



# The Role of the Actuary in M&A

Casualty Loss Reserve Seminar

**Bruce Fell, FCAS, MAAA, CFA**

**September 5, 2012**

**TOWERS WATSON** 

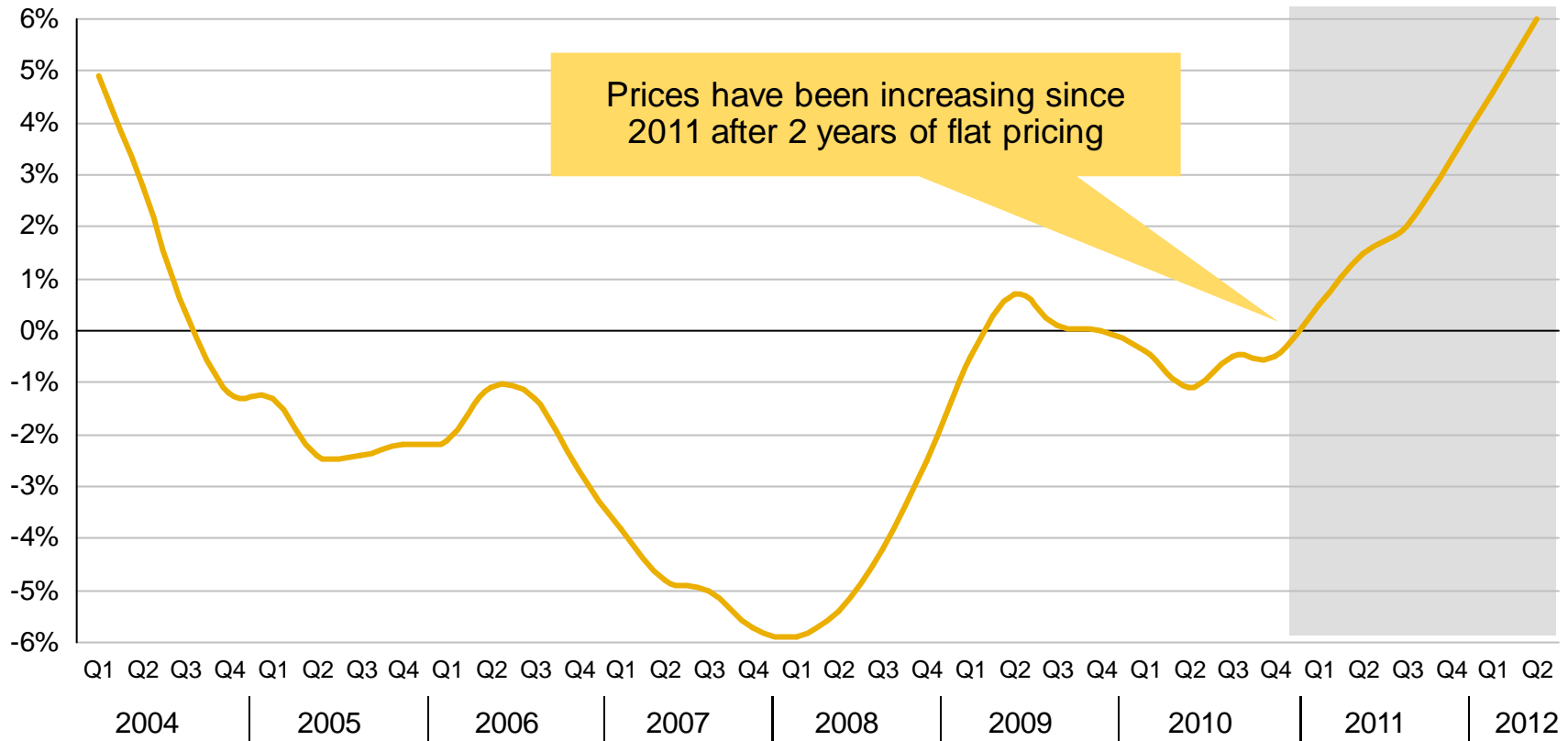
# U.S. P&C Insurance/Reinsurance Market Trends

## While pricing is beginning to improve, global catastrophes have made underwriting profitability an elusive goal, even in light of the benefit of continued loss reserve releases

- Towers Watson's CLIPs pricing survey indicates that commercial insurance prices have continued to rise
  - Aggregate increase of almost 6% during the second quarter of 2012
  - For the sixth straight quarter all standard commercial lines show an uptick in pricing
- Through 2011, the U.S. P&C insurance industry failed to generate an underwriting profit for the fourth year in a row (i.e., combined ratios above 100%)
- Global catastrophe losses drove earnings down in 2011 and marked the second costliest year for insured catastrophe losses
- P&C reserve releases continued throughout Q1 2012, but at a slower pace
  - Commercial lines reserve adequacy may be turning the corner
  - Personal lines retaining slight redundancies
- Although industry capital is strong, lower investment yields continue to challenge insurers

Since 2011, commercial lines pricing continues to exhibit positive rate movements, yet is just starting to reach the level of loss cost trends

