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NAVIGATING THE M&A LAND-SCAPE BETWEEN REINSURERS AND PRIMARY INSURERS

By Christian Reber and Ofir Eyal

Reinsurance is an industry under pressure. Rates are stuck at historically low levels, and they show no sign of rising substantially. In addition, a surplus of third-party capital is exerting downward pressure on prices and margins. The result is slow growth and modest returns that are probably unsustainable at current levels.

The industry's challenges do not end there. There are also a number of structural trends that are undermining performance:

- Reinsurance is fragmented, and many players are too small to shape their destiny.
- Third-party capital providers have become more established and sophisticated.
- Brokers are seeking a larger share of the value chain.
- Regulation requires more capital and adds complexity and cost.
- Digital technology and advanced analytics present an opportunity but also a strategic conundrum.
- High embedded costs and entrenched ways of working are constraining innovation.

Reinsurers will evolve amid these challenges in three distinct ways. First, the industry's *knowledge players,* Munich Re and Swiss Re, will continue to invest significantly more than others into insight and expertise—reinventing their franchises and positioning themselves in parts of the value chain traditionally occupied by primary insurers, supported by cutting-edge digital offerings. Second, *capacity players* will comprise the majority of the market, and in some areas offer value-added services to their clients. Finally, *local players* will continue to leverage their natural advantages in certain geographies.

The Growing Trend of Mergers Between Reinsurers and Insurers

These evolutionary strategies, however, may not always be enough. Given the tough commercial landscape, mergers and acquisitions can be an excellent way for reinsurers to move forward. (See Exhibit 1.) And M&A trends are shifting. In 2014 and 2015, there was a wave of intra-reinsurer deals, but today matches are more common between reinsurers and primary insurers.

The future will likely bring further consolidation. Reinsurers will be motivated to diversify and tap additional firepower to develop new risk pools, such as cyber and emerging markets. They will wish to invest, particularly in capabilities related to digital and data and analytics. They will also aim to strengthen their position in relation to brokers—and generally boost their presence in a market in which size does matter. Similarly, we are likely to see more purchases of reinsurance companies by primary players.

Diversification over Operational Synergies

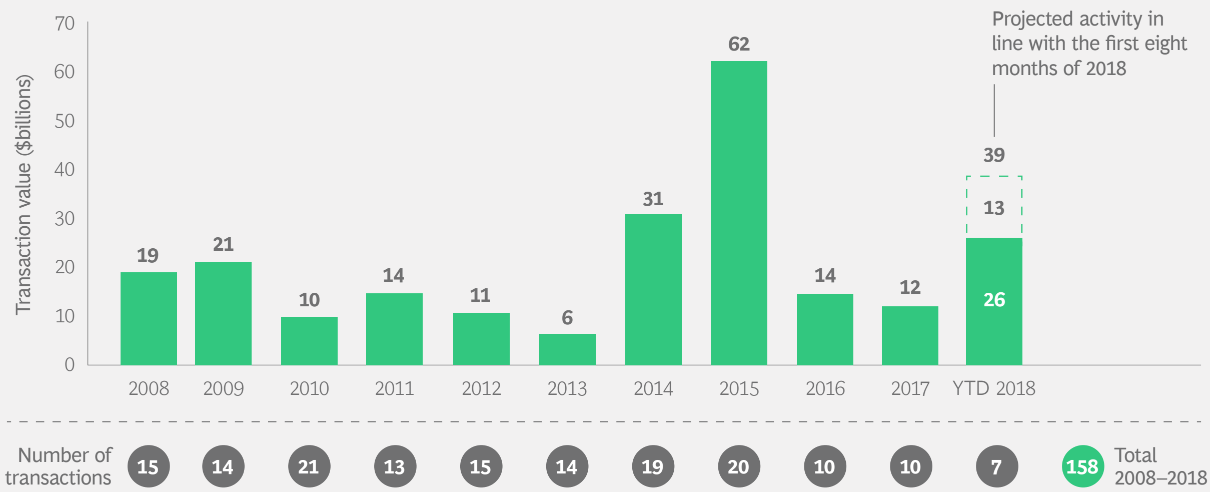
Marrying a primary insurer and a reinsurer is not trivial; although the businesses share some similarities, they are not the same. (See Exhibit 2.) Both use balance sheets to carry risk, administer contracts, pay claims, and manage capital. However, there are strong variations in underlying economics, business logic, and operating models. General (nonlife) reinsurance and personal lines are profoundly different, but there is significant overlap between life insurance and reinsurance. There is also an overall trend toward the blurring of lines between big-ticket commercial insurance and reinsurance, and we often see both sides competing for the same business—mostly through their facultative platforms.

Given the contrasts, M&A is complex, and expectations are sometimes not matched by reality. (See Exhibit 3.) There is no general rule as to whether the combination creates value for shareholders or is strategically beneficial. There is certainly potential to optimize capital exposures, unlock new sources of revenue, and benefit from diversification. But mergers in which reinsurers retain a high degree of business autonomy—amid process and cultural independence—are more likely to meet realistic expectations. Also, a delicate balance has to be struck when it comes to reinsurers moving into, or collaborating closely with, insurers, as cedants may well perceive this as direct competition that will cannibalize the core reinsurance activity.

