MILLIMAN REPORT

Profit-sharing of runoff providers

Effects of M&A and portfolio migrations on profits of runoff providers

February 2025

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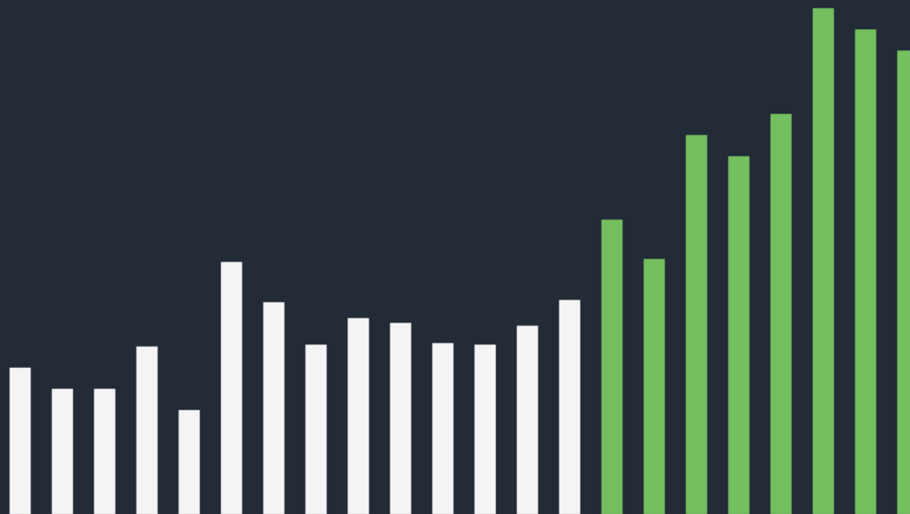

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Introduction

A current hot topic in the life insurance industry is runoff insurance portfolios. These portfolios consist of insurance policies that are closed to new business, allowing for more efficient management. This efficiency can potentially lead to savings in administration costs for the insurer and, in certain regions or under specific conditions, for the policyholders as well. Runoff portfolios can be managed internally by segregating them from active portfolios or they can be sold to external insurers. An insurance provider that exclusively acquires and manages these portfolios is known as a runoff insurance company.

The sale and acquisition of portfolios in runoff is gaining more attention in many large insurance markets, including the US. However, the particulars of who purchases these portfolios can vary. In Germany, it is uncommon for an active insurance company to acquire a runoff portfolio, while this practice is more prevalent in the UK, where runoff companies often continue to write new business alongside managing closed runoff blocks.

Over the past several decades, the acceleration of globalisation, rapid market fluctuations and advancements in risk calculation have underscored the benefits of consolidating risk and streamlining portfolio management. This has led to significant growth in the runoff specialist market. In Germany alone, numerous runoff specialists have emerged since the early 21st century, becoming an increasingly significant presence in the life insurance sector. By consolidating the risks associated with older policies, updating outdated actuarial calculations and reducing administration costs, these specialists can achieve economic success with runoff portfolios where some active insurers may struggle. Additionally, the reduction in costs associated with developing, marketing and processing new products further enhances their profitability. In the UK, the acquisition of closed portfolios is viewed as a key growth strategy and, in 2021, runoff insurers held a 4% market share of the German life insurance market.

Mergers and acquisitions (M&A) are crucial for the growth of runoff specialists. Many of these companies start with the merger of one or more providers that have recently closed their books, followed by further acquisitions of portfolios through additional mergers or by purchasing portfolios from insurers looking to offload older policies. Because all growth for a runoff specialist derives from M&A, this creates unique opportunities for analysis. The absence of new business simplifies the determination of cause and effect from M&A activities, making it an interesting area of study.

Executive Summary

Before any merger or acquisition can be finalised, it must receive approval from the relevant financial authority.[1] These authorities assess the solvency of the acquiring company and examine various factors such as company history, structure and ownership to ensure the security of the policies acquired.

Several factors enable a runoff insurer to increase profits on closed-book portfolios: consolidating risk, improving actuarial assumptions due to more available experiential data for analysis and reducing administration costs. Once a merger or acquisition is completed, migrating the policies to the new provider's administration system is the final major step to realise expected profit increases through improved calculations and reduced costs. Depending on the complexity of the administration system, which is influenced by local regulations and trends, the migration process can take anywhere from approximately one to five years. Therefore, one would expect to see a noticeable decrease in costs in the financial records of runoff providers once the migration is completed.

However, for pure runoff platforms—insurance companies that do not write new business—there can be a conflict of interest when it comes to sharing those profits. Without the incentive to attract new business, the benefits of increasing profit-sharing from these savings are less apparent. In such cases, maintaining a reputation for good customer service becomes a secondary concern. Active insurance companies may be reluctant to sell closed books to a runoff specialist if it results in negative public relations, which can hurt sales or cause concerned clients to cancel or transfer policies before they can be sold or reinsured. Additionally, maintaining a strong profit-sharing margin is favourable when financial authorities evaluate runoff companies for acquisitions. Consequently, while a merger or acquisition of a runoff provider or portfolio should theoretically lead to increased profits through cost reductions and other anticipated factors, it is not necessarily clear whether these increased margins will be passed down to policyholders.

In this study, we analyse the time series of various financial, policy and profit-sharing metrics of runoff portfolios from before their sale or acquisition through the migration of the policies to a new administration system. Our goal is to determine whether there is a connection between the migration of policies and changes in the amount distributed to profit-sharing policies. If such a connection is identified, it would indicate stronger-than-expected indirect incentives for runoff providers, given there is no new business to drive with the offer of higher profit-sharing.

For Germany, the measures observed in this study include the cancellation rate, closing cost rate and administration cost rate (or, where necessary, the operating cost rate, which considers both closing and administrative costs), the running average interest rate and the net interest rate. Because these measures are not publicly available in the UK or Italy, we can only provide a more general impression for those countries.

1. In the case of the UK, the insurance regulators do not approve the transfer; they will raise their objection in Court, and otherwise confirm they have no objection to the transfer if the Court is minded granting its approval. The one exception is a transfer of business between friendly societies (a small part of the insurance industry), which only requires regulatory approval.

1. German life insurance

1.1 INTRODUCTION TO PROFIT-SHARING IN GERMANY

The interest rates, biometric assumptions and costs used in the premium or reserve calculation of life insurance contracts are chosen conservatively and therefore usually differ from actual experience or from long-term observations of interest, mortality and costs. At the end of each fiscal year, after the payout of all benefits and costs and after determining the required provision for technical reserves, either a profit or a loss for the insurance company, known as the gross surplus, arises. Corresponding to the three bases of calculation, three main sources of profit can be identified, namely investment gains, mortality or general risk gains and other gains, which include all other types but mostly refers to expense-related cost gains.

The profits earned by the insurance company are primarily based on cautious calculation and a significant portion is generated from the premiums paid by the customers. Consequently, the policyholders participate in the company's profit by receiving a refund of a certain portion of the premium. This premium refund is called surplus participation or profit-sharing. The amount of surplus participation is usually expressed in percentages that relate to certain reference values. The annual process of determining these surplus rates is called declaration and is carried out before the end of the fiscal year based on the (expected) company results. The results are also published. However, the declaration only applies to the following fiscal year, in which the surpluses are then allocated and credited.

The participation of policyholders in the company's profits is legally anchored in section 153 VVG (the German Insurance Contract Act). Unless explicitly and entirely excluded in the policy, policyholders are entitled to participate in the (gross) surplus (and valuation reserves). For the implementation of surplus participation, the legislation requires a cause-oriented or otherwise appropriate procedure.

For this purpose, similar contracts, i.e., contracts similar in terms of capital equipment, risk-bearing and cost structure, are grouped as homogeneously as possible. The Versicherungsberichterstattungs-Verordnung (BerVersV), the German Insurance Reporting Regulation, specifies which groups of contracts need to be formed. Accordingly, individual and collective insurances are distinguished from each other, as well as different product types such as capital or term life insurances, pension insurances, occupational and disability insurances and unit-linked insurances. These divisions can be refined by forming additional subgroups. For each portfolio, the surplus must be determined separately and distributed within it, so that cross-subsidisation between them is excluded.

