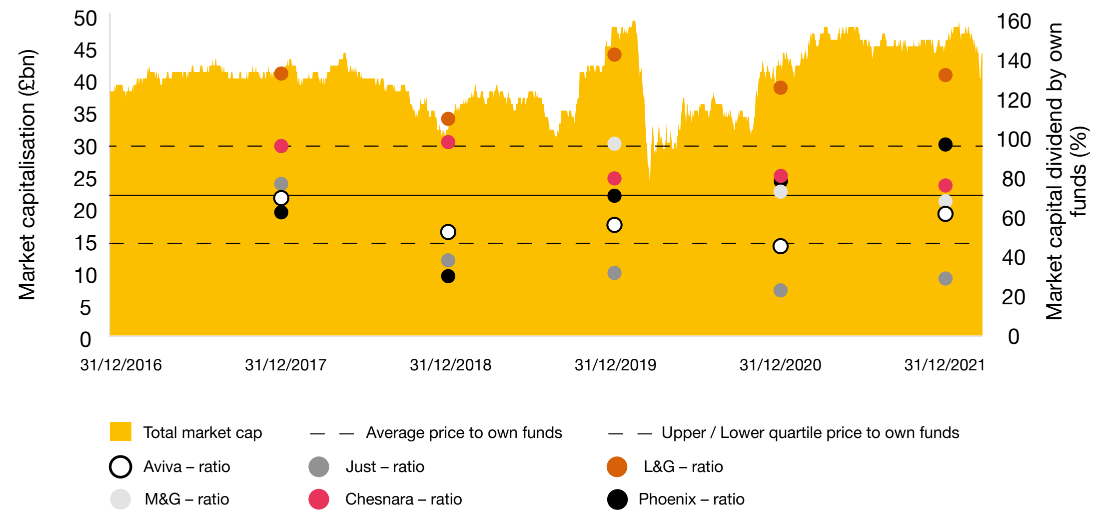
Figure 36: Price to unrestricted tier 1 Solvency II own funds



Source: PwC

Price variability is expected as acquirers and their advisers begin to examine the financials of a potential target. However, significant variability in pricing is also observed in the market. Figure 37 shows a comparison of share prices for six UK listed insurance companies and the market capital to own funds at reporting dates, as a proxy for price to own funds. Again, significant differences are observed which can be attributed to differences in the underlying business, market outlook and, to an extent, availability of data.

Figure 37: Implied price to own funds for select FTSE listed insurers



Source: PwC

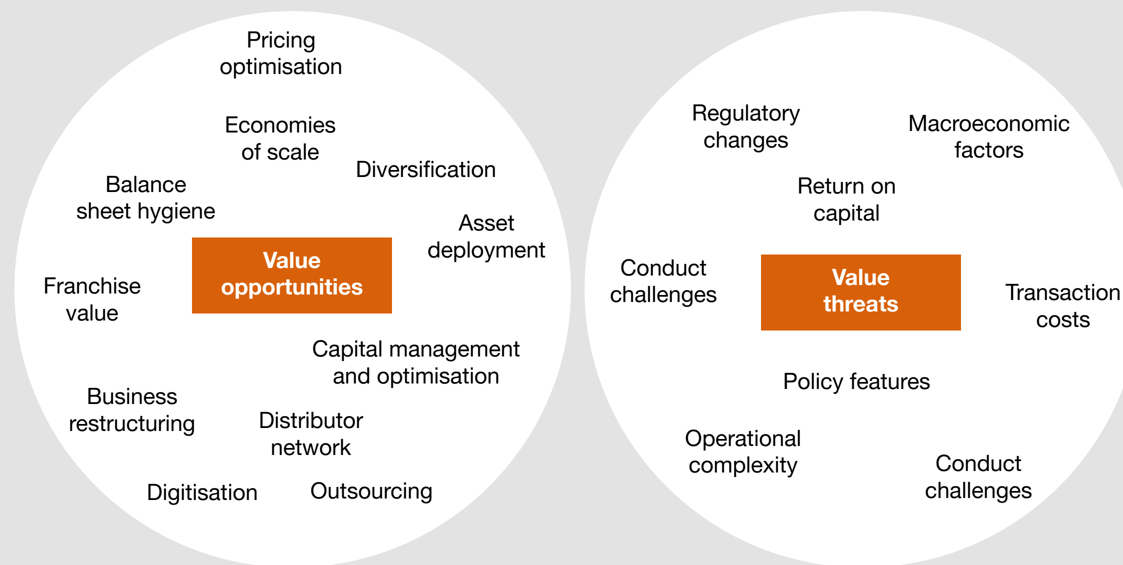
Our survey participants indicated that economies of scale (and other such cost-related factors) is the most significant driver for M&A and restructuring activity. It is therefore no surprise that this is one of the most common price adjustments observed in the market, with some transactions including cost-related price adjustments of over €100m.

