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M&A Insurance:
Demand and product mature as market and claims volatility accelerate

Corporate life moves at an ever increasing clip; the protections that firms put in place to protect themselves need to keep pace. This is especially so when executing an M&A transaction. There are clear signals that Warranty & Indemnity (W&I) insurance is proving a key deal ally with demand rising steadily over the last 3-5 years.

Global merger and acquisition activity is tipped by JP Morgan to remain robust through 2017 after $US3.9 trillion worth of deals in 2016. However the firm has identified rising uncertainty and volatility as significant features of the international M&A landscape.

Against this backdrop it is clear that no matter the calibre of due diligence conducted ahead of an M&A transaction, there is residual risk that requires careful management, particularly in cross border transactions. Consequently buyers and sellers have come to rely increasingly on well-crafted and robust W&I insurance and other types of transactional insurance solutions to provide protection should the representations and warranties made in purchase agreements prove to be inaccurate or indemnities triggered.

There are signs that savvy buyers are increasingly viewing this form of protection less as “sleep at night insurance” only to be exercised in the case of catastrophe or disaster with large policy limits and high deductibles, but instead are looking to insurance as a crucial tool to de-risk transactions.

Elissa Etheridge, head of M&A insurance at Aon Australia, says “Whilst W&I insurance is maturing globally to reflect the complexities of dealmaking, Australia and New Zealand remain at the forefront, being viewed as two of the world’s most mature W&I markets. This parlays into some of the most competitive premiums, extensive scope of coverage and sophisticated policy structures.”

But there is always scope for improvement – both in terms of negotiating effective protection and successfully navigating the claims process. A more mature understanding of W&I insurance has shifted the dial on discussions about coverage. Rather than focusing purely on coverage and costs, forward thinking deal makers and advisers are exploring how claims work and how they are paid.

Claims frequency increases

In its second global study of W&I claims, insurer AIG has confirmed the maturing of the sector and credibility of the insurance product. At the same time it has identified a marked increase in claims. For larger deals valued at $US1 billion and above, claims frequency is now running at 23 per cent with claim rates for deals sub $US1 Billion running at 17-18 per cent.

Once the domain of mid-market deals, Aon has seen the demand for W&I escalate on larger transactions, acting as the risk adviser on a series of $US1+ billion insured deals over recent years. With many of these deals taking place in recent years, the unfolding claims environment will face continued scrutiny.

Interestingly, Australia is equally as litigious as the US market when it comes to claims frequency on W&I insurance policies – reinforcing the need for W&I policy structure to be well designed from the outset, and any claims to be handled expertly.

Loss triggers identified

AIG’s analysis of W&I breaches worldwide notes that 20 per cent of cases relate to a financial statement breach, including accounting rule breaches, mis-statements of accounts receivable/payable and inventory, undisclosed liabilities and overstatement of cash holdings or profit. A further 15 per cent stem from regulatory compliance issues, and 14 per cent from both tax and material contracts.

Aon's experience when it comes to ANZ claims types broadly tracks with AIG's international findings. Etheridge notes, "Locally the most common warranty breaches resulting in claims involve breaches of tax and financial statement warranties, followed by breaches of material contract warranties and compliance warranties." This serves to reinforce the requirement for robust due diligence on all these issues – but also the value in having reliable W&I as an important line of defence and support in situations where the pre-deal promise exceeds reality.

AIG's analysis reveals that half of all notifications to the insurer are received in the first 12 months, with the first six month period being the busiest. Aon's deep local experience with W&I across ANZ confirms that the first six month window when the buyer first takes control sees a higher volume of claims, and then following the initial annual audit,12 to 18 months later, there is another claims peak.

Mature approach reins in risk

The focus on W&I policies responding to claims comes at a time when Australian and New Zealand assets are in demand and hotly contested, increasingly by inbound Asian investors.

There is also an increasing trend for sellers to demand "stapled" W&I insurance as a requirement for the buyer, with the seller structuring the W&I insurance on behalf of all bidders. This is increasingly common in large, competitive auction transactions in order to streamline the process-- in the last 12 months Aon has witnessed a 30 per cent rise in the number of transactions that originated as seller mandated W&I processes.

In Aon's experience buyers, both private equity and trade buyers are increasingly seeking lower deductibles for additional premiums and extended coverage – reinforcing the shift from a pure catastrophe focus for W&I towards viewing it as a tool to help de-risk transactions.
Over the last two years, Aon's deal statistics have shown there has also been a shift in insured amounts. Previously in $US1 billion plus deals insured limits ranged from 15-25 per cent of the total deal value. Over the last two years this has adjusted to 10- 15 per cent of the total deal value. Aon's data also shows that Buyers are increasingly exploring aggressive 'tipping' deductible options rather than a fixed higher set deductible, 24 months to three year policy terms instead of 12 to 18 months for operational warranties and as low a per claim threshold as possible.

Broader selection, smarter choices

The choice of W&I insurers is improving across the entire ANZ market. The number of insurers writing W&I for Australian and NZ deals on a first loss or primary basis has increased by at least a third in the last two years and the excess market has matured significantly with the number of available excess insurers doubling as insurers once focused on the US and Europe are now exploring opportunities in this region.

Given the breadth of the market, the rising sophistication of policies, and the fluid claims market, there is an enhanced need for both buyers and sellers to seek out expert support to not only deliver the most effective structure and coverage but also to ensure claims performance.

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