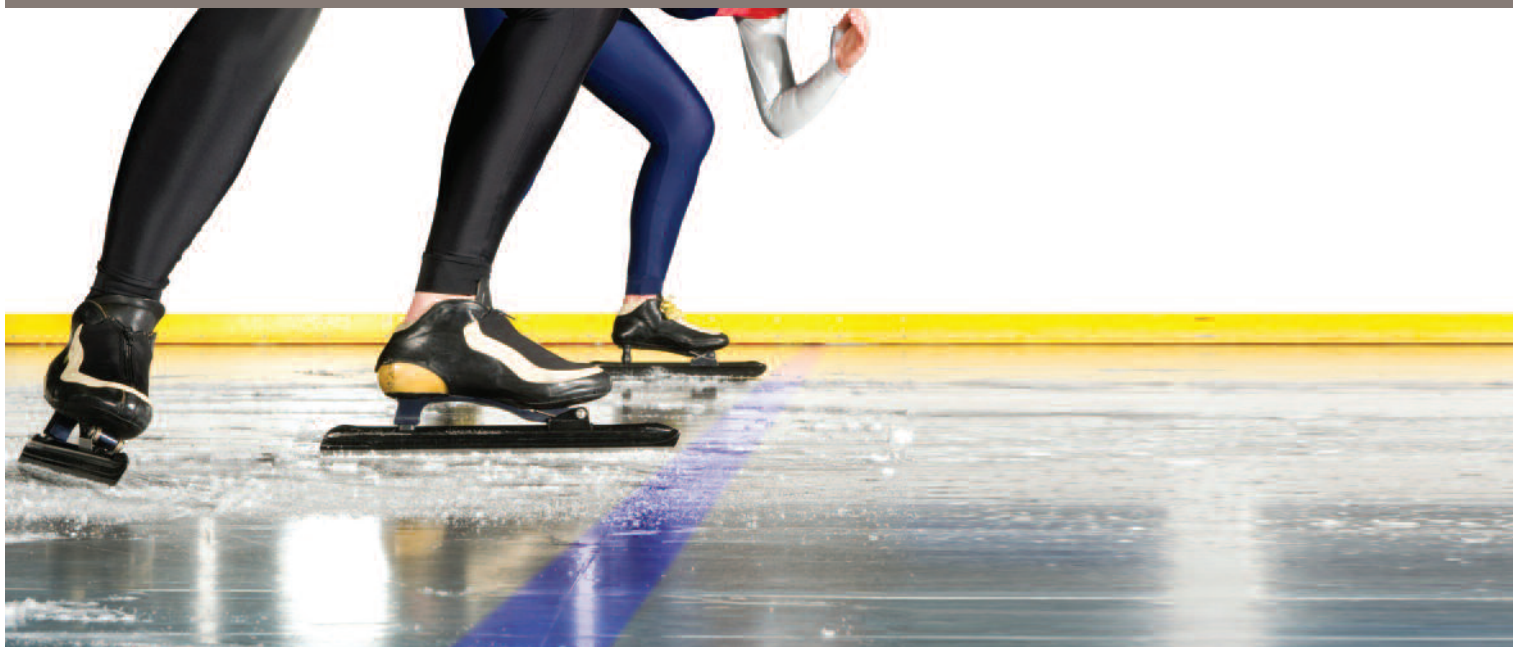


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Shaping up Solvency II and M&A

How will the strategic implications of Solvency II drive M&A and what will be the impact on the shape of the industry?

With many insurers still mired in the minutiae of model development, documentation and other aspects of Pillar 1 implementation, it is easy to lose sight of the bigger strategic picture.

Strategically, the key driver for change will be the closer integration of enterprise risk management (ERM) into business decision-making and its opening up to far greater analyst, rating agency and regulatory scrutiny. This will have a profound effect on the way risks are evaluated, how capital efficiency is judged and, ultimately, how and where insurers choose to compete. Specific ramifications include potentially higher capital charges for policies with volatile or uncertain risk profiles such as guaranteed life products and long tail casualty business. The directive will also highlight the capital tied up in discontinued business. For non-life insurers, in particular, there is the challenge of being required to take investment risks fully into account, which will make it more difficult for companies to compensate for poor underwriting performance by running high investment risks.