YOY Price Level Change — All Commercial Lines Combined

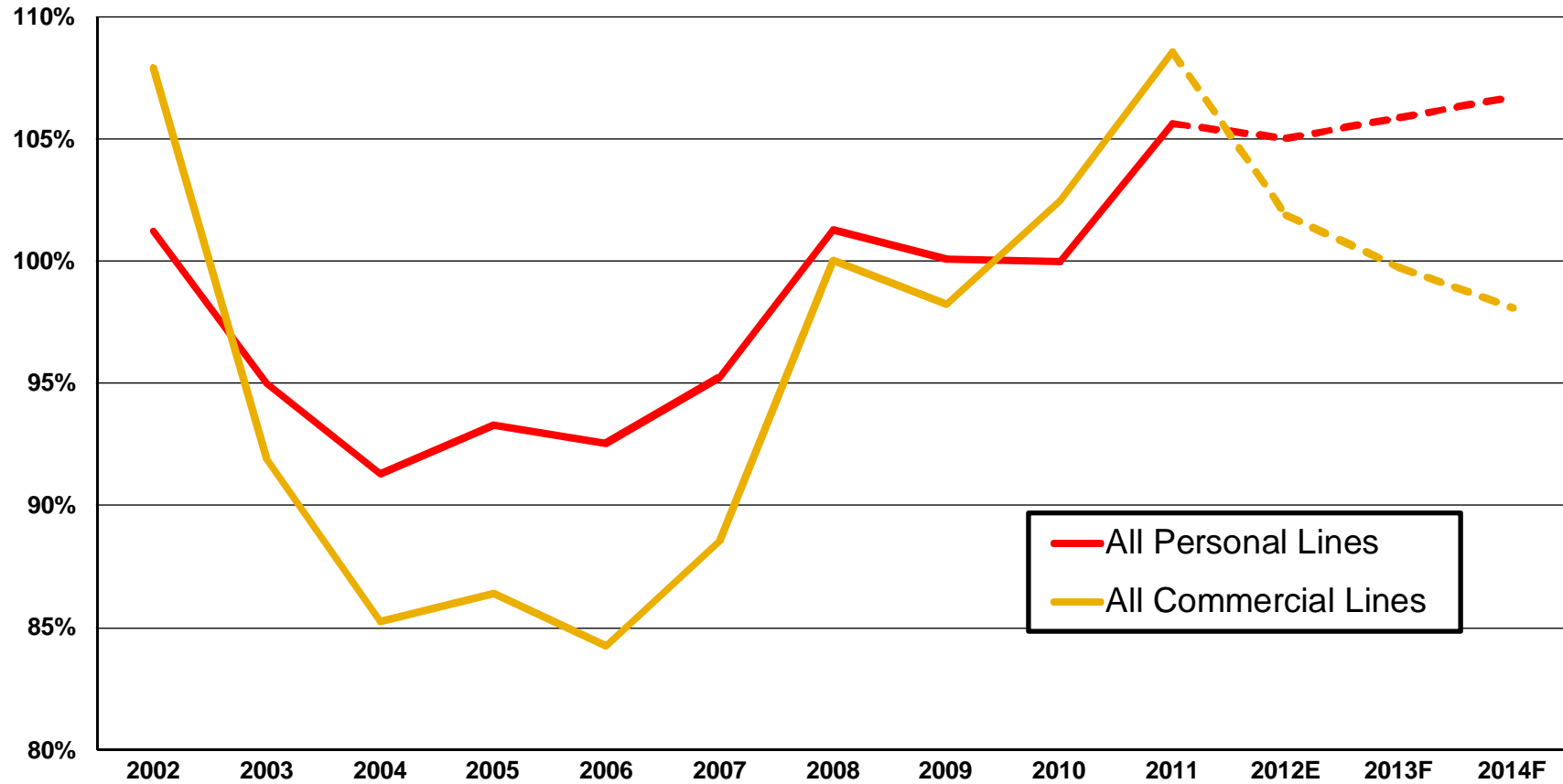


Note: Written premium basis.

Source: Towers Watson Commercial Lines Insurance Pricing Survey.

# U.S. P&C Industry failed to generate an underwriting profit for the fourth year in a row

## U.S. Industry accident year combined ratios

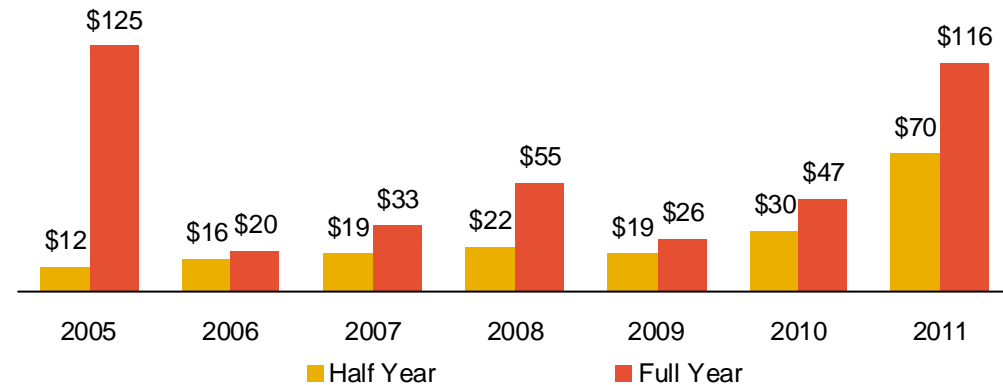


Source: Towers Watson.

## 2011 marked the highest year in insured earthquake losses and ranks as the second costliest year for insured cat losses

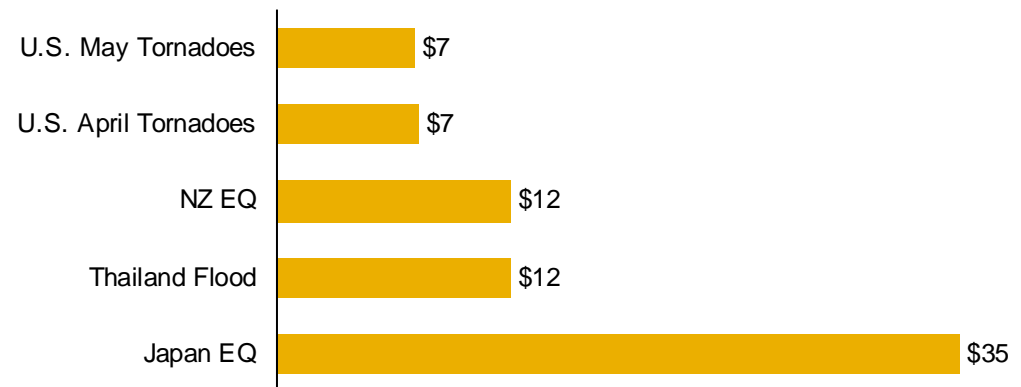
- Combined, 2010 and 2011 had over \$160 billion of global insured cat losses
- 2011 cat losses of \$116 billion far outpaced recent comparable periods
- Ongoing and material upward loss creep is likely due to reporting lags

Global Insured Cat Losses (\$ Billions)



Five Costliest Disasters in 2011 (\$ Billions)