Creating Value Through Reinsurance-Insurance M&A

Despite the challenges, a number of insurers and reinsurers live under one roof—

EXHIBIT 1 | Growing M&A in the Insurance Reinsurance Space



Source: BCG analysis.
Note: Includes deals between insurance and reinsurance players with transaction volume greater than $100 million.

EXHIBIT 2 | Primary Insurance Versus Reinsurance

PRIMARY	Primary insurance is B2C; customer acquisition, marketing, and channel management play an important role.	Processes in primary insurance are more standardized and industrialized.	Risk management and capital management tools are optimized to manage higher-frequency, lower-impact claims.	Claims are high frequency and tend to be of lower severity.
REINSURANCE	Reinsurance is B2B, focused on fewer larger and more complex transactions and with an emphasis on technical excellence.	Reinsurance processes tend to be more "high touch," often built to deliver customized solutions to clients.	Reinsurance typically covers the peak and tail ends of the risk curve, requiring different—and sometimes more advanced—risk and capital management.	Tails and peaks are periodic, but the impact is much larger.

Source: BCG analysis.

and have found success. Primary insurers have bought reinsurers and reinsurers have bought primary insurers. There is a sense that no company is absolved from the need for strategic breakout.

Hybrid players operating both as insurer and reinsurer—such as XL Catlin, Amlin, Beazley, AXIS, and Validus—have existed for decades in the London and Bermuda markets. Examples of primary insurers venturing into reinsurance for international diversification and growth include Talanx (comprising Gerling and HDI, both historically strong in commercial insurance) and Hannover Re (organically grown out of HDI, with a partial IPO later); Mapfre (primarily strong in personal lines) and Mapfre RE; and Mitsui Sumitomo and Amlin. Munich Re and Ergo is an example of a reinsurer venturing into primary insurance.

These deals are less designed to add scale to existing businesses than to meld complementary skill sets and realize joint benefits that may include:

- **Capital Optimization.** The combination of insurer and reinsurer balance sheets can help optimize exposures; natural catastrophe, longevity, and market risk, for example, are highly uncorrelated. It can also help companies build solvency capital and free up resources for expansion or other purposes.
- **Mitigation of Shifts in Earnings Pools.** Combined companies can more easily mitigate the impact of a shift in a particular source of premium, such as moves from automotive to cyber or renewable energy
- **Jointly Shaping Disruption.** Partners can work together to build innovative ecosystems, foray into new risk pools (such as cyber), or share investments in data—creating more advanced insights and offerings.
- **Negotiating Power with Brokers.** Combining a primary commercial book and a reinsurance platform to create a larger whole can be more powerful when it comes to negotiating with brokers.

There are also compelling drivers of M&A activity that are specific to each partner in the alliance. For reinsurers, the strategic rationale can include:

- **Getting out of the Line of Fire.** Diversification can help reinsurers

EXHIBIT 3 | The M&A Vision Does Not Always Match Reality

PRESUMED SOURCES OF VALUE CREATION	REALITY
Merging primary insurers and reinsurers will result in operational synergies.	There are very few operational synergies.
Reinsurers can leap into primary insurance with the help of an insurance affiliate.	There will be cases in which insurers will perceive a reinsurer's move into primary as direct competition, and adapt its reinsurance program.
Reinsurers know exactly how to manage primary insurers, and vice-versa.	Management teams often struggle to apply different management approaches, business philosophies, and success KPIs to two businesses within one group.
Merging primary insurers and reinsurers will allow the sharing of market insight from which primary insurers can build new businesses.	The value of these insights is often overestimated, as the data sets reinsurers hold are typically neither sufficiently comprehensive nor granular to allow an insurer to build a business.

Source: BCG analysis.

offset weak ROE performance in the core reinsurance business.

- **Expanding Access to Risk.** Reinsurers may feel they have a bird's eye view of the market, but they are likely to gain even more insight working directly with an acquired subsidiary—particularly if the subsidiary is a primary insurer.

- **Dampening Volatility and Increasing Financial Stamina.** Primary insurance brings inherent stability through a steady flow of premiums and steady performance.

- **Learning from Primary Insurers.** Reinsurers may increase their knowledge of ecosystem management, distribution, underwriting, and digital customer journeys—helping them differentiate and capture new sources of value.

And reinsurers can offer primary insurers advice on new risk pools and solutions; a reinsurance backing, allowing them to take bigger risks; and access to investment assets.

Winning with M&A

A well-structured offer can be the catalyst for a successful merger between reinsurers and primary insurers. Success may be defined as a combined business that has a well-diversified portfolio of risks and activities and a stable earnings position, which can help optimize capital management. Promising tie-ups also create capabilities for developing the business over time.

The key to getting there is to align expectations on the attainable benefits and to avoid the many pitfalls. Primary insurers and their boards should be prepared for the increased volatility that is part and parcel of reinsurance. Reinsurers, on the other hand, should not underestimate the more radical pace of disruption in their industry. The key to their future lies in more honestly scrutinizing their own position (and their ability to shape their destiny) and to decisively make changes to become a sustainable and thriving business.

In any event, change is afoot. Forward-looking reinsurers are acting already—determined to take advantage of the opportunities offered by an evolving marketplace. In the process, many are naturally moving a step closer to their primary cousins.

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