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REINSURANCE: A USEFUL TOOL FOR M&A RUN-OFF TRANSACTIONS

The European run-off market is expected to continue to have very high activity levels once the Coronavirus crisis is over. Insurance companies are increasingly taking decisions to divest from non-core portfolios in view of Solvency II, IFRS 17 and other circumstances such as Brexit or, potentially also now, the impact of Coronavirus. At the same time, specialist (re)insurers and private equity players, through their (re)insurance platforms, are interested in these portfolios -particularly in the life sector. Reinsurance can prove to be a useful mechanism in getting these new transactions done.

Reinsurance provides an alternative in structuring insurance portfolio deals to the more obvious shares purchase agreement or asset deal transfer mechanisms. It can also be combined with such mechanisms for the reasons explained below.

Via reinsurance the insurer is ceding the economic risk associated with the target portfolio which it wishes to dispose from its own balance sheet to that of the reinsurer whilst it retains its full legal position as insurer vis-à-vis the policyholders.

There might be different advantages of relying on reinsurance in this context. By way of example:

- It adds flexibility to transactions when it comes to delimitation of their perimeter, as the parties can easily agree between themselves the scope of the insurance business which would be reinsured, with almost no constraints - a useful feature for transactions in some jurisdictions where the benefit of the regulatory portfolio transfer regime only applies to portfolios fulfilling certain requirements.
- It also reduces timings in completing deals, as entering into a reinsurance agreement is usually not subject to regulatory approvals. It is necessary though to check the position in each jurisdiction as different regulators have issued relevant guidelines in relation to reinsurance in run-off transactions, to ensure that they do have a chance to review the substantive transaction before it is entered into. Even in transactions structured as business and portfolio transfers, reinsurance could be useful in order to transfer the economic risk to the acquirer while the authorisation for the portfolio transfer is obtained.

- Reinsurance meeting certain conditions allows for a reduction in solvency capital requirements of the ceding entity – even providing liquidity in certain cases. In order for the reinsurance to be considered an effective risk mitigation technique according to Solvency II, it must fulfil the requirements of Commission Delegated Regulation 2015/35 and EIOPA guidelines 14/172 on basis risk or the relevant internal model requirements. A related important element of the reinsurance transaction would then be the collateral structure to be put in place to manage the reinsurer credit counterparty risk.
- It is also likely that any VAT issues which are often a hot topic for discussions on business and portfolio transfers would be more straightforward-as payments made out of a reinsurance agreement would not in principle be VAT chargeable.
- Reinsurance would usually be easier to implement than portfolio asset deals which in many jurisdictions would imply the need for third-party consents (other than from policyholders whose consent is not necessary according to the Solvency II portfolio transfer regulatory regime). This does not mean that due diligence can be dispensed with in reinsurance transactions. In fact it is crucial to identify risks associated with the business to be reinsured, such as eventual third-party consents on retention provisions, potential triggering of profit-sharing arrangements with policyholders, impact on the transaction of any cash matching adjustment being applied by the reinsured portfolio, and for the reinsurer to understand and be comfortable with how the cedant manages policy servicing and claims issues.

All in all, for these and other reasons, reinsurance definitely continues to be a mechanism to be taken into account when analysing how to structure M&A deals within the run-off sector.

CONTACTS

Jaime Sánchez
Counsel
Madrid
T: +34 91 590 7574
E: jaime.sanchez@cliffordchance.com

Juan Valcárcel
Abogado
Madrid
T: +34 91 590 9421
E: juan.valcarcel@cliffordchance.com

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