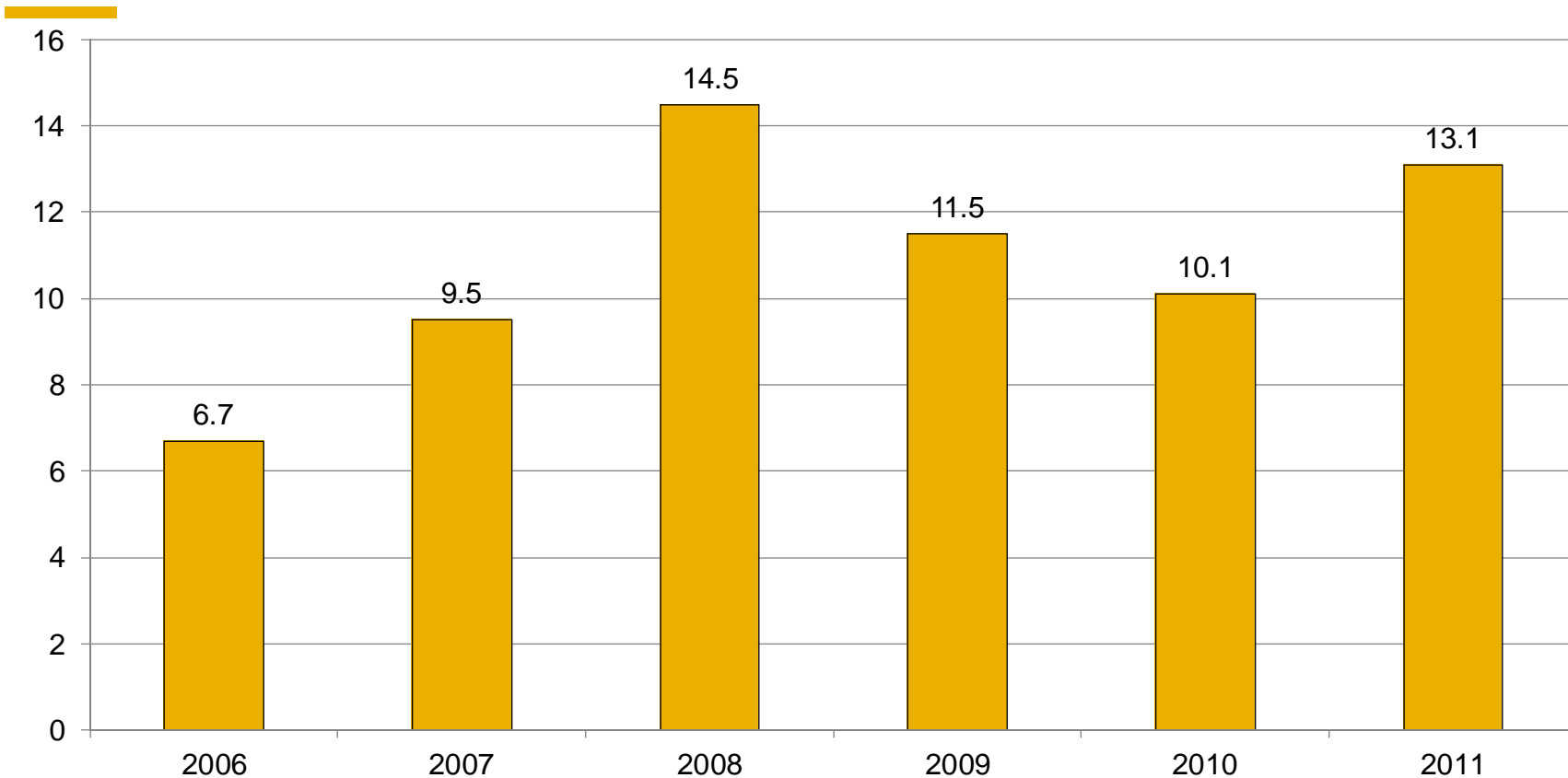
- Four of the top 15 most costly global cats have occurred in the past 12 months\*\*
- Both U.S. and non-U.S. cat events affected reinsurers, the retro market and blanket property insurance covers



\*\*\*Aggregated U.S. April and May Spring Storms.  
Sources: Swiss Re Sigma, PCS, Towers Watson.

## Reserve releases have increased during the most recent years of the soft market...\$58.7 billion in past five years

Reserve Releases (\$B)

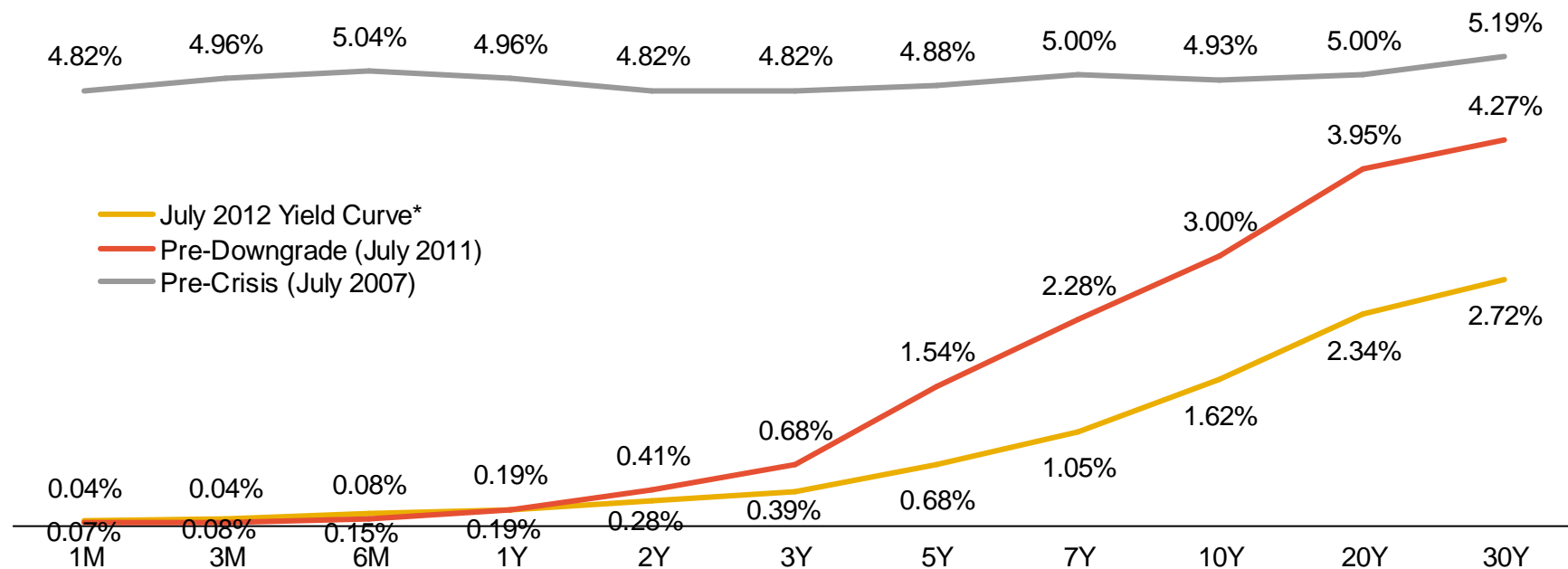


Source: SNL Financial (excluding Mortgage and Financial Guaranty lines)