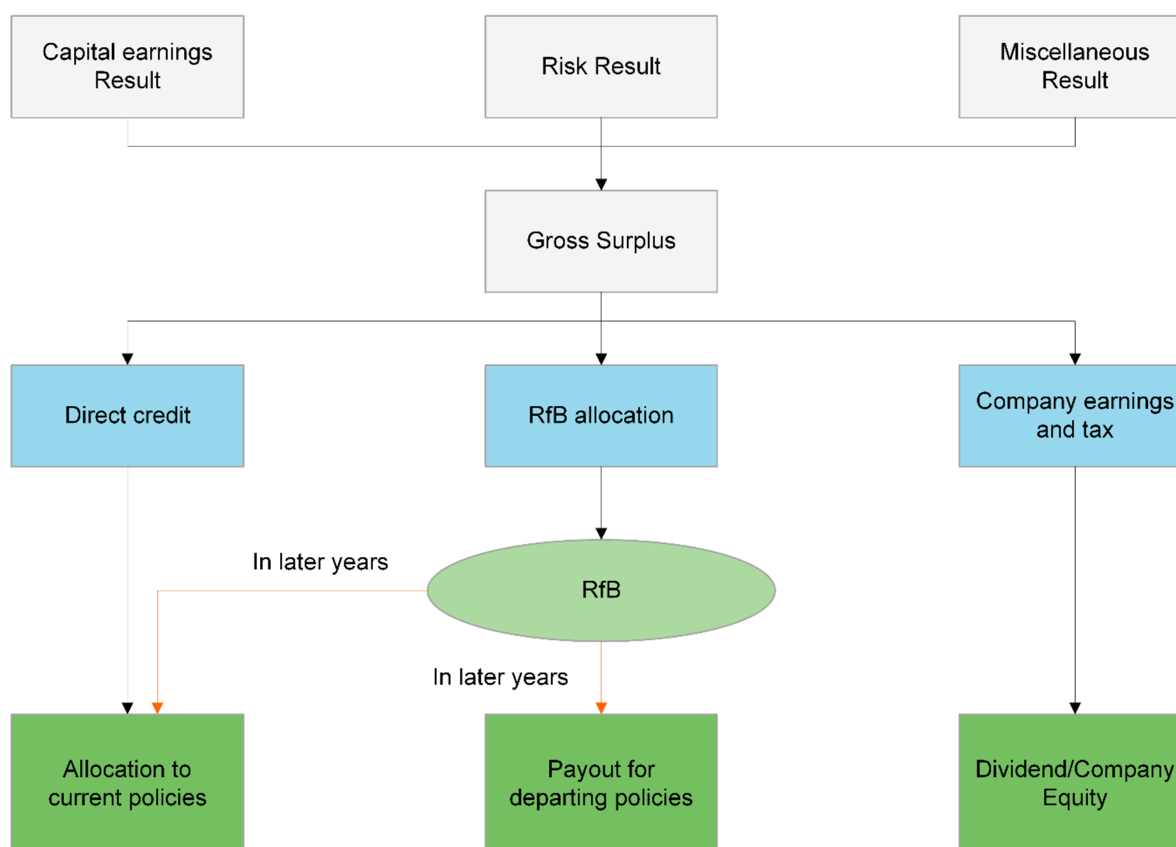
The surplus participation takes place, according to section 139 VAG (the German Insurance Supervision Act), in two ways. A part of the amount designated for surplus participation is directly allocated to the contract; this process is therefore also called direct credit (German: *Direktgutschrift*). The remaining, most predominant part of the surplus is allocated to the provision for premium refund (German: *Rückstellung für Beitragsrückerstattung* [RfB]).

Section 140 VAG regulates specifics regarding the RfB, including that the amounts contained in this balance sheet item may only be used for the surplus participation of the insured. With the approval of the supervisory authority, surplus shares from the RfB that have not yet been determined can also be used otherwise, e.g., to avert an impending emergency or to finance a necessary increase in the provision for premium reserves.

Section 140 VAG also defines the appropriateness of the surplus participation. Accordingly, on the one hand, the allocation to the RfB must meet certain minimum limits—taking into account the actuarial interest and the direct credit. On the other hand, the funds contained in the RfB must also be used or may not be accumulated indefinitely or in an unlimited way; more precisely, the unallocated funds of the RfB must not exceed a specified maximum limit. Starting from the gross surplus with the three result sources of investment, risk and miscellaneous, both the insured and the shareholders participate in the economic success of the insurance company. The insured benefit from the surpluses to be distributed both as a direct credit and through an allocation to the RfB. The remaining part of the gross surplus is either distributed to the shareholders in the form of a dividend payment or used to increase the insurance company's equity.

The diagram in Figure 1 shows a schematic representation of surplus participation.

FIGURE 1: SURPLUS PARTICIPATION



In the case of surplus participation as a direct credit, a part of the current surpluses is credited directly to the insured, i.e., without any time delay, still in the same year; the remaining part is allocated to the RfB and distributed to the policyholders at a later date. The decision on how much is granted as a direct credit and how much is allocated to the RfB is up to the insurance company and can vary from year to year. Because the direct credit is charged directly to the fiscal year in which the distribution occurs, the decision on the distribution ratio is primarily based on the business result to be achieved in the respective year. The RfB is a construct specific to German life insurance. One can think of the RfB as a buffer, with the main intention to enable a stable surplus declaration, which is important in the eyes of current and potential customers. This is because annual fluctuations in business results generally lead to fluctuating surplus declarations. In years when a higher surplus participation occurs, the amounts allocated to the RfB can be set aside to some extent for worse times. Thus, the RfB has a smoothing effect on the granted surplus participation. The minimum surpluses allocated to the RfB are regulated in the "Regulation on the minimum premium refund in life insurance," also referred to as the minimum allocation regulation (MindZV). The minimum allocation to the RfB for surplus-entitled insurance contracts is composed as follows, depending on the three results (sections 6 to 8 MindZV):

$$
\begin{aligned}
&\text{Minimum allocation to the RfB} \\
&\qquad = \max\{0;\ 90\%\ \text{of the attributable capital earnings} - \text{actuarial interest}\} \\
&\qquad + \max\{0;\ 90\%\ \text{of the risk result}\} + \max\{0;\ 50\%\ \text{of the miscellaneous result}\} - \text{direct credit}
\end{aligned}
$$

The RfB consists of the following components: allocated RfB, the Schlussüberschuss Anteilsfond (SÜA)[2] fund and unallocated or free RfB. The allocated RfB, also called the determination layer, contains all amounts that are already determined for a distribution of current or final surpluses in the following (mostly one to two) years. These funds are thus bound in their use and no longer freely available. The allocated RfB counts—like the provision for premium reserves—among the insurance technical provisions and must be covered by the security assets according to section 125 VAG. The SÜA fund represents a partial provision within the RfB, which serves to

2. The SÜA is a fund for reserving surplus specifically for a closing surplus participation, which only gets paid out if the policy is held to maturity.

finance the future final surplus participation as well as participation in the valuation reserves. All other financial resources contained in the RfB are summarised in the free RfB. They are also funds intended for the surplus participation of the insured but not yet determined. Exactly this unallocated part of the RfB is what exercises the described buffer function and balances the surplus declaration in consecutive years. The free RfB thus has the character of a fluctuation reserve, which is built up in years of high earned surpluses and reduced again in years with lower surplus incomes. The unallocated parts of the RfB (free RfB and the SÜA fund) represent funds whose specific use has not yet been decided by the insurance company and on which, therefore, no claims exist on the part of the policyholders yet.

1.2 MAXIMUM ACTUARIAL INTEREST RATE (*HÖCHSTRECHNUNGSZINS*)

To ensure the security of insurance products in Germany, the German Ministry of Finance limits the interest rate that a provider can guarantee for its policies. The maximum actuarial interest rate (*Höchstrechnungszins*) is set annually by the German Ministry of Finance after the joint recommendation of the Financial Supervisory Authority (BaFin) and the German Actuarial Association (DAV).

The calculations of the maximum actuarial interest rate are initially based on the current yield of European AAA-rated government bonds with a 10-year term published by the European Central Bank (ECB), from which the average yield of the past 10 years is calculated. Assuming various interest rate developments, these average yields are projected into the future. Until 2015, the maximum actuarial interest rate could not exceed 60% of the average yield on these 10-year government bonds (section 65 of the Insurance Supervision Act). In 2016, the VAG was updated, and section 88(3) of the current VAG also contains a comparable authorisation to issue an ordinance for a maximum interest rate but does not specify a calculation method due to the elimination of the previous basis under European law. The change in legislation was justified with the reduced importance of the actuarial reserve following the introduction of Solvency II.