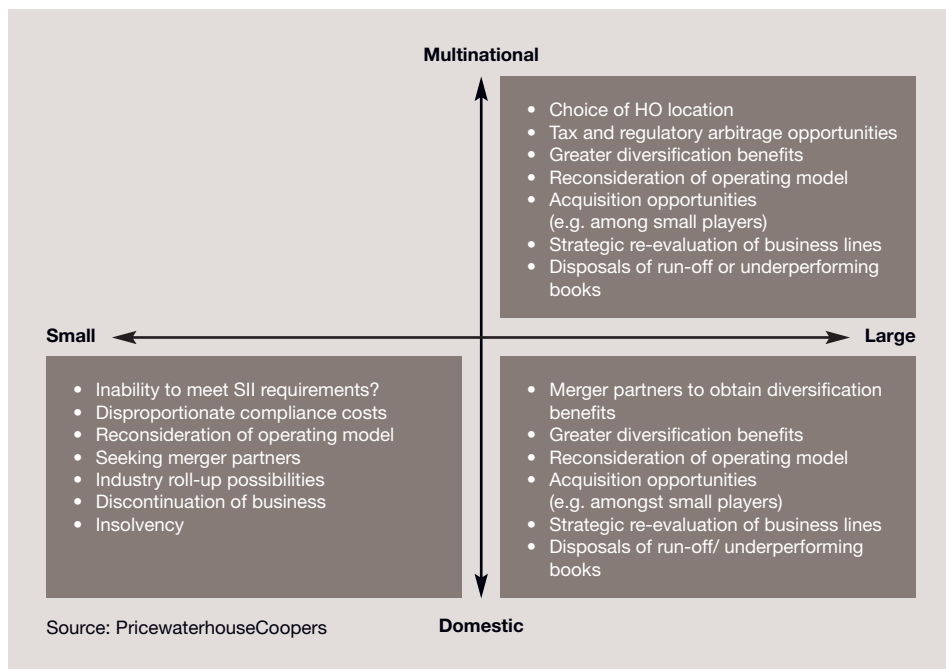
More broadly, the concept of 'diversification' will need to be re-examined and refined in the light of Solvency II as companies look at such factors as size, geographical reach, multi-line operations and the correlation of assets and liabilities. As a result, larger and genuinely diversified businesses will be able to develop the balanced portfolios and resulting capital advantages that will not be open to smaller and mono-line entities. On the flip side, the difficulties of oversight and control created by managing complex group structures across multiple territories can increase operational risk and associated capital charges.

The cumulative impact of these developments will force insurers to review their strategies, structures and product mixes as they look at how to optimise capital efficiencies and develop a clear articulation of their business objectives and the trade off between risk and reward (see Figure 1).

Impact on M&A

The re-think of strategic options will provide a strong spur for deal activity.

Figure 1 | Possible commercial and practical implications of Solvency II



The underlying considerations are what business model is likely to be most appropriate for a particular company and what part M&A will play in the resulting reshaping of the enterprise. We expect to see the emergence of two distinctive paths for M&A:

Redefining diversification

One model will be the true consolidators. Companies that are already reasonably diversified and will therefore realise capital advantages under Solvency II will be able to look at how M&A could further enhance the balance of their portfolio. These acquirers will be highly selective in seeking out targets that will enable them to bridge diversification gaps in their product line or geographical spread. One of the key value metrics for their choice of which company to buy will be the enhanced level of capital efficiency the deal will generate. Tax synergies and tax optimisation strategies will also be a key driver of value, especially in the UK life market.

At the other end of the spectrum will be the true specialists. Some companies will not be able to secure effective diversification and could face additional capital charges because of a narrow product or regional focus. These firms will want to look at the adequacy of risk-adjusted return on capital from each element of their portfolio and judge which operations are therefore worth

retaining within a specialised entity. Underperforming lines will either be sold to the true consolidators or discontinued.

Unbundling the value chain

As Solvency II increases transparency and forces insurers to re-assess the capital dynamics of their operations, some companies may look at alternative business models. Rather than being a consolidator or specialist, the choice would be whether to focus on a particular aspect of a value chain that is likely to be increasingly segregated between distribution, manufacturing, service (IT, administration etc) and capital provision.

One of the potential benefits opened up by the unbundling of the value chain would be enabling capital providers to align investment more closely with their risk appetite and return expectations. There will continue to be investors who will want to assume direct exposure to insurance risk in return for the required level of reward. However, there would also be other investment opportunities that retain minimal insurance risk and operate with reduced regulatory requirements as they concentrate on areas such as distribution, insurance services or other non-manufacturing parts of the value chain. This is likely to attract fresh interest from a range of capital providers including financial investors, who may previously have been deterred by the

complex compliance requirements and the need to tie up significant capital to support risk within a conventional insurance business. Other investors could include new entrants from sectors such as IT or retail as they seek to tap into opportunities close to their respective expertise. The overall result would be clearer and more differentiated investment prospects within the insurance industry and hence the ability to attract more capital from a wider array of providers.

Enhanced transparency may also lead insurers to consider whether certain aspects of the value chain could be performed in different locations in order to minimise tax and other operating costs.

Emerging stronger

With only two years to go before Solvency II comes into force, the need for boards to assess the impact on the economics of their businesses and how they should respond is becoming ever more urgent. Divestment and consolidation are set to play a key part in this strategic reappraisal and resulting restructuring, enabling companies to re-balance their portfolios, sharpen specialisation or focus on a particular aspect of the value chain, depending on their choice of business model.

Giving you the edge

PricewaterhouseCoopers is helping a range of insurers to assess the strategic implications of Solvency II and capitalise on the opportunities. If you would like to know more about how Solvency II could affect your business and how to develop an effective response, including plans for restructuring, acquisition and divestment, please contact:

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