Another area of focus is capital deployment and efficiency. This principally affects value through a reduction to the cost of capital for an acquirer through extracting dividends earlier, with price adjustments reflecting a host of actions from implementation of complex capital management actions such as partial internal model to more simple balance-sheet 'clean-ups'.

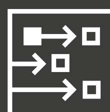
The extent to which franchise and new business value is reflected in the transaction price varies significantly, primarily being driven by performance to date with little value being placed on speculative volumes.

Transaction financing and existing debt structures are also a key consideration for value, with the recent market movements leading to an increase in the cost of debt. While debt is still likely to lower the weighted average cost of capital for the acquirer, the extent to which debt can be used in a transaction is dependent on the seller's existing leverage. This does not necessarily mean that all sellers should seek to fully de-leverage their businesses, as creative financing structures can be a valuable tool to manage capital and other financial constraints, such as liquidity.

Figure 38: Value opportunities and threats

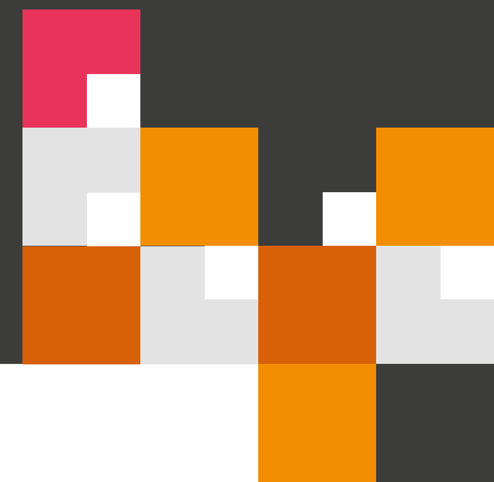


Source: PwC



Value optimisation ahead of a transaction for the seller

It is likely that value opportunities and threats can be foreseen by the seller, who can take actions to implement value creation initiatives, present upsides or remediate challenges ahead of a transaction process. We have seen this approach achieve positive outcomes, be that a greater price achieved by the seller, as an acquirer will pay face value for actions already implemented, or a faster transaction.



Target rate of return

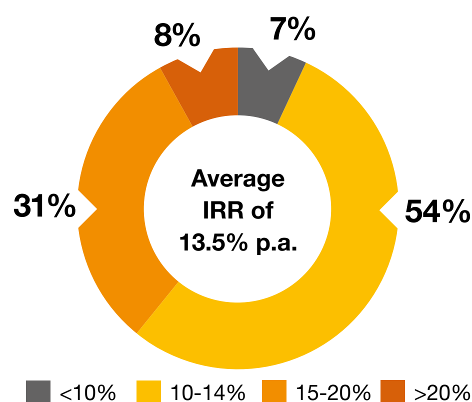
There are very few bilateral transactions in the life insurance market occurring across Europe, with most having a competitive process with multiple bidders.

A significant driver for such competition is the amount of value opportunities available on most life insurance portfolios, as well as the extent to which specific market participants have the ability to implement them.

Such drivers of value mean that acquirers are typically looking for double-digit returns with over 90% of participants defining a target IRR above 10% p.a.

When considered alongside the long-term nature of capital backing life insurance companies, these levels of return are extremely attractive and are reflective of the number of value levers available to acquirers of life insurance companies relative to other industries.

Figure 39: Survey participants' view on the target IRR to achieve when pricing a life insurance transaction

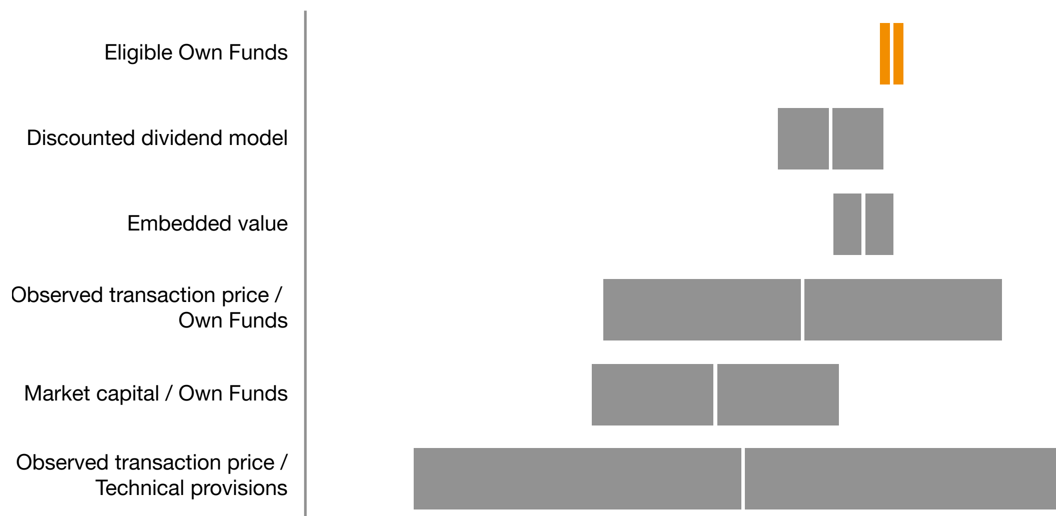


Source: PwC

Pricing metrics

Differences in transaction prices are inevitably driven by the underlying insurance portfolio and value identified by prospective acquirers, but it is clear that deal pricing itself has also evolved and become more sophisticated over the past decade. There are a number of ways to orientate value across the industry, some of which provide a greater range than others.