The maximum actuarial interest rate limits the discounting of the actuarial reserves and thus ensures a certain minimum level of the balance sheet representation of the insurer's underlying obligation. The interest rate used for the actuarial reserves when the contract is issued, which may not exceed the maximum actuarial interest rate applicable at that time, may not be subsequently increased; it may only be reduced if the insurer can no longer generate this interest rate itself or if this is required by law. The maximum actuarial interest rate thus ensures that the insurer has sufficient financial provisions in its balance sheet and is therefore not overindebted in future periods of low interest rates (compared to the time the contract was concluded). Indirectly, the maximum actuarial interest rate for the actuarial reserves forces the insurer to take into account future investment income only to an extent that does not deviate too far from the maximum actuarial interest rate when calculating the premiums. According to section 138(1) VAG, the premiums must be calculated sufficiently to finance the actuarial reserves. This means that the maximum actuarial interest rate for the actuarial reserves also prevents prices that are calculated too optimistically. In the European Union outside of Germany, however, there is not generally a direct limit on the interest rate that may be used when calculating premiums. This interest rate given in the premiums is often referred to as the guaranteed interest rate, but legally it has nothing to do with the maximum actuarial interest rate or the interest rate of the actuarial reserves, even if in practice these interest rates are often the same.

After a high rate of 4% soon after reunification in 1994, the maximum interest rate slowly and consistently decreased, and was set at 0.25% in 2022, staying there until an increase in 2024 to 1%, the first increase in 30 years, bringing the rate to a level above that of the maximum interest rate set in 2017 (0.9%).

1.3 GERMAN RUNOFF INSURANCE PROVIDERS

In Germany, most of the big runoff insurance companies began to merge and acquire large portfolios in the mid-2010s. The German companies that we will be considering in this study are the Viridium Group, the Frankfurter Leben Group and the Athora Group.

Of these, the Viridium Group was the first to form and to begin acquiring companies and portfolios already in or going into runoff. In 2014 the Heidelberger Leben Group, which owned Heidelberger Lebensversicherung, was acquired by a consortium of Cinven and Hannover Rück and restructured as a runoff provider, holding 555,000 policies. At the same time, they acquired Skandia Lebensversicherung with approximately 285,000 policies and bringing the total investments of the concern to around EUR 10 billion. Although managed by the same umbrella runoff provider, Heidelberger Lebensversicherung and Skandia Lebensversicherung remain separate legal entities. The Heidelberger Leben Group was renamed the Viridium Group in 2016. The next year, Viridium

purchased Protektor Lebensversicherung and renamed the provider Entis Lebensversicherung. This increased Viridium's holdings by around 100,000 policies and brought the total investments to around EUR 14.6 billion. The most recent acquisition by Viridium was the closed portfolio in 2018 of Generali Lebensversicherung, the Italian insurer Generali's German life insurance wing (Generali subsequently reopened its life insurance business in Germany under the name Generali Deutschland Lebensversicherung). This portfolio was restructured under the newly formed Proxalto Lebensversicherung. This significant purchase added nearly 4.8 million policies to Viridium's holdings and increased its investment value to around EUR 60 billion. As of 2022, Heidelberger Lebensversicherung held EUR 11.9 billion in investments and around 330,000 policies, Skandia Lebensversicherung held EUR 49 billion and around 200,000 policies, Entis Lebensversicherung EUR 1.5 billion and 61,000 policies and Proxalto EUR 44.7 billion and 3.05 million policies.

Following Viridium, in 2015 Delta Lloyd Lebensversicherung and its subsidiary Hamburger Lebensversicherung merged to form Athene Lebensversicherung, which was renamed the Athora Group in 2018. As of 2022, Athora held EUR 4.1 billion in investments to manage 180,000 policies.

In 2017, the Frankfurter Life Group began its work in the runoff sector by acquiring Basler Lebensversicherung and transferring its portfolio of 128,000 policies and EUR 1.72 billion in investment capital to the newly created Frankfurter Lebensversicherung, as well as purchasing the closed life insurance portfolio of 322,000 policies and EUR 2.8 billion in investments from ARAG Lebensversicherung and with it created Frankfurter Münchener Lebensversicherung. Expansion continued in 2018 with the purchase of Pro bAV and the group of 260,000 pension plans of the AXA concern with investments of EUR 3 billion, as well as Prudentia, which consisted of 50,000 pensions for the clothing company C&A and EUR 1.8 billion in investment capital. Current financial holdings of Prudentia and Pro bAV are listed at almost EUR 1.6 billion and EUR 3.8 billion, respectively, while Frankfurter Lebensversicherung manages over 76,000 policies with more than EUR 1.6 billion in investment capital and Frankfurter Münchener Lebensversicherung manages almost 193,000 policies with over EUR 2.4 billion in investment capital.

1.4 ANALYSIS

As mentioned above, we consider, where available, the cancellation rate,[3] closing cost rate and administration cost rate (or, where necessary, operating cost rate, which takes both closing and administrative costs into account), the current interest rate[4] and the net interest rate[5] for runoff companies in all countries and then contrast them with those values for peers, i.e., insurances companies of similar size, as well as for the market as a whole. In addition, we study those rates in comparison to the official reference rate. This reference rate is used to determine whether additional reserves due to low market rates must be set. For Germany, because profit-sharing funds are already segregated into the RfB, we also consider for the given years the total RfB funds and the unallocated funds within the RfB.

1.4.1 Proxalto

Proxalto[6] is part of the Viridium group and can be considered as a prime example of large migration projects in the German insurance market. Proxalto's portfolio of policies is quite diverse and covers all common products in the German insurance market. Additionally, the portfolio is so expansive that many different niche products are contained within. Such niche products can often push the costs of a migration up and as such can strain the profitability of a migration. But, as we will see, Proxalto is doing quite well, both in contrast to the general markets, as well as in contrast to its direct peers. To select peers for Proxalto, we chose the life insurance companies with the most similar premium amounts in 2022, which are the latest available as of writing this report.[7]

Its peers for the purposes of this report are Cosmos Lebensversicherung, which is part of the Generali Group and a direct insurer, i.e., company products are sold directly to consumers, mostly online, instead of through a traditional sales structure such as sales teams or agents, and Nürnberger Lebensversicherung, a traditional German life insurance company.

3. The number of policies cancelled before maturity as a proportion of all active policies.

4. The current capital return consists only of proper capital returns, i.e., recurring returns. Thus it is calculated capital gains without gains or losses from sales of assets, divided by the average value of the assets.

5. The net rate consists of all capital return. Thus it is calculated as all capital gains and losses, divided by the average value of the assets.

6. Our analysis includes data from before 2018, at which time Proxalto was technically still Generali. We omit this detail in the graphs shown.

7. Statista. Largest Life Insurance Companies in Germany by Gross Premiums Earned in 2022. Retrieved 6 December 2024 from https://de.statista.com/statistik/daten/studie/188694/umfrage/groesste-deutsche-lebensversicherer-nach-bruttobeitraegen/.

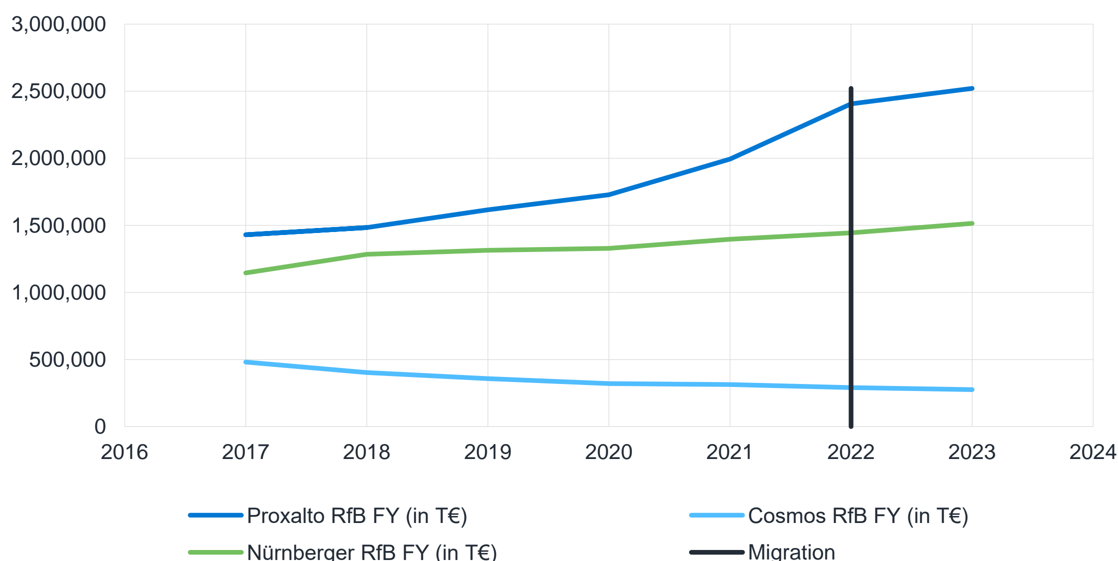
Costs (Proxalto)

Unfortunately, Proxalto switched its cost reporting in 2020. Up to and including 2020, costs reported were closing costs in parts of the premium sum of new policies and management costs in parts of premiums earned. Starting in 2021, Proxalto only reported a combined cost for both closing and management in parts of premiums earned. Neither the German Insurance Association (GDV) nor the peers of Proxalto are reporting those numbers. Thus, we cannot draw conclusions on the administration costs of migration within Proxalto.