## Declining investment yields and lingering soft market are changing the way insurers think about investments

- Few bonds with purchase yields above 4.5% remain on balance sheets
- Insurers have to accept a lower level of income support from investments or change their asset allocation

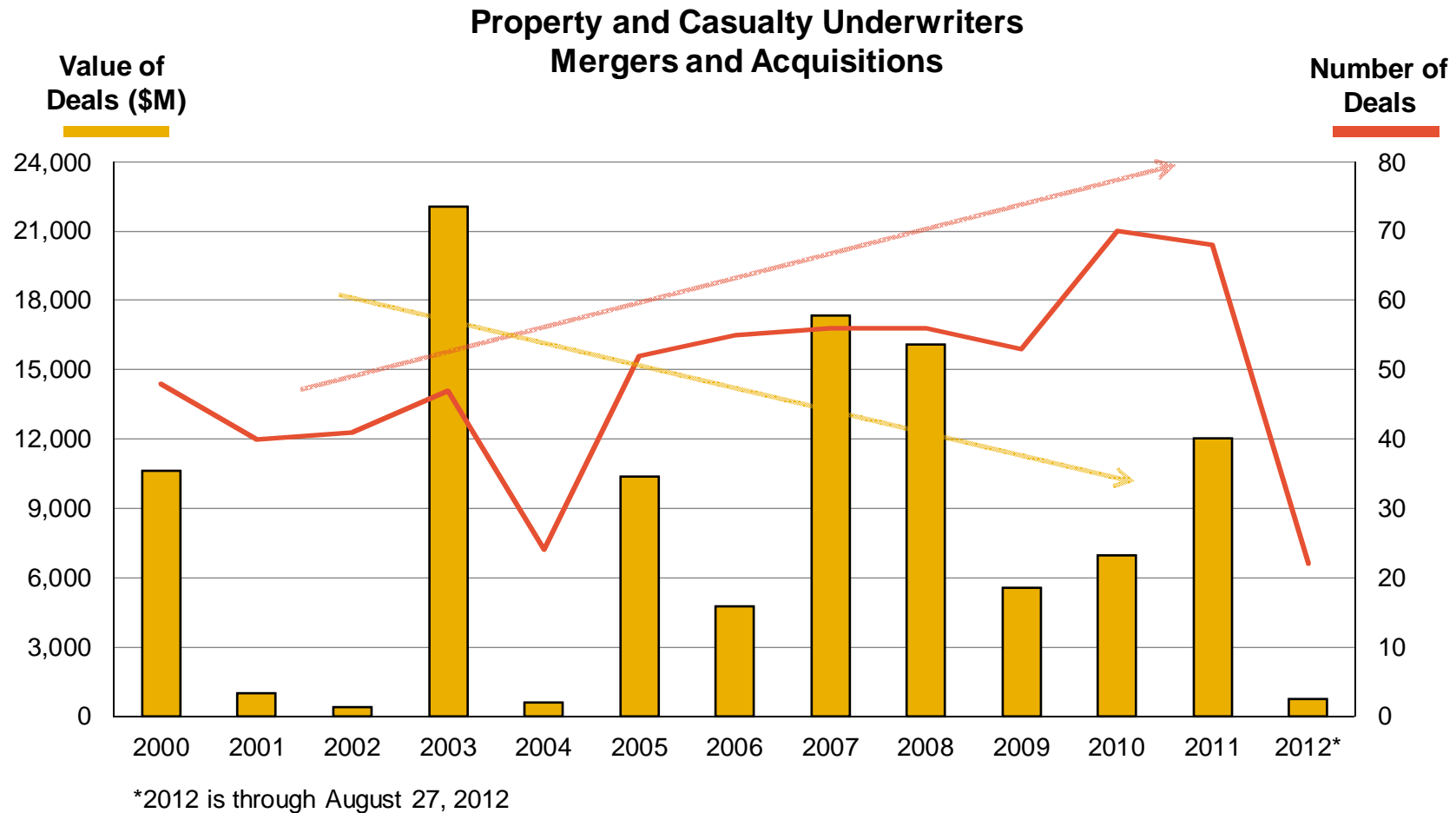
### U.S. Treasury Yield Curve Trends



\*July 5, 2012. Sources: Board of Governors of the United States Federal Reserve Bank, Insurance Info. Institute.