Figure 40: The variability in pricing under different value metrics



Source: PwC

> Deal pricing has evolved over recent years. With a focus on cash generation and tangible value creation activities, there is significant variability in observed transaction multiples. A more sophisticated buyer universe has been making deeper and broader due diligence demands on sellers, both from a financial and an operational perspective.

Martin Watson, Associate Director, PwC UK

Each valuation metric has its own merits. Solvency II is a cornerstone of any valuation exercise due to its consistency across the market and own funds are often the reference point for value. However, there is a convergence towards dividends and cash generation, with this being identified by 69% of participants as their primary pricing metric.

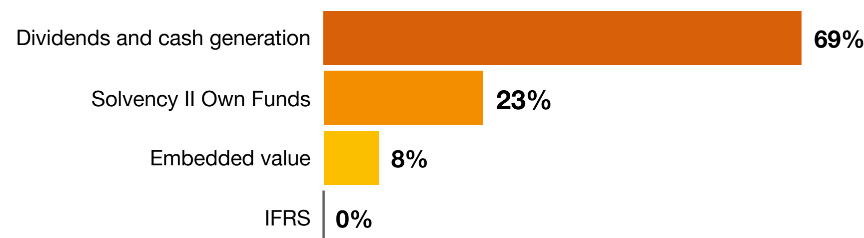
Top areas of focus

There are many factors considered by buyers as part of any transaction. Our survey participants highlighted three key areas:

- **Deployment of capital** – Identification of capital synergies was highlighted as the top area of focus for participants. As well as helping to reduce the capital strain of an acquisition, capital synergies can act to enhance the existing operations of an acquirer, offering diversification or providing scale to undertake specific capital management actions. While having the potential to provide significant upside to an acquirer, the total capital for an insurer involves significant judgment and requires a proportionate level of diligence.
- **Operational and technological complexity** – The commercial success of a transaction can often be linked to the execution of operational and technological activities, including separation, integration and strategic initiatives. For this reason, data / valuation systems, transformation programmes, people and the implementation of transitional service agreements occupy a significant proportion of management meetings as part of negotiations between buyer and seller.
- **Return on capital** – The achievability of an acquirer's required return on capital is inevitably a top area of focus for any commercial transaction. We see this manifesting itself in two ways. Firstly, acquirers require a clear understanding of the sources and nature of cash generation from an insurance portfolio. Secondly, a seller must be able to demonstrate the stability of returns through sensitivity and scenario testing, which is becoming an increasingly important part of the transaction cycle.

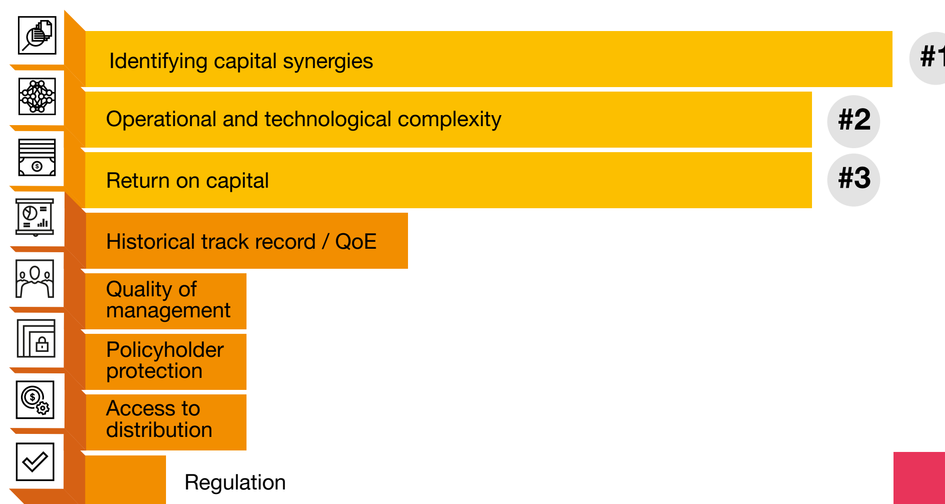
While not necessarily being identified as a top areas of focus, other areas also play a key role in any transaction process.

Figure 41: Primary metric for deal valuation



Source: PwC

Figure 42: When involved in a transaction, what are your three top areas of focus?



Source: PwC

IFRS 17 – What change will it bring?

