Brexit

Boom time for the non-life run-off sector?

Much has been written about the record size and number of deals in the non-life legacy market in recent years. Market participants and commentators alike are firmly of the view that the current growth trajectory in the legacy market is set to continue.

We believe that this sense of optimism is justified given that the key demand-side drivers are still very much in evidence but also because of additional supply-side opportunities that the market disruption caused by Brexit will generate.

Much of the recent buoyancy in the legacy market has been demand led - the sector continues to be a very attractive asset class in terms of the absolute and comparative levels of return and also from a diversification perspective. The progress that acquirers have made with regard to both the sophistication and simplification of their business models has further encouraged record investment in the sector.

From the supply-side perspective, the landscape is more mixed. While several large insurance groups have dedicated teams focused on proactive legacy management, they tend to be the exception and not the rule. In many cases, disposals of run-off portfolios are driven by a portfolio specific issue and in a relatively narrow number of lines of business. These deals are predominantly opportunistic in nature rather than being part of a wider strategic program of legacy management activities with Board level sponsorship. Solvency II was predicted to be a major supply-side driver of run-off deals. While we have seen some evidence of this, in our view the disruption caused by Brexit in the live market could generate significantly more opportunities for the run-off sector in the near term.

Use of Freedom of Establishment and Freedom of Services across Europe

Our analysis suggests over 300 UK insurers take advantage of FOE/FOS rules to underwrite in the EU; and more than 650 EU insurers have the equivalent permissions to underwrite UK risks.

The table overleaf summarises the number of EU carriers writing in the UK under FOE/FOS and the GWP by EU country. It clearly demonstrates that in certain EU countries, such as Germany, France, Ireland, Belgium and Luxembourg, there has been very significant use of FOE/FOS licenses to access the UK market, but even in some of the smaller EU countries, FOE/FOS activity in the UK is material.

Although the terms of the UK's withdrawal from the European Union ("EU") are yet to be finalised, it looks very likely that there will be a loss of passporting rights which will mean that UK insurers will be unable to access EU markets on Freedom of Establishment and/or Freedom of Services ("FOE/FOS") bases beyond 2020 (assuming transitional arrangements are granted and not extended). Many insurance and reinsurance groups with significant levels of Gross Written Premium ("GWP") in the UK and across the EU are already well advanced in their post-Brexit planning. In the case of a typical UK-domiciled insurer looking to secure access to the EU markets post-Brexit, it involves establishing and licensing a new carrier in their chosen jurisdiction in the EU (which may also include establishing a 'third country' authorised branch in the UK) from which new EU business will be written post (and, potentially pre) – Brexit.

EU domicile	Number of carriers	FOE & FOS licenses for UK	GWP £m	Average size: GWP/ FOE & FOS licenses (£m)
Germany	275	60	7,264	121
France	205	63	5,496	87
Ireland	170	131	2,755	12
Belgium	30	22	2,087	95
Luxembourg	153	55	729	13
Total Top 5	833	331	18,331	
Gibraltar	53	53	4,251	75
Other EU	616	282	1,195	4
Total	1,502	666	23,777	35

In most cases, it will also involve a transfer of the historic EU business (via a Part VII transfer), to the new EU carrier. In the case of a typical EU-based insurer, the level of restructuring is perhaps less onerous, but not without its own complications – establishing and obtaining authorisation for a third-country branch or subsidiary in the UK.

Why will Brexit generate more legacy deals?

The cost and disruption involved in restructuring the businesses means that those groups with far smaller (sub-scale) footprints in the EU (in the case of a UK-based insurer), or vice versa in the case of an EU-based insurer, may decide to exit these market(s) rather than undertake a full Brexit related restructuring.

Assessing the number of these potentially sub-scale portfolios is problematic given the availability of sufficiently granular data. However, the right hand column of the table above indicates there are a significant number of smaller UK portfolios. Within the top 5 domiciles, GWP underwritten by Irish and Luxembourg carriers in the UK, for example, were on average only £12-13 million per carrier. Outside of the top 5 domiciles, the average GWP per carrier was only £4 million.

The existence of sub-scale portfolios and businesses will create a number of 'stranded' portfolios in the UK. While the equivalent data in respect of the UK carriers using FOE/FOS to access EU markets is a little more difficult to analyse, it is undoubtedly the case that there will be a number of 'stranded' EU portfolios of UK-domiciled carriers.

In addition to the sub-scale nature of certain portfolios of business, there are a number of other reasons why Brexit is likely to generate additional market transactions.

- Planning for Brexit is forcing the larger (re) insurance groups to reassess the profitability of their markets and lines of business on a more granular level; this is likely to highlight underperformance and hasten disposal activities;
- Some insurers are keen not to be 'dual' regulated;
- Lack of clarity with regard both to transitional arrangements and the position post-Brexit. This may generate two drivers of future activity – both in terms of those groups without the desire to undertake a significant restructuring who assume a worst case scenario and seek 'early' disposals and, at the other end of the spectrum, those who assume everything will be ok and are continuing on a 'business as usual' basis and will have little time to restructure as Brexit approaches; and
- The increasingly long-tail nature of certain lines of business, often driven by lengthy legal processes, e.g. medical malpractice and motor. The longer the tail of the business, the more likely the potential 'back-book' issue will 'bite' post-Brexit.

What actions do the run-off acquirers need to undertake to take advantage of the opportunities?

There is no doubt that run-off buyers will need to be agile as it is likely that the portfolios that come to the market will be diverse in nature in terms of liability type, risk location and size. Many portfolios will still have some active business within them. We have seen increasing agility and flexibility from buyers in recent years and would fully expect them to deal with the variety in the portfolios and the unexpired risks contained within such portfolios.

In addition to the need for agility and flexibility, there are other practical steps that buyers will need to take in order to take advantage of these Brexit related opportunities:

- Establish dual platforms in the UK and EU, where they don't have them already. While the opportunities generated post-Brexit will be significant, buyers will need to be mindful of the implications of the dual platform on capital requirements (loss of diversification benefits may be critical here) and on their operations, understand and minimize any adverse tax consequences of the new structure and ensure proper governance, risk and compliance structures are in place across both entities.
- Work closely with the live market and regulators to try to reach a sensible landing on the potential 'dislocation' between historic EU risks being administered and managed by a UK business and vice versa without appropriate authorizations (the so called 'back book' issue). If a sensible agreement cannot be reached on this issue then run-off consolidators will need to prepare to split future acquisitions between their UK and EU constituent parts (potentially undertaking more than one transfer in respect of a given portfolio) and also establishing an authorised third country branch of their EU carrier, in addition to the UK platform.

Conclusion

Brexit is set to generate another significant boost to the already buoyant non-life run-off market. A supply-side boost that will, nevertheless, test existing buyers and new entrants as some of the opportunities will undoubtedly be different in nature, size and location to those which they have historically pursued.

Buyers should be alive now to the restructurings that they may need to undertake in order to take advantage of these opportunities while at the same time continuing to demonstrate the agility and flexibility that they have shown in recent years to meet seller demands.

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