End of Fiscal Year RfB (Proxalto)

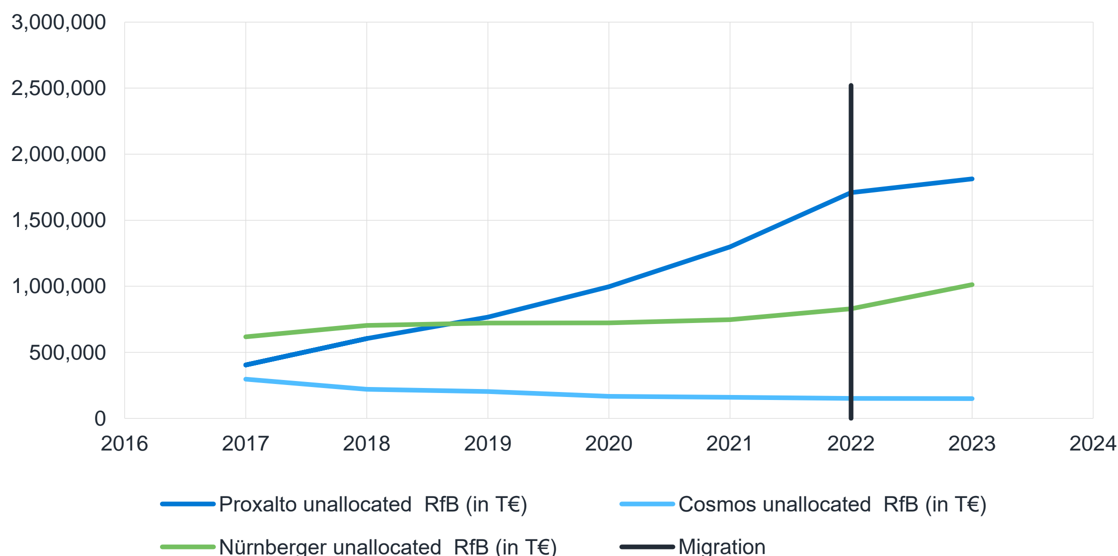
Proxalto's end-of-year RfB is growing at an average rate of 10% year on year. The RfB of Nürnberger is also growing, but only at an average rate of 5% year on year, and the RfB of Cosmos is decreasing by an average rate of about 9% year on year.

FIGURE 2: END-OF-YEAR RFB



The unallocated RfB of Proxalto is growing at an impressive average rate of 29% year on year, slowing down to about 6% in 2023. Meanwhile, the RfB of Nürnberger is also growing, but only at an average rate of 9% year on year, and the RfB of Cosmos is decreasing by an average rate of about 10% year on year.

FIGURE 3: UNALLOCATED RFB

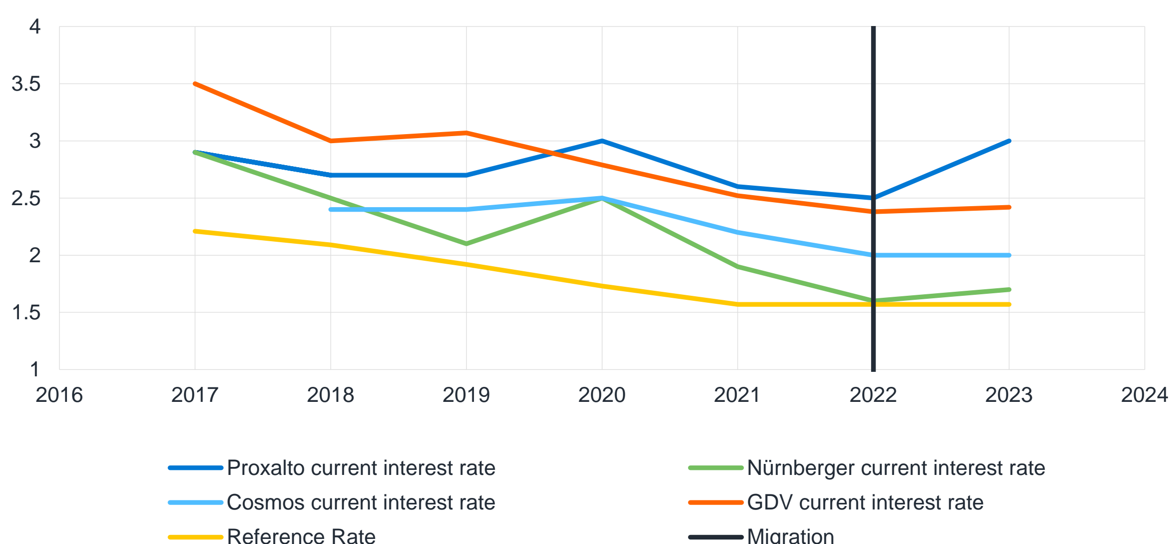


When looking at the available data about the RfB, we can only conclude that Proxalto is doing better than its peers, both before the migration is completed as well as afterwards. As there has only been one fiscal year since the end of the migration, we cannot conclude whether the slowing in growth of the unallocated RfB might be a consequence of regular business fluctuations or not.

Capital Gains (Proxalto)

The current capital return for all three studied companies is above the reference rate, which is often used as a minimum target for the current rate. However, it is worth noting that Nürnberger was close to falling below this rate at the end of 2022. The current rate is typically slow-moving, especially within large insurance companies, mostly because it is derived from long-term bonds or property rents, which are not easily adjusted. This makes it particularly remarkable that Proxalto managed to increase its current rate in 2023 back to the level observed in 2020. This could indicate that runoff platforms, or at least Proxalto as part of the Viridium Group, might be better positioned to capitalise on changing market conditions compared to other insurance companies of similar size, especially since the low-interest environment ended in 2021.

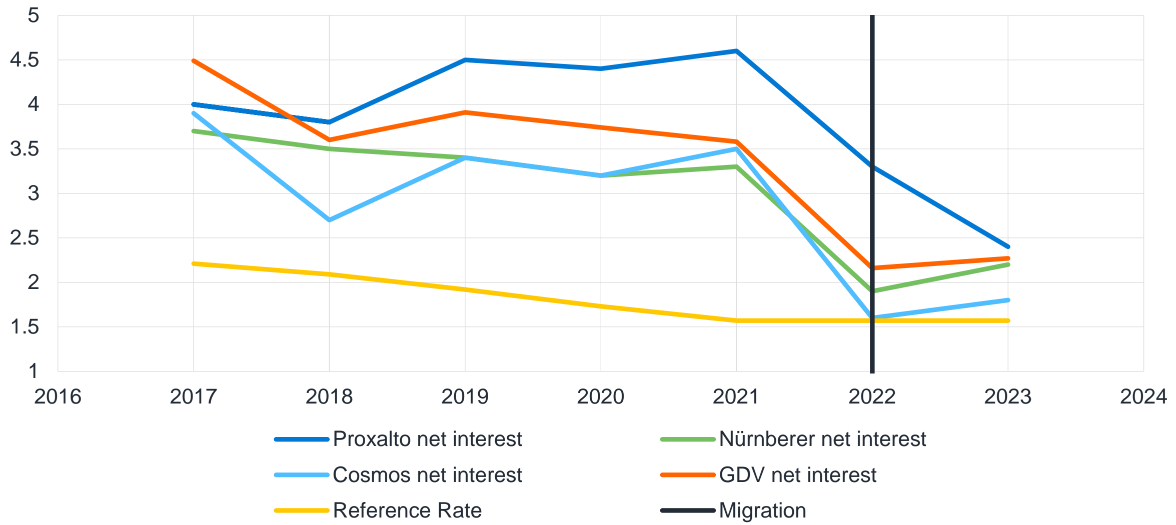
FIGURE 4: CURRENT CAPITAL RATE



The net interest rate for all three insurance companies is also above the reference rate, although Nürnberger came quite close to it again in 2022. The end of the low-interest rate environment in 2021 reduced the value of fixed-rate long-term bonds, which constitute a large portion of the assets held by most life insurance companies in Germany. The German Commercial Code (*Handelsgesetzbuch*, or HGB) requires an immediate write-off of assets if their value drops below book value, which adversely affects the net returns of most German insurance companies.