The introduction of IFRS 17 brings a seismic change to the manner in which accounting profits are recognised for insurance contracts. However, the current view is that the new standard will not lead to changes in the way insurers manage and run their businesses.

As IFRS 17 becomes embedded, more consideration will be given to whether its introduction will lead to changes in how the profitability of a business is viewed. Under IFRS 4 upfront profits were recognised immediately – particularly on annuity products. Under IFRS 17, the introduction of the contractual service margin ("CSM") means that such profits are now deferred over time and released over the duration of the contract.

Impact on current strategy

From an accounting perspective it is clear that IFRS 17 brings about a number of wholesale changes. However, the extent to which it will impact the day-to-day management and strategy of a business is less clear. Recent investor communications by Lloyds Banking Group and Zurich have explicitly highlighted that IFRS 17 will not lead to changes in their dividend framework.

This is a consistent theme we are seeing across the industry, with most companies viewing IFRS 17 as solely an accounting basis. The expectation is that Solvency II will continue to be the primary metric for assessing risk, capital and cash generation.

One area which is beginning to receive focus for insurers is how IFRS 17 will be perceived by rating agencies. Given IFRS 17 defers the release of profits through the CSM, capital is locked up for a longer period and will possibly delay dividends. However, the extent to which items such as the CSM can be allowed for within capital-based ratios remains an outstanding point. Irrespective of this, IFRS 17 is still only expected to be one of a number of other metrics that rating agencies consider when making their assessment.

From an accounting perspective it is clear that IFRS 17 brings about a number of wholesale changes.

Anthony Coughlan
Partner
Risk Modelling Services
PwC UK

Other considerations

The implementation of IFRS 17 has been a considerable cost to the industry over recent years. Whilst efficiencies may be realised over the longer-term, those costs are not expected to reduce in the short-term with reporting teams needing to maintain additional resource.

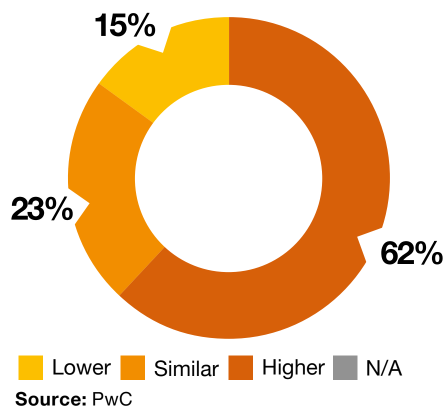
Further for those insurers who have sought to match asset and liabilities on an IFRS basis, the introduction of IFRS 9 at the same time may mean that there are additional costs in order to adapt the day-to-day running of a business.

From a pricing perspective, while only 23% of participants indicated that IFRS 17 will rank alongside their current key performance indicators ("KPIs") from a pricing perspective. The key pricing consideration will be the impact that IFRS 17 has on the profile of the tax paid by insurers, given the profit profile of insurance portfolios will change.

Looking forward

Given the length of time it took the industry to move to a Solvency II view of the world, it's no surprise that the changes from IFRS 17 remain quite hard to determine. However, as companies begin to emerge from their implementation phase, we may start to see many of them consider how they can embed IFRS 17 more deeply into the day-to-day running of their business.

Figure 43: Survey participants' ranking of IFRS 17 relative to their primary pricing metric



Source: PwC

The implementation of IFRS17 is estimated to have cost the insurance industry over €20bn, but it remains to be seen how it will shape future transactions with many participant still focusing on cash generation (which is typically disconnected from accounting).

Anthony Coughlan, Partner, PwC UK

Evolving solvency regimes

A significant aspect of any deal involving insurance liabilities is the regulatory and solvency environment in which insurance companies operate. Proposed developments to European solvency regimes provide the opportunity for more efficient capital deployment.

Background to Solvency II

Solvency II came into effect for insurers across the European Union (EU) on 1 January 2016, and resulted in a consistent approach characterised by the market value of assets and liabilities, as well as a risk-based approach to assessing and mitigating risks on insurers' regulatory balance sheets, with the primary objective of strengthening policyholder protection.

Naturally with a Europe-wide approach, there are certain elements of the Solvency II framework which are more suitable to individual insurance markets than others, based on the underlying dynamics of those markets, and vice versa.

Over time, industry bodies and market participants have commented on potential enhancements and suggested changes to the Solvency II framework to maintain its appropriateness and relevance in the continually evolving economic environment.

At its point of introduction, revisions were already planned to update the method of calculating capital requirements under the standard formula and to assess the application of long-term guarantee measures and measures on equity risks.

What was not anticipated, was the change in the political landscape which led to the UK leaving the EU and no longer being bound by decisions made either in Brussels or by EIOPA. 2020 saw both the UK Government and European Commission ("EC") launch separate reviews into Solvency II with a strong focus on maintaining the overall regulatory framework and levels of policyholder protection.