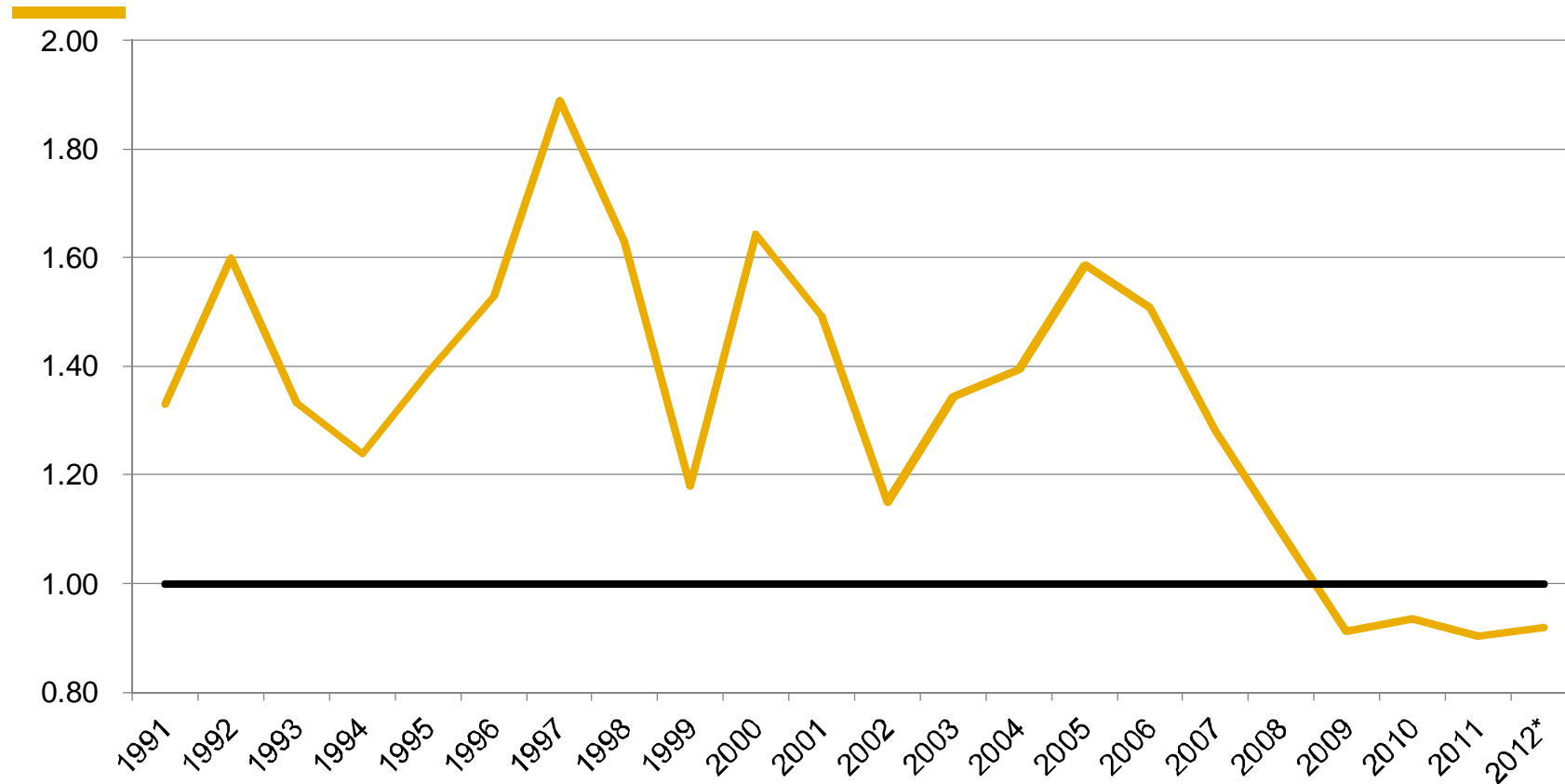
**While the number of mergers and acquisitions has increased since 2001, the value of the deals has decreased**



Source: SNL Financial, Towers Watson

Since 2008, market value has been below book value for the industry.

Price to Book Value



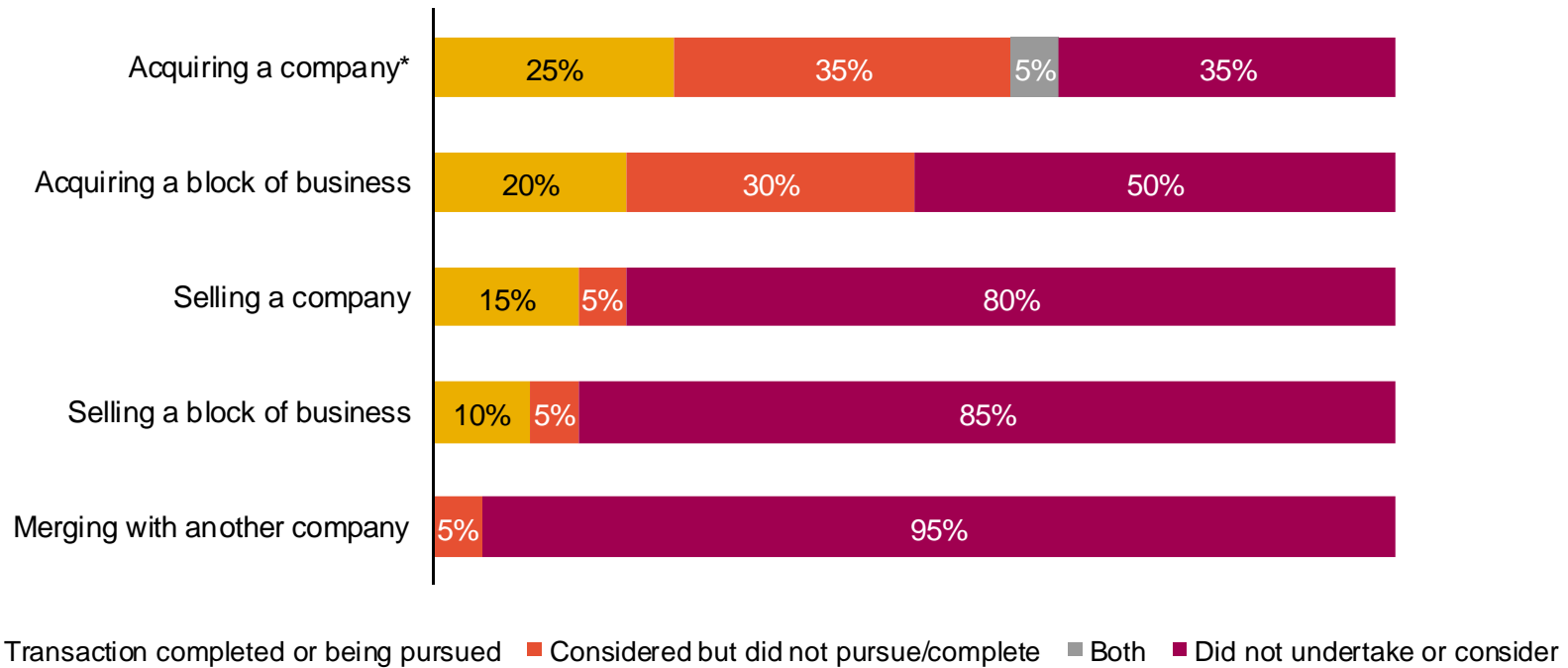
\*2nd Quarter 2012

Source: SNL Financial



# During the last 12 months, 30% of respondents acquired or pursued a company, while 20% acquired or pursued a block of business