The net interest rate data also show that Proxalto consistently achieved a higher capital yield than its peers. However, while its peers managed to increase their net rates from 2022 to 2023, Proxalto's net interest rate continued to decline, albeit from a generally higher level.

FIGURE 5: NET INTEREST RATE



Cancellation Quota (Proxalto)

Let's examine the cancellation rates of three insurance companies. It is important to note that the values for Nürnberger are based on premium volume rather than the number of active policies. Our analysis will focus on the trends rather than the percentage values themselves.

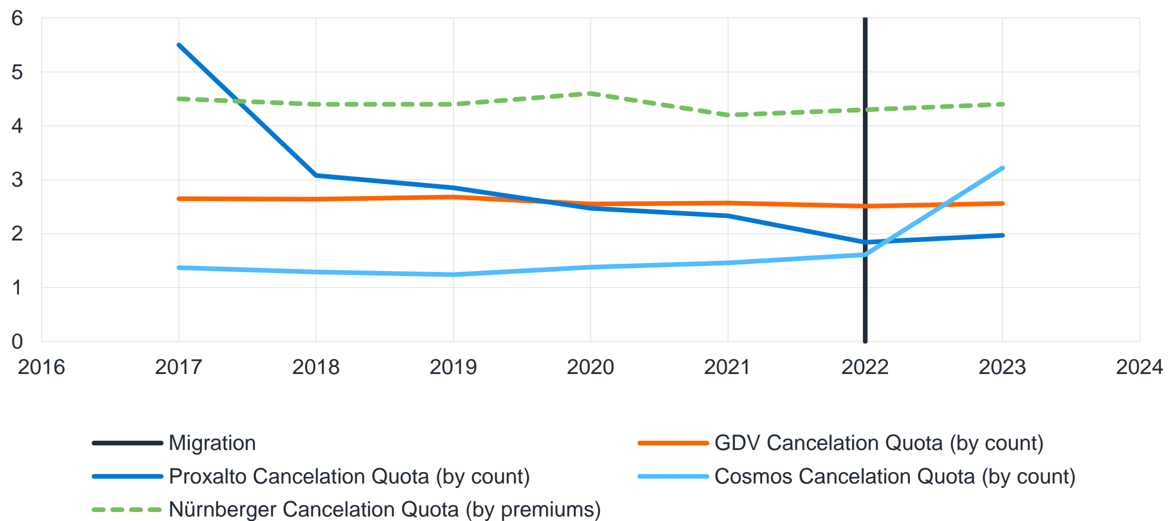
In 2017, before Proxalto was acquired by Viridium, its cancellation rate was quite high at around 5.5%. However, just one year after the acquisition, the cancellation rate dropped sharply to align with the market average reported by the GDV. The initially high cancellation rate may have been influenced by policyholder concerns and speculation about the potential acquisition. By 2020, Proxalto managed to reduce its cancellation rate to below the market average reported by the GDV.

The German market average, as provided by the GDV, remained constant throughout the studied period. Similarly, Nürnberger's cancellation rate also remained stable.

Cosmos, on the other hand, had a very low cancellation rate. While there was a minor upward trend starting in 2019, a significant spike occurred in 2023, with the cancellation rate doubling from 1.6% to 3.2%. This rate now surpasses that of Proxalto, which experienced only a slight increase from 1.8% in 2022 to around 2% in 2023.

For Proxalto, there are no indications that a migration project has led to an increase in the cancellation rate.

FIGURE 6: CANCELLATION QUOTA



1.4.2 ARAG LV

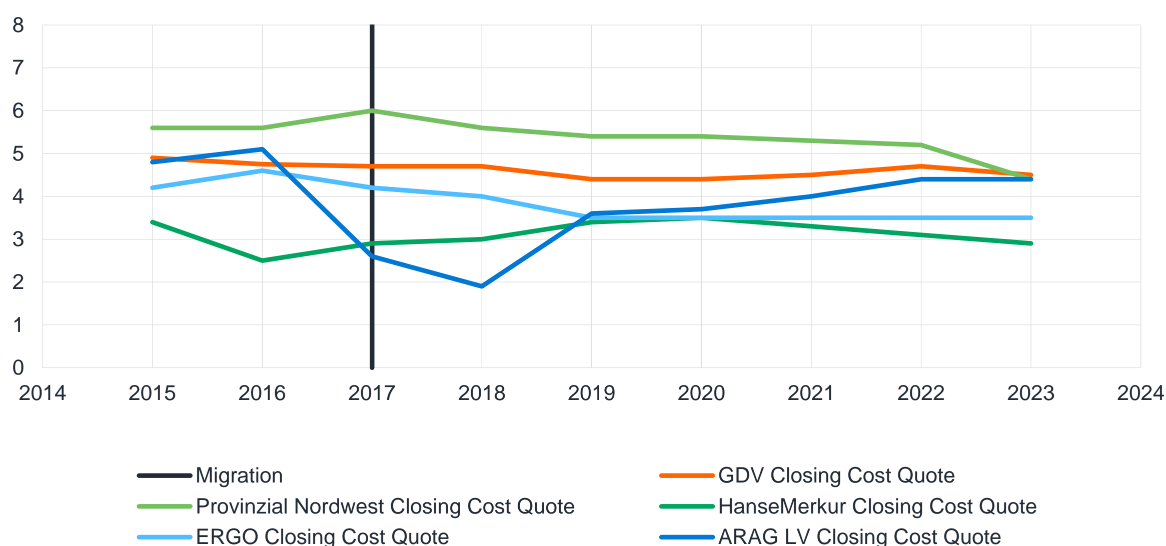
ARAG Lebensversicherung (ARAG LV) has been part of the Frankfurter-Münchener Group since 2017. The Frankfurter-Münchener Group is a notable player in the German insurance runoff market. This section aims to provide a comprehensive analysis of ARAG LV's performance, focussing on key metrics such as costs, capital gains, cancellation rates and the end-of-Fiscal-Year RfB (Rückstellung für Beitragsrückerstattung, or provision for premium refund). By comparing these metrics to its peers and the general market, we can assess the impact of mergers and acquisitions (M&A) and portfolio migrations on ARAG LV's profitability and policyholder benefits.

For comparison, we selected HanseMerkur Lebensversicherung, Ergo Vorsorge Lebensversicherung and Provinzial Nordwest Lebensversicherung as peers for ARAG LV.