The separate reviews are expected to result in further deviations across international regulatory capital regimes. Any divergence of the two regimes should be a focus of European life insurance deals and restructuring activity as differing solvency regimes will have an impact on insurers' capital optimisation strategies but may also present opportunities for optimisation of regulatory positions.

Over time, industry bodies and market participants have commented on potential enhancements and suggested changes to the Solvency II framework to maintain its appropriateness and relevance in the continually evolving economic environment.

Carlos Montalvo Rebuelta
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EU Solvency II Reforms

The EU's proposed reforms aim to increase the codification of Solvency II rules and achieve consistency of insurance supervision across the EU. The EU's reforms also expect to increase capital efficiency, with up to €90 billion of regulatory capital expected to be released into the economy.

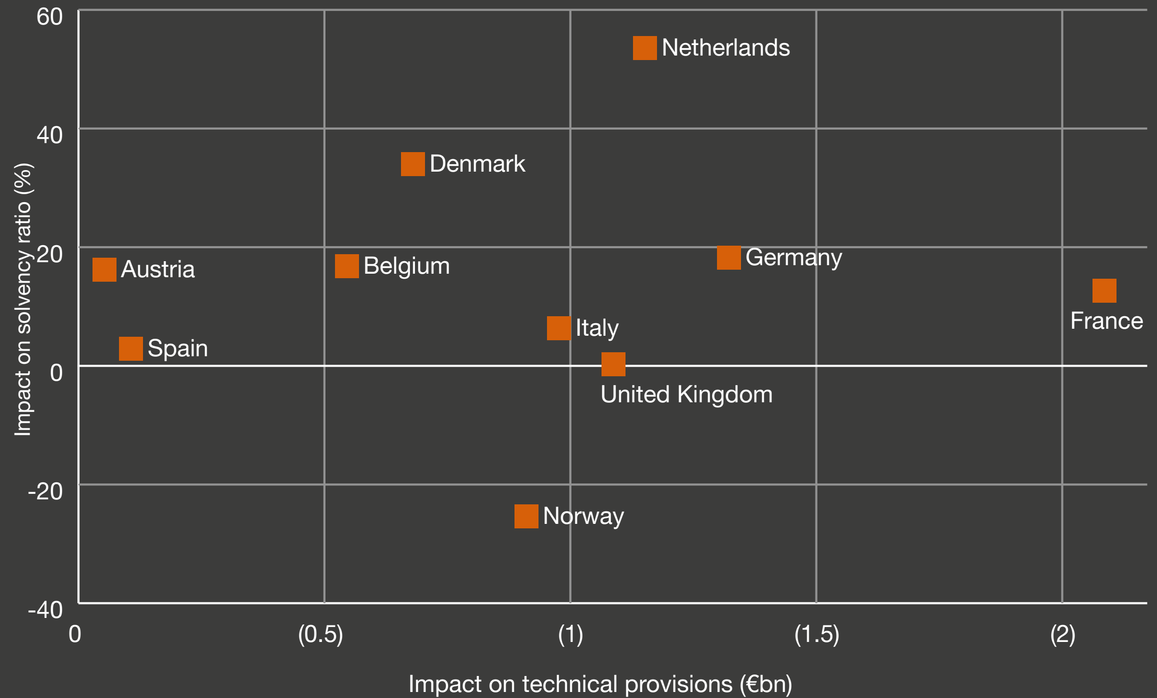
This codification is, in part, in contrast to the UK's proposed reforms and approach to regulation, where more subjectivity is permissible (subject to regulatory approval). However, there are consistencies in that both reviews have placed an emphasis on insurance companies investing in the real economy and either maintaining or enhancing policyholder protection.

The European Commission proposed changes to the Solvency II regime are also subject to ongoing consultation and cover the risk margin, the determination of the volatility adjustment ("VA"), ring-fencing of matching adjustment ("MA") portfolios, approach to extrapolating the yield curve and allowing for negative interest rates, and proportionality of reporting measures.

Volatility adjustment

The VA represents a fixed addition to the risk-free rate to address the unintended consequences of short-term volatility in bond markets and is produced by EIOPA on a monthly basis. The EC's proposals currently aim to recalibrate the application ratios so that insurers are rewarded for holding illiquid liabilities. The proposed changes allow for three aspects: a 'permanent VA' set by EIOPA, a 'macro-economic' VA dependent on the country of issue, and a company specific VA adjustment based upon an insurer's 'credit spread sensitivity ratio'. This will increase the complexity of the VA calculation and could lead to divergence between ultimate discount rates used to calculate liabilities between countries and insurers. However, this will also likely lead to more effective asset-liability matching as the separate discount rates used to value the assets and liabilities may become more aligned.

Figure 44: Balance sheet benefits of volatility adjustment at year-end 2021



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Matching adjustment

Within the current Solvency II regime, some insurers can reduce their liabilities by taking credit for the MA. The MA capitalises on the future excess yield above risk-free that insurers earn due to the illiquidity premium on their fixed interest investments.