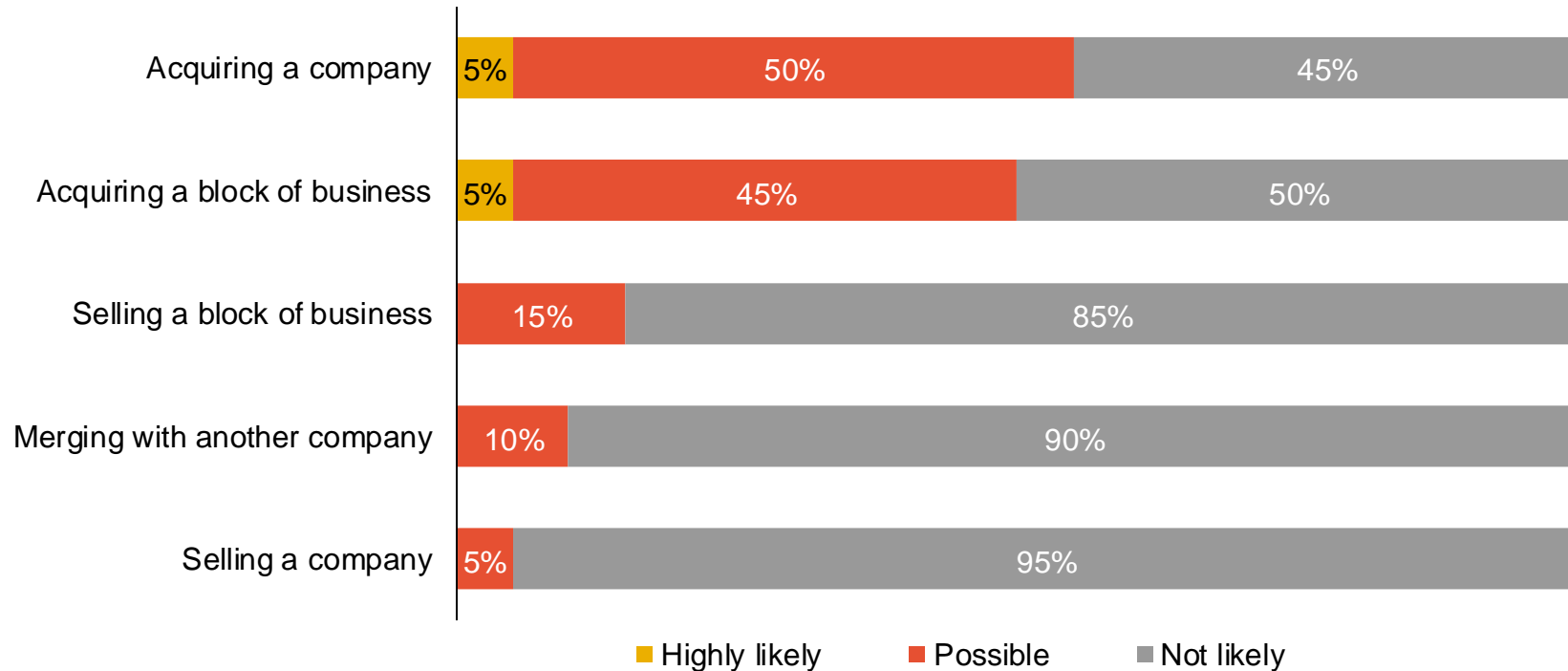
During the past 12 months, has your company undertaken or considered an M&A transaction?



Source: Towers Watson CFO Survey #2 – Fall 2011

**Further, at least half of respondents are considering acquiring either a company or block of business in the coming year; considerably fewer plan to sell or merge**

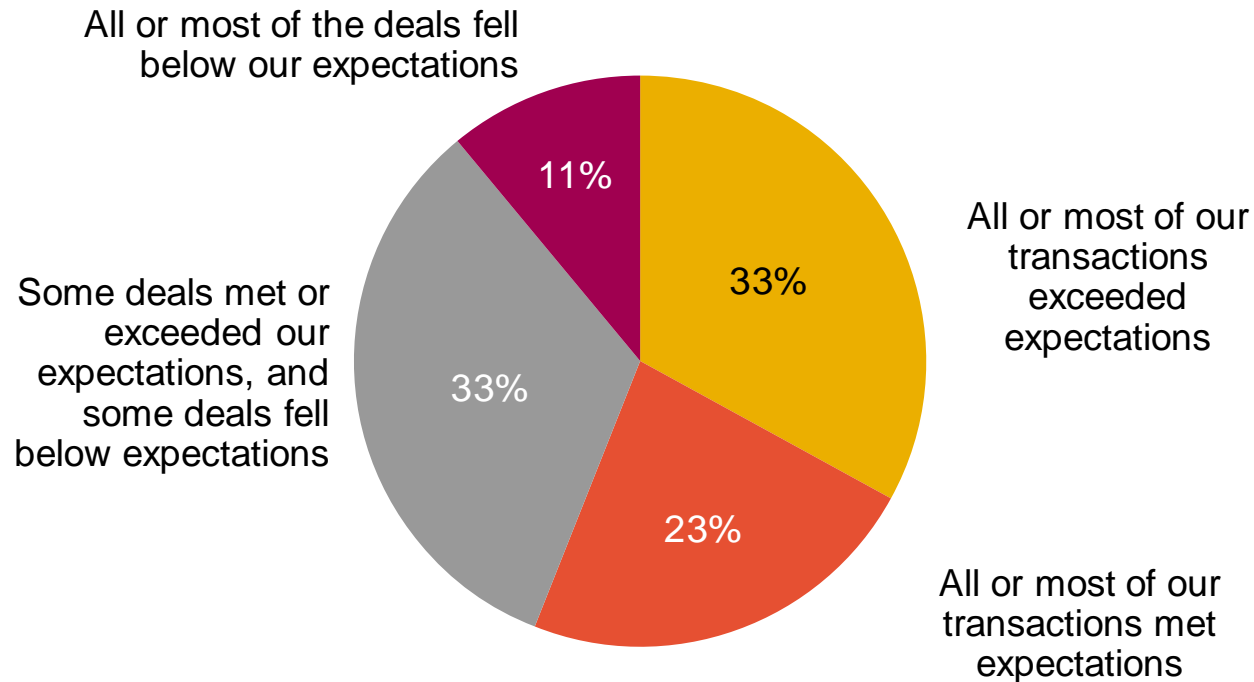
**Over the next 12 months, how likely is your company to undertake an M&A transaction?**



Source: Towers Watson CFO Survey #2 – Fall 2011

## Over half of respondents report that all or most recent M&A transactions met or exceeded expectations

**How would you rate the success of your company's M&A transactions during the last three to five years relative to expectations?**