Costs (ARAG LV)

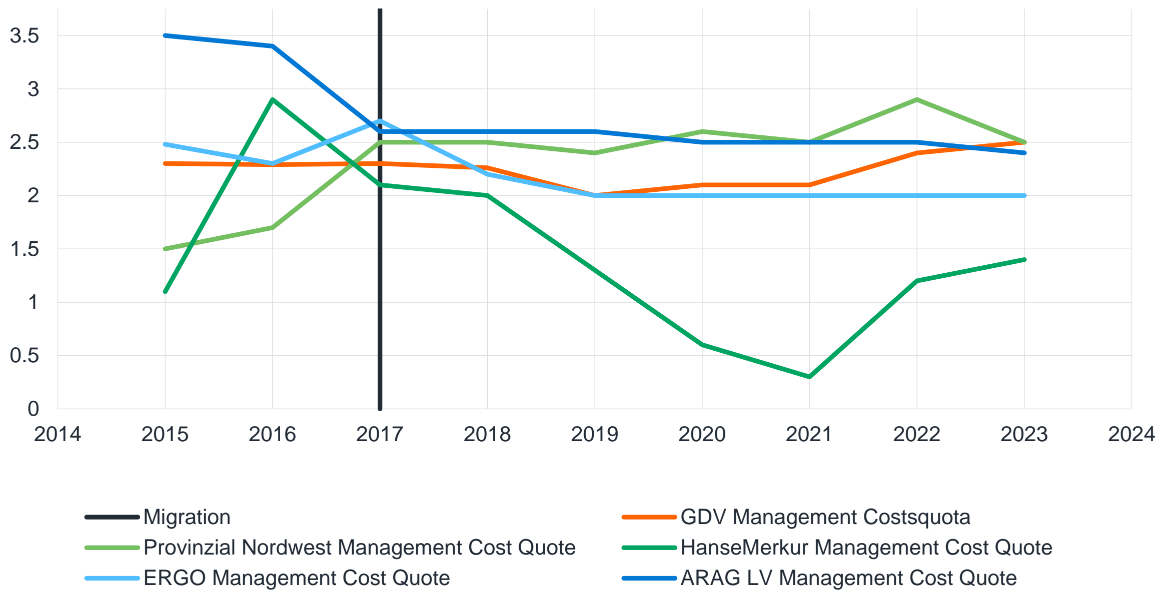
One of the key factors influencing the profitability of runoff providers is their cost structure. Our analysis examines both closing and management costs, starting with the closing costs. For ARAG LV, closing costs show a temporary decline during the years immediately following the migration, but they eventually return to premigration levels. In contrast, ARAG LV's peers maintain relatively stable closing costs with no significant fluctuations. Since 2016, ARAG LV has managed to keep its closing costs below the general market level as reported by the GDV, although these costs nearly align with the market level by 2023.

FIGURE 7: CLOSING COSTS



Continuing with management costs, ARAG's management costs decreased from 3.5% to around 2.5% during the migration period and have since remained stable at this level. Despite this reduction, ARAG's costs are still higher than those of its peers. Notably, HanseMerkur exhibits significant volatility in its management costs, coinciding with an internal migration project, suggesting that even internal migrations can lead to reduced management costs. The other peers maintain their management costs consistently between 2% and 2.5%. Additionally, the general insurance market, as reported by the GDV, shows a gradual increase in management costs. As a result, ARAG's management costs are below the general market level in 2023.

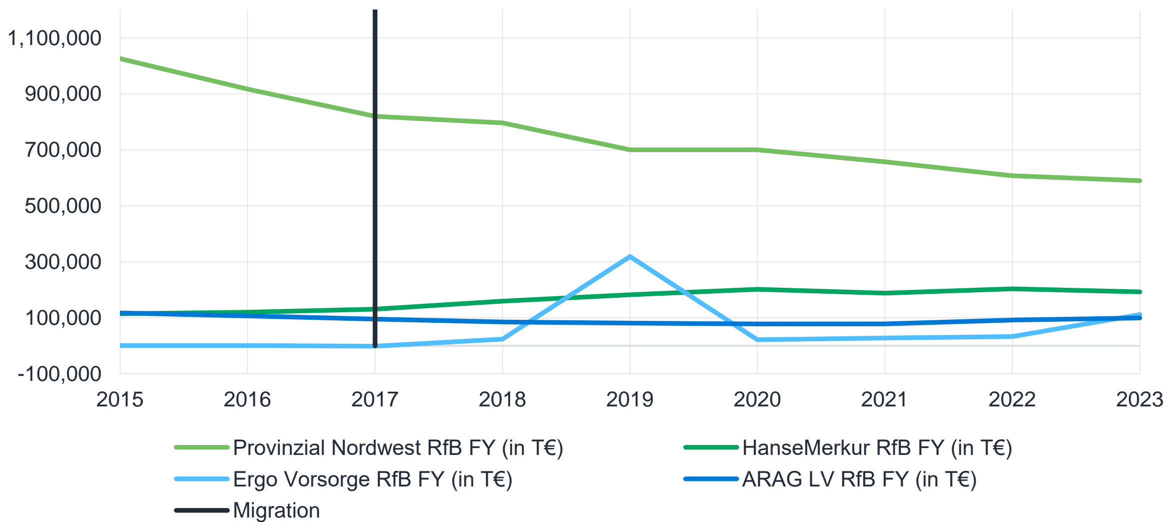
FIGURE 8: MANAGEMENT COSTS



End of Fiscal Year RfB (ARAG LV)

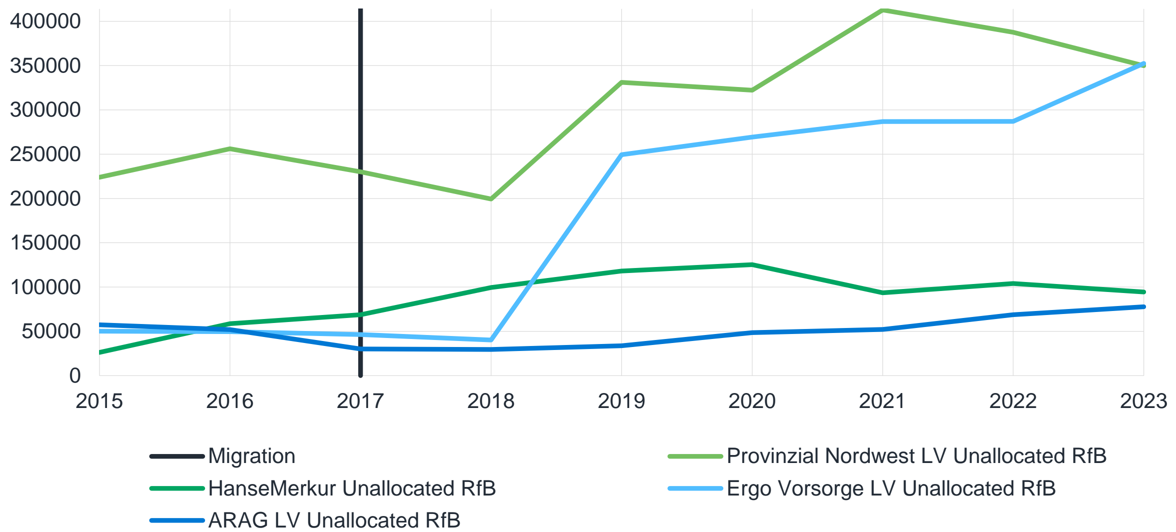
The RfB is a crucial indicator for evaluating the financial health and profit-sharing capacity of a runoff provider. For ARAG LV and its peers, the end-of-year RfB generally exhibits a stable trend. The only exception is Provinzial NW, which shows a clear negative trend. Ergo displays an anomaly in 2019 but subsequently returns to its baseline level. From these data points, we cannot draw definitive conclusions about the strength of ARAG before and after migration or about runoff providers in general.

FIGURE 9: END-OF-YEAR RFB



The unallocated RfB for ARAG LV begins below EUR 50 million and remains relatively stable, with only minor fluctuations, barely surpassing EUR 50 million at its peak. In contrast, HanseMerkur's RfB demonstrates significant growth over time, while Provinzial Nordwest exhibits more noticeable fluctuations. The relatively flat trend of ARAG LV's unallocated RfB underscores its minimal growth compared to the substantial increases seen in other providers' RfBs.