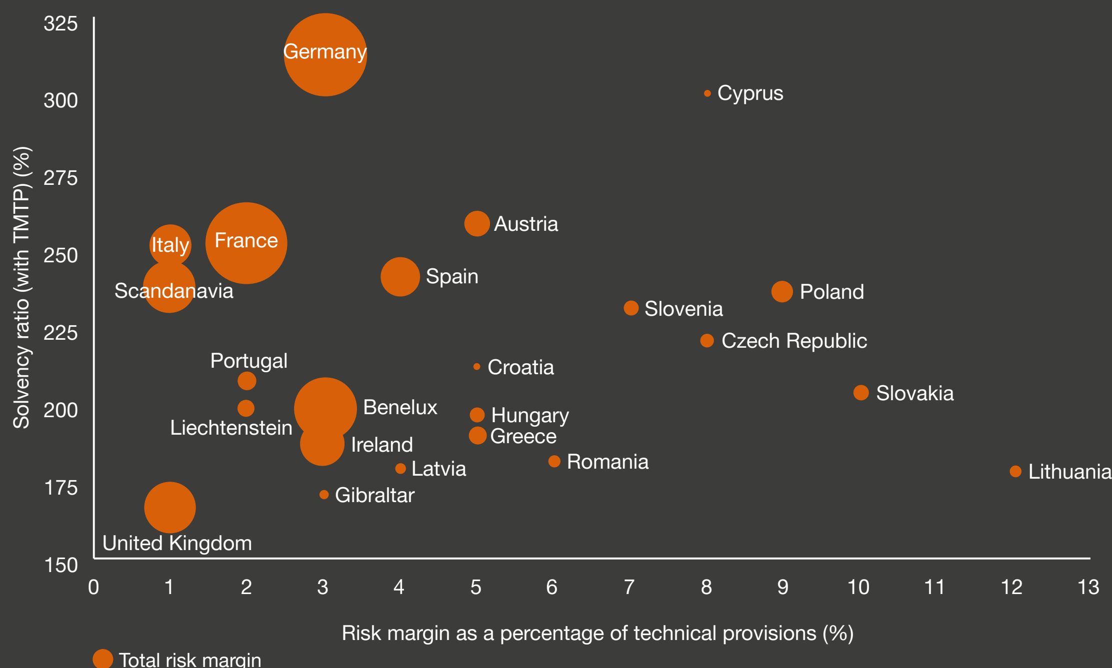
The upcoming review will make the use of MA more attractive to EU insurers, with the possibility of extending its use beyond the UK and Spain, as the current limitation to allow for diversification benefits to those assets backing MA portfolios would be removed. This, combined with the increase of interest rates and the perception by regulators that transferring all the market risk to policyholders is not always in their best interest may entail an opportunity for new products being designed within an MA framework, allowing insurers to offer guaranteed products to clients again. The relative benefit of extending the scope of products to use the MA for European insurers can not be underestimated, with the benefit of the the MA in the UK being almost 40 times more than the corresponding benefit of the VA.

Risk margin

A key area of focus for the EC has been the appropriateness of the risk margin. The aim of the risk margin is to ensure that insurers hold the market price of their liabilities. However, the risk margin has come under continuous criticism since the implementation of Solvency II for being too large and too sensitive to interest rate movements.

The proposed risk margin reforms also aim to reduce the size and volatility of the risk margin. It is expected that EIOPA's new method could include the introduction of a 'lambda factor' to the current cost of capital approach, which aims to reduce the risk margin contribution at later durations, as well as a reduction in the cost of capital rate from 6% to 5%. Figure 45 illustrates the significance of the risk margin by territory. The proposed reduction in the cost of capital rate is expected to provide varying degrees of benefit across Europe.

Figure 45: Risk margin as a proportion of technical provisions (for life obligations) held across Europe at year-end 2021



Source: AM Best – Best's Financial Suite – Solvency II, EIOPA

Interest rates
The current interest rate extrapolation methodology and standard formula interest rate stress do not account fully for information from financial markets. The EC has proposed changes to both areas:

1. Extrapolation – recognition of a deep, liquid and transparent market beyond the current assumption of 20 years.
2. Standard formula SCR – allowance for negative rates in the calculation of interest rate risk capital charge.

A phasing approach up to 2032 is planned to introduce these changes, to defer the impact on the balance sheet. However, given the increase in interest rates during 2022, these are likely to have a smaller impact on insurers' balance sheets than originally anticipated by the proposed reforms which commenced during a prolonged low and negative interest rate environment.

Proportionality of reporting requirements
The current regulatory requirements do not distinguish between the size of individual insurers, and as such can be quite onerous for small firms. The EC has proposed the introduction of 'low-risk profile undertakings' which can benefit from simplifications to the SCR and a more proportionate set of regulatory reporting requirements.