Source: Towers Watson CFO Survey #2 – Fall 2011

## Key findings about overall deal activity in the marketplace...

- General CFO sentiment regarding deal activity is similar over both short- and medium-term horizons, with a majority expecting an increase
- Expanding into new markets and achieving economies of scale are the biggest factors influencing deal activity
- General economic uncertainty and capital constraints are the biggest concerns dampening deal activity
- Respondents consider actuarial advisors the most important for buy-side transactions, followed by legal and investment banking
- Investment bankers are rated most important for sell-side transactions, followed by legal and actuarial
- Over one third of respondents expect an increase in bidding wars/hostile takeover activity over the next 12 months

Source: Towers Watson CFO Survey #2 – Fall 2011

## Drivers of M&A activity depend upon the constituencies

- Customers
  - Bigger is better = +
  - Lots of choice is good = —
- Company Management
  - Supply/Demand imbalance (many voluntary buyers but few voluntary sellers) = —
- Insurance and Reinsurance Brokers
  - Smaller insurers give brokers more negotiating leverage = —
  - More insurers give brokers more choice = —
  - Bigger insurers provide clients with more security = +
- Rating Agencies
  - Bigger is better – more capital and diversified risk = +
- Company Owners/Investors
  - Bigger companies provide more stability = +
  - More insurers give investors the ability to diversify their holdings = —

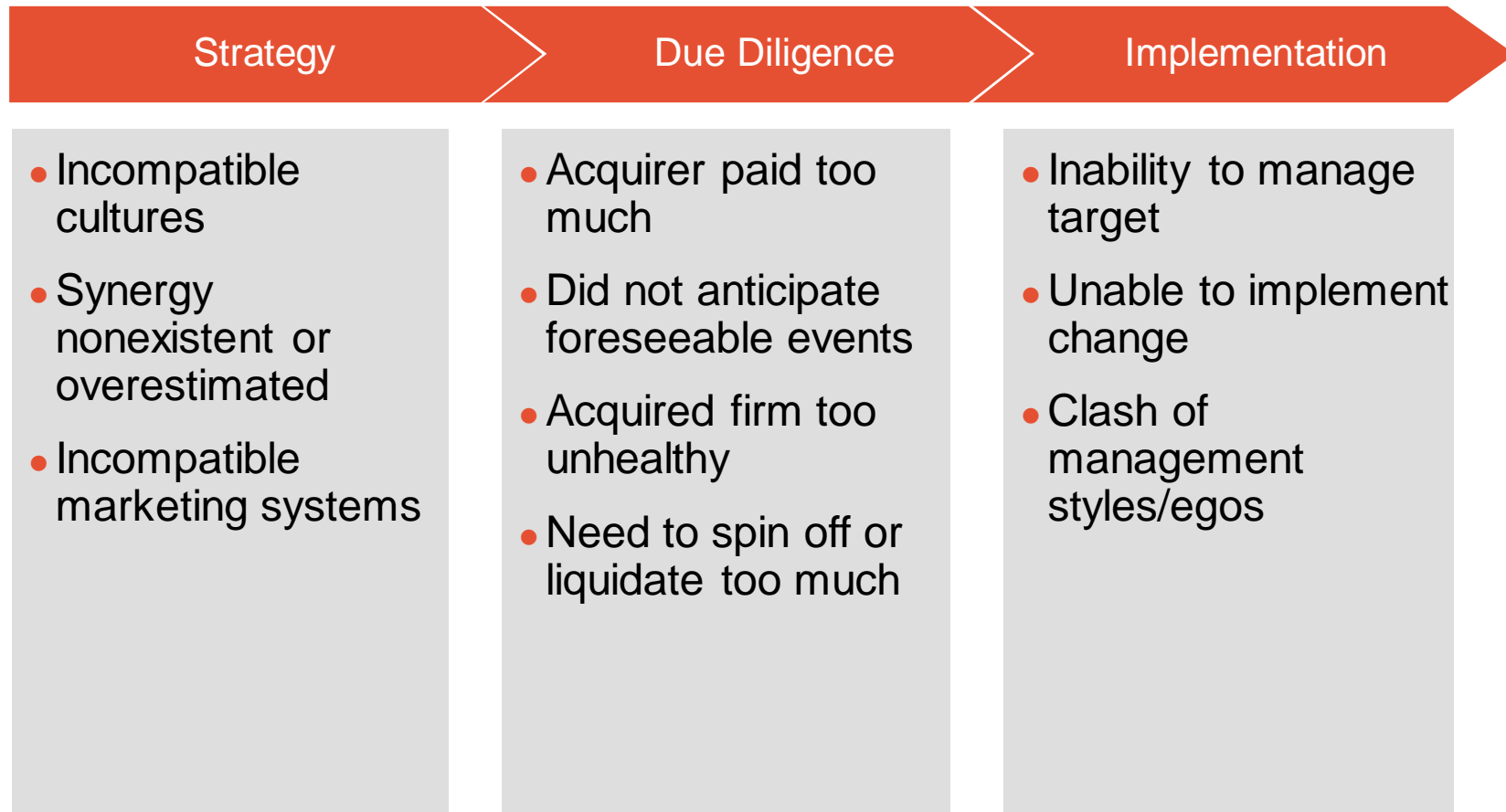
## We expect to see a sharp increase in M&A activity in the industry over the next few years

- Some of the key drivers (capital levels, stock valuations) may continue at current levels or even decrease before they increase
- Despite the past global catastrophic events and the continued economic volatility, we think companies will begin to look away from internal concerns and focus on M&A
- The key drivers of financial distress, consolidation, attractiveness of runoff deals, restructuring opportunities as well as the pent-up demand from private equity and other financial players still exists as capital is waiting to be deployed
- Regulatory changes around the world will impact activity in several different ways
  - In the short term, causing some companies to focus internally on capital management
  - For others and possibly over the longer term, acting as a driver of activity levels
    - As markets realign to the benefit of the most capital advantaged jurisdictions
    - As companies reassess the impact of the new capital requirements on group balance sheets and look to restructure or use M&A to manage or optimize the capital requirements of new solvency regulations
- Overall, willingness to buy and sell should increase as fire sale stigmas disappear, along with some realignment of valuation expectations

