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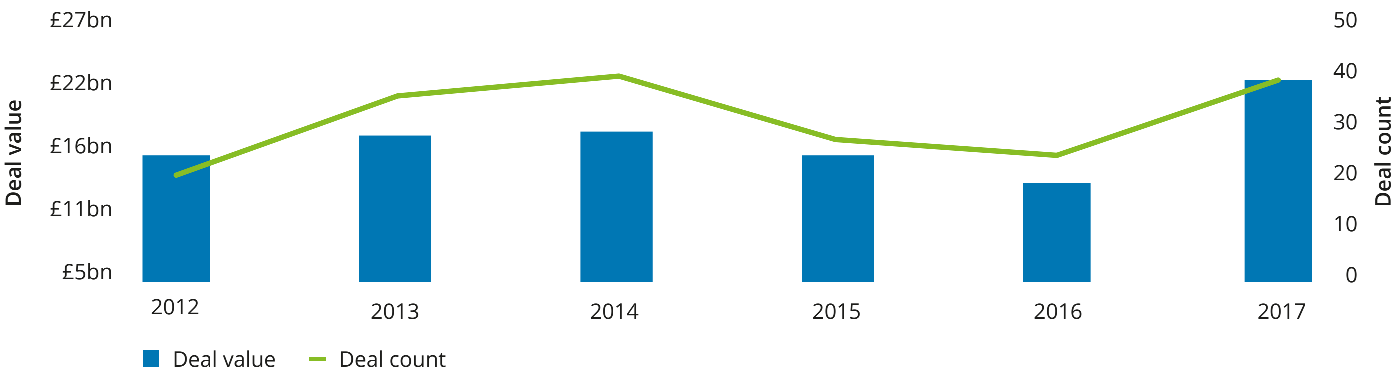
There will be an uptick in insurance mergers and acquisitions this year following massive regulatory compliance efforts.

During the first half of this decade, the insurance industry prepared extensively for the Solvency II regulatory overhaul and its capital and risk management ramifications. Following insurers' compliance with the regulation, they are facing both old financial pressures and newer opportunities that will motivate mergers and acquisitions (M&A).

Recovering appetite after Solvency II compliance efforts

Over recent years, insurers and potential investors had felt considerable uncertainty around the adoption of the Solvency II rules, somewhat dampening the appetite for acquisitions. Last year's total aggregate deal value rose to almost £22 billion, a significant rebound on £10.7 billion in 2016. Deal volumes also bounced back as insurers saw new opportunities: with thirty nine agreements of over £100 million across Europe, up by 14 on the previous year.

Figure 1: M&A deals in Europe from 2012-2017



Source: Merger Market, Deloitte Analysis

Two years on from Solvency II's implementation, as the period of uncertainty is being left behind, companies are now able to focus more attention and resources on spotting M&A opportunities and tackling modernisation pressures.

We believe that investor confidence is returning strongly after Solvency II implementation, and that it will mean more deals in the insurance sector. Meanwhile, increased business change capacity will be essential to meeting important customer, technological and cost demands.

Fundamental to our prediction of more deals is the returning willingness among sellers to do business - and to make sure this business is targeted. Top of their mind is divestment to aid a refocus: whereas a decade ago these insurance giants were often aiming to grow new businesses in markets worldwide, that process has effectively been put in reverse as priorities shift to enhancing competitiveness in core competencies and focusing on fewer geographies.

There is also an ongoing move among leading life insurance players away from traditional insurance products and towards more capital light, fee based products. The result of this has been an increase in willingness among traditional life insurers to explore options for their legacy portfolios, the goal being to de-risk portfolios, to free up capital, and to give management teams greater freedom as they make fundamental strategic decisions.

We expect to see continued interest from Asia-based buyers that have an ongoing focus to invest in the UK and Europe. Meanwhile, the pricing of intermediary deals which is returning to over 10 times EBITDA for the more attractive assets, particularly MGAs, is becoming attractive to sellers in that segment.

Consider M&A as the answer to growing challenges

At the same time, insurers face growing challenges from several existing problems, and they are likely to turn to M&A for the answer. Their triple financial problem remains, of having more money to look after, needing more investment to modernise and yet possessing less budget to do so. The greater mass awareness of consumers that they are 'under-saved' and coupled with various forms of compulsion, creates this pressure of having more cash to protect. Within the environment of low interest rates, expensive regulatory compliance, high consumer expectation and a dependence on multiple digital channels, there is simultaneously a requirement to spend on modernisation. But with the ever rising costs of legacy products and lower income from many modern lines of business, there is less money available for this investment.

The business implication of these challenges, throughout the industry, is that greater scale is needed to cover such transformation and to hedge against newer, low-margin activities - and the only real way to achieve this is with M&A. We will see mergers of large insurance incumbents and ever-modernising consolidators. Growing in this way is essential for insurers in retaining customers for longer, and continually expanding business for each client.

Making everything digital is also essential for all parts of insurers' activities, and those firms will turn to acquisitions of platform technology providers. Insurers equally need to be sure they are not being left behind when it comes to the use of the most cutting edge technology, including artificial intelligence, big data, and robotics.

This is increasingly resulting in focused acquisitions being made in these spaces. These purchases, investments or partnerships, while they can be important strategically, tend to be relatively small in deal value at present due to the "start-up" nature of many targets.

The effect of Brexit and Part VIIs

For M&A activity between insurers, while there is set to be a notable increase, it does not mean that a flood of completions can be expected this year. These processes take time to execute because of the sheer scale of the portfolios and in many cases the requirement of court approval through Part VII Transfers, which are sanctioned moves of policies from one company to another. Brexit and its potential regulatory ramifications are not proving to be major barriers to M&A activity in the insurance sector because the potential implications for group structures can be factored into deals that are in the process of being worked through. In addition, while the devaluation of sterling added to the cross-border attractiveness of UK firms, equity valuations already reflect the uplift in overseas earnings when converted back to the pound. We do not see much change to M&A volumes as a result.

However, Brexit has prompted a rise in group reorganisations within multinational insurance operations, looking to set themselves up with the most future-ready operational structure. That is resulting in a vastly increased demand being put upon the British courts for the Part VII Transfers required, and these processes can be complex - involving independent expert reports, and regulatory and policyholder notification. In the end, though, these complex processes will probably only lead to delays in the progress of deals rather than agreements being thwarted.

M&A in the new environment

The M&A data over the past half-decade tells the story of an insurance industry adjusting to and re-establishing norms. Solvency II went to the heart of the sector across Europe, and M&A volumes were dampened by the focus required from - and uncertainty caused by - the associated realignment and adjustment.

But with Solvency II now embedded, M&A activity is no longer being slowed by those factors and there is a greater degree of clarity about where sustainable profits are being made and how businesses should be structured. There will also continue to be myriad pressures on the profitability of insurers, not least the low interest rate environments we continue to see in the UK, Europe and beyond. But there are plenty of opportunities from new technology and fresh business lines, and M&A is certain to be an ever more important step for insurers readying themselves for the future.

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