'Low-risk profile undertakings' are expected to be identified based on criteria relating to the level of technical provisions (less than €1bn), the level of interest rate risk (less than 5% of Technical Provisions), the proportion of assets invested in non-traditional investments (less than 20%) and the amount of business written outside their home jurisdiction (less than 5%). Any insurers that use a full or partial internal model will not be classified as low-risk.

"Valuation of liabilities has always been the elephant in the room. Not surprisingly, the most relevant changes embedded in the Solvency II review (in the EU) are addressing it. With the impact of such changes targeting a €90 billion capital release, and the recent increases of interest rates, such changes will have the potential to re-shape life business in Europe, including by allowing insurers to re-launch guaranteed products, better aligned with the preferences of their customer base.

Carlos Montalvo Rebuelta, Partner, PwC Spain

UK Solvency II Reforms

The UK Government announced its decisions on the Solvency II review in mid-November 2022, and set out clear objectives which underpin the regulatory review and proposed reforms. These include encouraging investment within the UK economy, improving the international competitiveness of UK insurers and maintaining policyholder protection. The proposed reforms underwent consultation with the UK insurance industry which informed the final decisions made by the government, in discussion with the PRA.

Matching adjustment calibration

The UK reforms propose changes to the calculation of best estimate liabilities for insurers who hold annuities on their balance sheet through the MA.

Using the evidence gathered from the industry wide consultation, the UK Government has concluded that the current methodology and calibration of the fundamental spread (“FS”) will remain unchanged and that notched credit ratings will be introduced within major credit ratings to better reflect the risk profile of each asset.

In addition, the eligibility requirements for the MA will be broadened to allow the inclusion of assets with highly predictable cash flows, subject to adjustments to the FS allowance and safeguards to be implemented by the PRA. Generally speaking, the safeguards will enable the PRA to challenge the appropriateness of the FS used by individual firms and, where necessary, require add-ons in order to support the objective of maintaining the safety and soundness of policyholder protection.

From a deals perspective, the concluded outcome is expected to provide stability in insurers’ long-term asset portfolios and limit significant impacts on annuity pricing.

Matching adjustment application
Separately, discussions around expanding the number of products eligible to use the MA (for example, to cover income protection business) has the potential to stimulate innovation and growth.

Risk margin
The appropriateness of the risk margin has also been a key area of focus for the UK Government. The effect of interest rate movements are exacerbated for UK annuity writers, who carry long-tailed longevity risk and are typically required to hold a larger risk margin relative to other insurers. In order to manage this and introduce stability to their balance sheets, UK annuity writers reinsure a large proportion of their longevity risk. The presence of high levels of reinsurance also suggests that the market transfer value for longevity risk is lower than that implied by the regulatory capital currently held by insurers.

The UK Government has concluded that it will legislate to reduce the risk margin for long-term life insurance business by 65% under recent economic conditions and enable a modified cost of capital approach to its calculation. This is consistent with their initial communication that the risk margin would reduce for UK insurers by up to 70%.

In their approach, the UK government has acknowledged both concerns from the industry that any reduction in risk margin would be initially offset by a reduction in the transitional relief on pre–2016 business which was introduced when Solvency II came into force as well as the impact of the current changes in the macro-economic environment.

The actual impact and timing of the risk margin reforms for individual insurers will be a key consideration when pricing deals and understanding the potential value to shareholders.

Small changes in the FS can have significant impacts. Based on UK life insurer data at year-end 2021, the MA reduces Technical Provisions by £36bn, reduces the Solvency Capital Requirement by £41bn and improves the solvency ratio by c.83%. Without the MA, the aggregate solvency ratio of the UK life insurance industry would be below 100%.

Tax focus

The complex nature of life insurance taxation means that tax is often a key focus on run-off transactions, with potential for both value and risk

Acquisition of shares vs business transfer and reinsurance

The structure of a run-off life insurance deal is key to assessing its tax consequences. At one end of the spectrum, although care is still required, a simple acquisition of shares will often be relatively straightforward in comparison to other alternatives (such as a portfolio transfer), with the main focus being on preserving any losses or other tax attributes in the target.

By contrast, a transaction which involves either reinsurance or a business transfer can have the effect of transferring tax attributes and crystallising tax synergies. However, these transactions are often substantially more complex:

- The accounting for these transactions can be complicated (under local GAAP, IFRS 4 and IFRS 17) and result in complex tax considerations around the future tax treatment of accounting movements (e.g. value in-force, goodwill and CSM amortisation etc).
- Care also needs to be taken regarding local tax complexity around business transfers. For example, in the UK a targeted anti-avoidance rule governs the treatment of insurance business transfers, whether they are between group companies as part of a post-acquisition rationalisation project, or unrelated third parties. For that reason, it is market practice for UK taxpayers to seek clearance over any insurance business transfer in order to have certainty as to the tax outcomes.
- Lastly, where reinsurance is used in a run-off transaction, dealmakers need to watch out for the potential for frictional taxes and whether these can be minimised. Common issues include:
  - US Federal Exercise Tax (which can apply to reinsurance at 1% of premiums);
  - Withholding taxes on investment income, particularly in funds withheld or deposit back scenarios;
  - Transfer pricing and related matters such as local substance tests where intra group reinsurance is involved, particularly in a low tax territory.