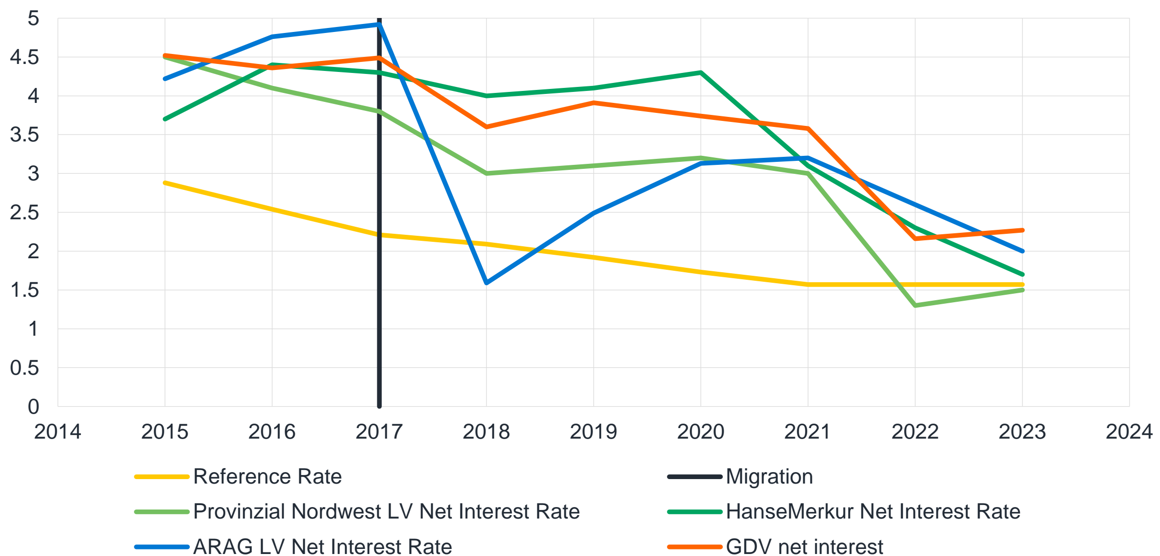
FIGURE 10: UNALLOCATED RFB



Capital Gains (ARAG LV)

Capital gains are another crucial metric for evaluating the performance of runoff providers. ARAG LV displays a generally declining trend from 2015 to 2023, starting around 4% and dipping below 2.5% in recent years. Notably, in 2018, ARAG LV's net interest rate fell sharply and has remained below the market average since then, with the exception of 2022. Compared to its peers, HanseMerkur and Provinzial NordWest also show a downward trend but maintain higher values than ARAG LV, particularly before 2019. ARAG LV's net interest rate is consistently lower than these benchmarks, indicating relatively weaker performance in net interest returns.

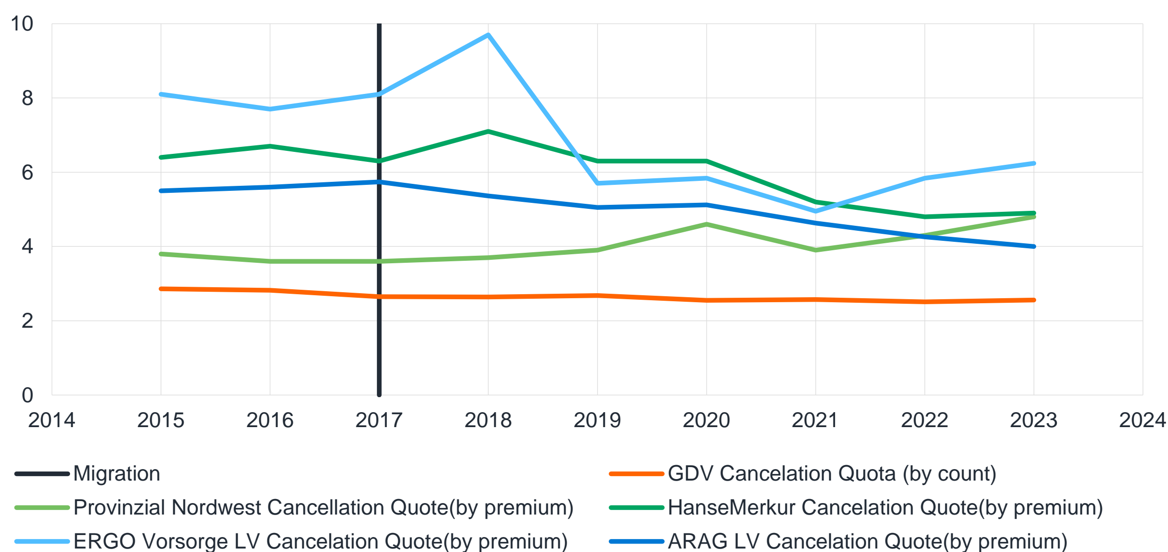
FIGURE 11: NET INTEREST RATE



Cancellation Quota (ARAG LV)

The cancellation quota is a crucial indicator of customer satisfaction and retention. For ARAG LV, the cancellation quota has shown a steady decline, which is a positive sign. Since the migration in 2017, ARAG LV has consistently seen decreasing cancellation rates and has maintained a lower cancellation quota compared to its peers since 2022. In contrast, Ergo and HanseMerkur exhibit more volatile fluctuations in their cancellation quotas, highlighting ARAG LV's higher customer retention. It is important to note that the GDV calculates the cancellation quota by amount, whereas the cancellation quotas for its peers are calculated by premium.

FIGURE 12: CANCELLATION QUOTA



1.5 KEY FINDINGS IN THE COMPARISON OF PROXALTO AND ARAG LV

After examining both Proxalto and ARAG LV, it is difficult to draw a singular conclusion. While all metrics studied for Proxalto appear to be strong, ARAG LV, although not outperforming its peers, is on par with or better than the general market as indicated by GDV numbers. Both Proxalto and ARAG LV show a trend of improvement following their respective migrations. However, the overall condition of the company, its size and the specific portfolio in question seem to play a crucial role in the metrics studied. Therefore, we do not observe any negative effects of portfolio migration on the companies in question. If the positive trends continue, the migrations will be beneficial for all stakeholders, including both the issuers and the policyholders.

2. UK

2.1 INTRODUCTION TO PROFIT-SHARING IN THE UK

Profit-sharing in the UK is (in general) limited to a specific class of business known as with-profits business. The business is designed with the following key features to meet specific customer needs:

- Guaranteed minimum maturity/retirement benefits[8] set at a level to provide protection to policyholders, but also at a low enough level to allow freedom to invest in more risk-seeking assets with the aim of achieving increased return for policyholders when compared to non-participating (nonprofit) business.
- Increases to guaranteed minimum benefits over the policy term through the addition of regular bonuses (typically added annually). These increases should reflect the investment growth over time (while still maintaining a buffer for investment freedom) but provide visible increases to policy benefits.
- A final bonus payable at maturity or retirement, which is used to increase the guaranteed benefits to the current underlying policy value based on (amongst other things) premiums paid, charges for expenses and any insurance coverages, investment return and any other sources of surplus or deficit within the participating fund. This underlying policy value is referred to as the "asset share."[9]
- Smoothing, which may be smoothing of claim values or smoothing of bonus rates declared, reduces the extent to which policy values change from year to year. The level of smoothing may be reduced or removed in extreme circumstances.
- Investments are pooled between groups of policyholders, so investment experience is smoothed within groups of with-profits policies. Groups of policies can be invested in different mixes of investments.

The two main forms of with-profits business are:

- Conventional with-profits (CWP). These policies have a guaranteed benefit ("sum assured") payable on death, and/or maturity or retirement, depending on the product type. The guaranteed benefit may be increased over time with the addition of regular bonuses and a final bonus added at the point of claim. The guaranteed benefit (plus bonuses) is only payable if all contractual premiums are paid. Paid-up sums assured[10] and surrender/transfer values are typically complex and lack transparency in these policies.
- Unitised with-profits (UWP). Each premium paid buys a number of units at the current unit price and so, unlike CWP, the benefit is not expressed as a defined sum assured subject to all contractual premiums being paid. Instead, the benefits increase with each premium payment. Regular bonuses will be added through either additional units or through increases to the unit price. A final bonus may be added at the point of claim, or a Market Value Reduction (MVR) may be deducted if the underlying asset share is lower than the current unit value. Typically, there will be MVR-free dates specified in the contract, which will always include a claim on death. Benefits are generally more transparent throughout the policy term given the explicit link to premiums paid.

With-profits policies in the UK are written and held in a ring-fenced fund within the life insurer, generally referred to as a "with-profits fund." A with-profits fund is:

> *a fund of assets and liabilities in respect of profit participation business that is only available to cover losses arising in respect of particular policyholders or in relation to particular risks, and where the following key features exist:*
>
> *(i) policyholders within the ring-fenced fund have distinct rights relative to other business written by the undertaking;*
>
> *(ii) there are restrictions on the use of assets, and the return on such assets, within this fund to meet liabilities or losses arising outside the fund;*
>
> *(iii) an excess of assets over liabilities is generally maintained within the fund […] since its use is subject to the restrictions referred to in point (ii);*

8. Surrender values (life business) and transfer values (pension business) are not guaranteed.
9. If the asset share (the policy value) is lower than the minimum guaranteed benefit, then the minimum guaranteed benefit is paid, i.e., the final bonus is zero. Surrender/transfer values also target asset share, but are not subject to a minimum guaranteed amount
10. If premiums cease before their contractual end date (the policy is made paid up), then the sum assured is reduced.