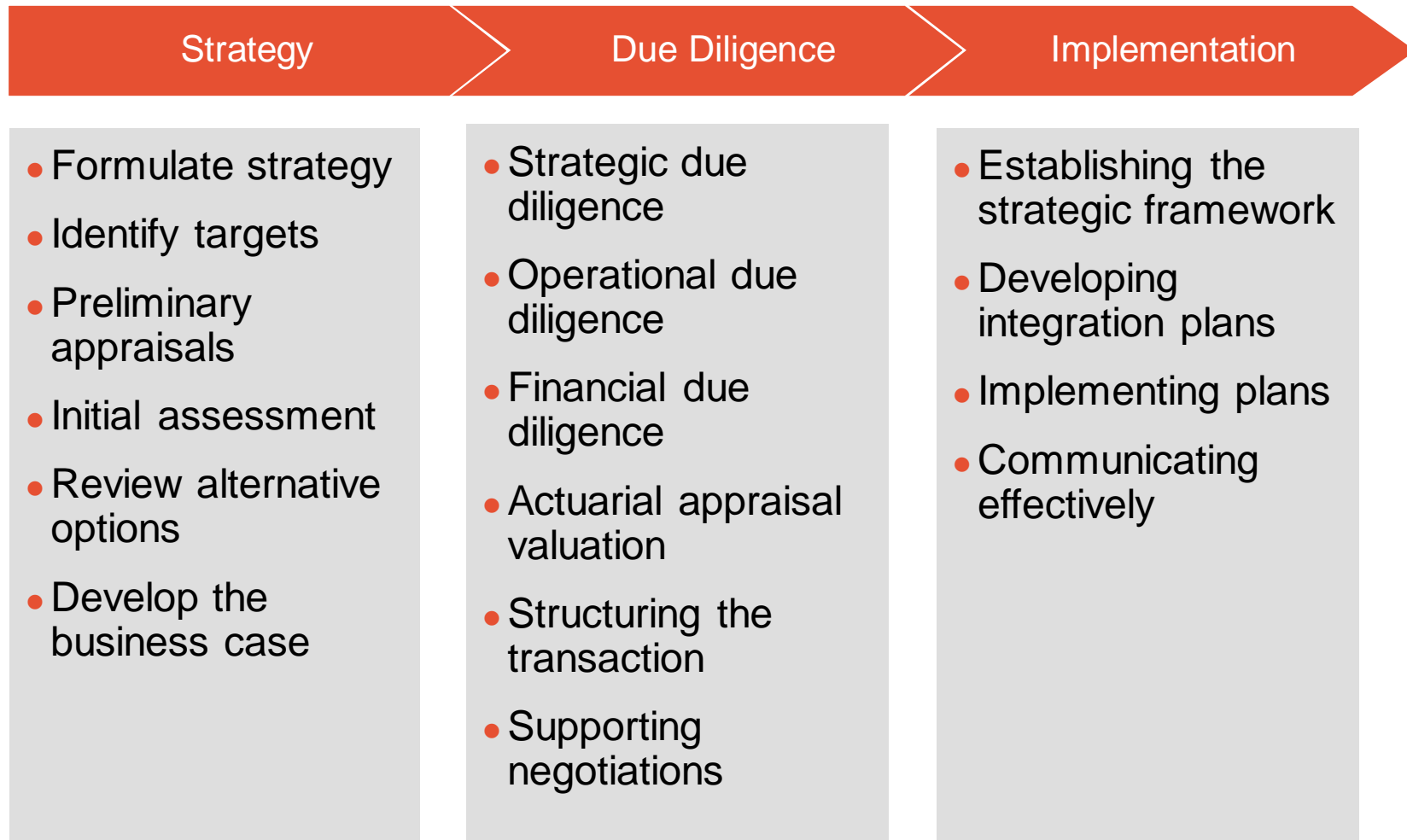


# The Role of the Consulting Actuary

## Unsuccessful transactions can be attributed to failures or omissions at key stages in the acquisition process



## Actuaries have a key role in many areas of the M&A process to ensure success



# Strategic evaluations require actuarial assistance with quantitative analysis

## Pre-Due Diligence

- Market scans for companies that meet the targeted criteria
- Preliminary financial projections and appraisals of potential targets
- Preliminary projections of combined new company

## Due Diligence

- Competitive market position of target company
  - Product offerings and specialization
  - Actuarial pricing/rating
- Sustainability of target company business results

## Many aspects of due diligence are critical



## Operational due diligence is all about getting behind the numbers

Are you getting what  
you pay for?

*or*

Is it all good news before you buy  
and bad news after?

### Areas to be Investigated

- Actuarial management, structure and personnel expertise
- Reserving process, methods and assumptions
- Rating/pricing procedures
- Management information system access and use
- Price-monitoring approaches
- Underwriting
- Claim handling
- Business distribution economics
- Expected profitability and results monitoring
- Capital management
- ERM capabilities
- Reinsurance structure analysis

## Financial due diligence will focus on analysis of the available financial information

Actuarial Valuation	Liabilities Review	Financial Management	Financial Projections
<ul style="list-style-type: none"><li>• Calculate/ review<ul style="list-style-type: none"><li>• Assumptions</li><li>• Methodology</li><li>• Accuracy of results</li></ul></li><li>• Sensitivity analysis</li></ul>	<ul style="list-style-type: none"><li>• Adequacy of claim/loss reserves</li><li>• Other loss sensitive assets and liabilities</li><li>• Hidden liabilities</li><li>• Claims exposures</li></ul>	<ul style="list-style-type: none"><li>• (Economic) capital requirements</li><li>• Asset/liability management</li><li>• Rating agency impacts</li><li>• Financial/actuarial controls</li><li>• Risk mitigation strategies</li></ul>	<ul style="list-style-type: none"><li>• Earnings re-statements<ul style="list-style-type: none"><li>• U.S. GAAP</li><li>• Other</li></ul></li><li>• Pro forma earnings projections</li><li>• Business plans</li></ul>

## Review of Liabilities

- Adequacy of the loss reserves (including latent exposures)
- Variability of loss reserves
- Adequacy of unearned premium reserves
- Reinsurance collectability
- Loss sensitive commissions and premiums
  - Direct and Assumed
  - Ceded



## Implementation Efforts

- Form A filings
  - The change in corporate structure associated with the acquisition of a U.S. company requires a Form A Filing with the appropriate insurance regulator for the target company's state of domicile
  - Regulatory approval is needed prior to closing
  - Completion of the Form A Filing will require the combined efforts of actuarial, legal and business management
- Rate filings
  - New product offerings or pricing schemes may be developed for the new combined entity
- Merging the various actuarial aspects of the new combined company

## Conclusions

- Actuary's role in M&A encompasses more than just the loss reserves
- Stay focused on the broader business issues and not just the technical actuarial ones
- Keep digging in to issues as they are identified. Often there is something more there.
- Don't forget to quantify the impact.