Michael Trigg
Director
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Brent Hadley
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Other tax considerations

Two additional key areas to consider from a tax perspective in any transaction are the funding structure and VAT leakage.

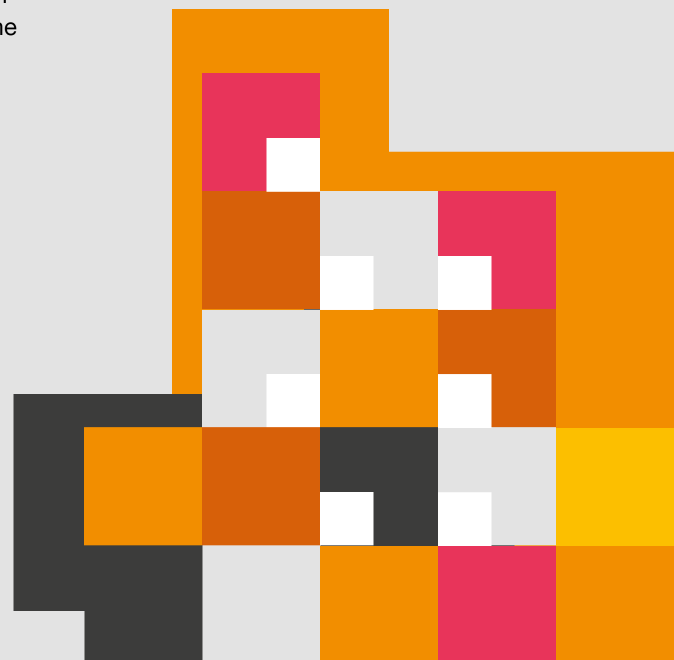
Transactions can sometimes be funded using tax efficient forms of regulatory capital, such as Restricted Tier 1 Securities. Interest deductibility rules for such funding structures are complex, particularly if the structure involves shareholder debt. To minimise any unforeseen surprises, the capital structure must be commercially robust.

The risk of VAT leakage arises where outsourcing is used. This can vary substantially based on the type of services outsourced and the form of the outsourcing arrangement in place. A clear understanding of recoverability of costs is therefore critical.

Areas of tax diligence

From a diligence perspective, the risk areas will to some extent depend on the profile of the target. However, there are a few key areas where we see buyers focus:

- **Base erosion and profit shifting ("BEPS") 2.0**
  The potential application of Pillar 2 of the OECD's BEPS 2.0 project is an increasing area of focus for multinational groups. This imposes a minimum tax rate of 15% on the profits of multinational groups. For groups with operations in lower taxed territories, there is a potential for these rules to have a direct impact on assessing deal economics. While this might seem unlikely to apply in higher tax rate countries, there can be unexpected results for life insurers due to the impact of policyholder tax, deferred tax and the taxation of investments. These rules are still new and many groups have not yet modelled them thoroughly. That in turn makes it challenging to conduct due diligence, and hard for purchasers to assess their impact on valuation models.
- **Operational taxes**
  Operational taxes (i.e. taxes collected or administered on behalf of the policyholder) vary by country but can include complex rules and large volumes of reporting, usually administered outside of tax teams. Rules often rely on having accurate information regarding policyholders and their circumstances and can present an increased risk of error in deals.
- **IFRS 17**
  For IFRS reporting groups, there is naturally a focus currently on the effect of IFRS 17 on tax profiles. There may be specific tax transitional rules on adopting this regime, but these are likely to have fairly complex application where there is a subsequent transfer of business.
- **VAT recoverability**
  Another area of uncertainty for buyers can be VAT. For example, UK HMRC are increasingly active in challenging the partial exemption methodology for life insurers, which in turn means that buyers can have less certainty regarding the future levels of VAT cost.



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The life insurance deals team consists of a multi disciplinary team of dedicated insurance experts across the PwC network, working together for the benefit of our clients. The team provides expert support in a number of areas (see below), where the scope is tailored to the needs of the client and their situation. In particular, the team is able to provide advice, support and assistance on:

Lead financial advisory	Transaction and financial diligence support	Actuarial and valuation services	Taxation	Regulatory, ESG and Cyber	Legal, HR and Operational

Methodology

Our online Survey was sent to a cross section of individuals at (re)insurers, private equity firms, investment banks, brokers and other stakeholders in the life insurance transaction market. Responses are anonymous and we do not collect any data on the participants. This publication includes a summary of the results. Where appropriate, we have rounded results to ensure the totals add up to 100%.

The research was conducted by PwC UK.

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