> *(iv) there is generally profit participation within the ring-fenced fund whereby policyholders receive a minimum proportion of the profits generated in the fund which are distributed through additional benefits or lower premium, and, if relevant, shareholders may then receive the balance of such profits.*[11]

An insurer may have more than one with-profits fund, depending on the history, policy types and level of participation. For example, an insurer may acquire a block of with-profits business and maintain this business in its own dedicated with-profits fund to retain the current profit participation arrangements for the acquired business and its existing participating business.

With-profits funds in the UK are generally structured as either 90:10 or 100:0 as follows:

- In the 90:10 structure, 90% of the profits and losses of the fund are attributable to the participating policyholders, and the remaining 10% is attributable to shareholders. The shareholders' 10% is "unlocked" through bonus additions to with-profits policies; that is, at the time at which a guaranteed addition to policyholder benefits is declared (through regular bonus additions or at the point of claim/exit), 10% of the value of this declaration will be transferred to shareholders.
- In the 100:0 structure, 100% of the profits and losses of the fund are attributable to the participating policyholders. Generally, there will be alternative mechanisms for shareholders to generate profits on these types of funds, such as charging annual management charges (AMCs) to with-profits policies and/or the surplus (or "estate") of the with-profits fund, in return for the shareholder meeting the actual expenses of running the fund.

Profit-sharing in the UK is therefore focussed on specific participating (with-profits) policies managed in a ring-fenced fund, whereby the profits and losses of the fund accrue to the with-profits policies in that fund (subject to the arrangement for sharing profits with shareholders). The primary source of profits and losses will be investment returns, but there will be other sources such as profits or losses on any nonprofit business also written in the fund.

2.2 REGULATIONS ON PROFIT-SHARING

With-profits policyholders automatically receive the specified proportion of profits arising in a with-profits fund that the firm's board of directors determines should be distributed (with the balance accruing to the shareholder if applicable), and so regulations around the form of profit-sharing are limited in this respect.

Regulations for with-profits business therefore tend to focus on the management of the business, as there is significant discretion in this, including:

- The investment strategy for the asset shares and the surplus (estate) of the with-profits fund.
- The bonus policy, including the balance between regular bonuses (which increase a guaranteed minimum benefit during the lifetime of a policy) and final bonuses (which do not).
- The level of expenses or charges passed to the with-profits policyholders and/or fund.
- The size of the estate of the with-profits fund, how it is used and how it is distributed.
- For with-profits funds open to new business, the volume and profitability of new business expected to be written, and the mix of with-profits and nonprofit business expected to be written.

Regulation of this business is largely principle-based, with the key principle (applying more widely than with-profits) being that "*a firm must act to deliver good outcomes for retail customers.*" This principle was introduced recently under the Consumer Duty regulations of the Financial Conduct Authority (FCA), with implementation dates of 31 July 2023 for open blocks and 31 July 2024 for closed blocks. It supersedes and strengthens the previous principles of "*a firm must pay due regard to the interests of its customers and treat them fairly*," and "*a firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading*," which have been well embedded in the management of with-profits business (and wider) for many years.

11. The Bank of England's guidelines on ring-fenced funds are available at https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/december/gl-ring-fenced-funds.pdf.

The Consumer Duty includes three cross-cutting rules that require firms to act in good faith towards their customers, avoid causing foreseeable harm to their customers and enable and support their customers to pursue their financial objectives. It is also accompanied by specific outcomes that firms should achieve for their customers, and the FCA has shared examples of good and poor practice to support these outcomes (although covering all retail products, not only with-profits business).

In addition to these overarching rules, the FCA's Conduct of Business Sourcebook (COBS) Chapter 20[12] contains various rules and guidelines specifically covering the management of with-profits business. Of particular interest in the context of this paper is COBS 20.2.23R, which states that, "A firm must only charge costs to a with-profits fund which have been, or will be, incurred in operating the with-profits fund. This may include a fair proportion of overheads." In reality, for many closed with-profits funds there are expense agreements in place with the shareholder (or the open fund in the case of a mutual). They determine the investment and administration expense charges that will be deducted from the fund. This protects the fund from increasing per-policy costs with the number of policy runoffs, but also typically includes an initial profit margin to reflect the transfer of expense risk to the shareholder. Such expense agreements will eliminate the potential savings to with-profits policyholders from any harmonisation/integration activities, as the cost benefits would accrue to the shareholder.

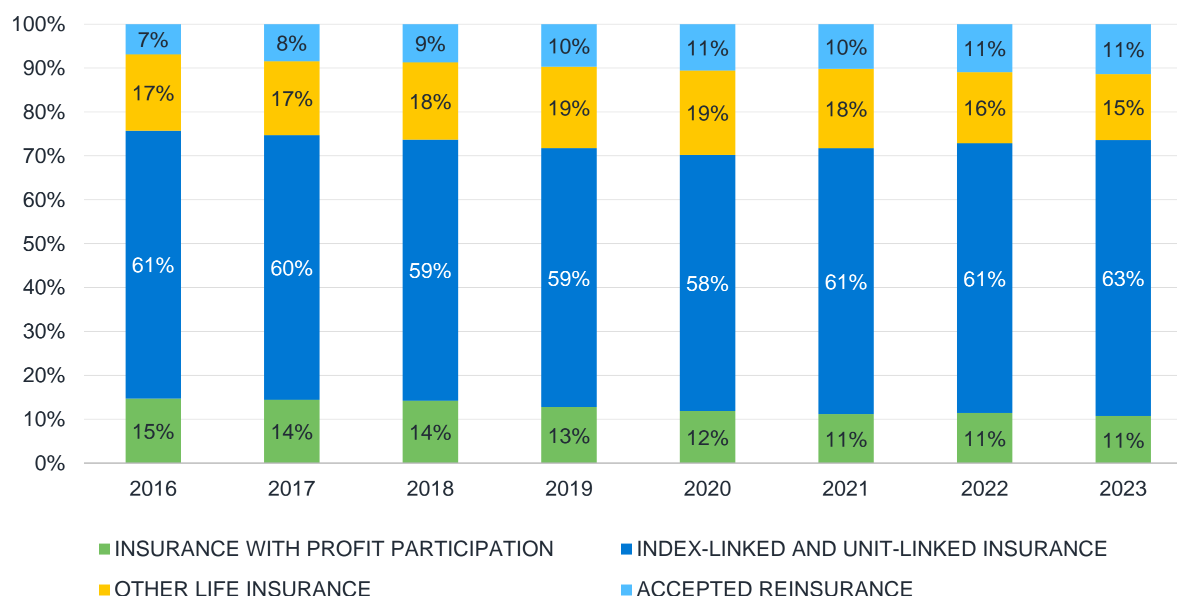
As there is considerable discretion in how to manage with-profits business in a way that complies with the principle of acting to deliver good customer outcomes, there are two key forms of additional governance for insurers with with-profits business (over and above the board, which has ultimate responsibility):

- A With-Profits Actuary, who must be approved by the Prudential Regulation Authority (PRA) and whose principal duty is to advise the insurer's board and With-Profits Committee on the exercise of discretion affecting the with-profits business.
- A With-Profits Committee (or, typically, advisory arrangements for smaller firms), whose role is to act in an advisory capacity to inform the decision-making of the insurer's board. The With-Profits Committee acts as a means by which the interests of with-profits policyholders are appropriately considered within an insurer's governance structures.

2.3 PROFIT-SHARING PRODUCTS AND UK RUNOFF PROVIDERS

The graph in Figure 13 shows the market share of with-profits products in the UK (in orange) as measured by Solvency II technical provisions.

FIGURE 13: MARKET SHARE OF WITH-PROFITS PRODUCTS, UK AND SOLVENCY II TECHNICAL PROVISIONS



12. COBS. Chapter 20: With-Profits. Conduct of Business Sourcebook. Retrieved 6 December 2024 from https://www.handbook.fca.org.uk/handbook/COBS/20.pdf.

As can be seen from Figure 13, the proportion of the UK market related to with-profits products is steadily declining, from 15% in 2016 to 11% in 2023. Many with-profits funds in the UK are closed and in runoff, and with-profits products are somewhat out of favour. This may be attributed in part to:

- Adverse publicity for with-profits products, such as the misleading sales of with-profits endowment mortgages. These products were intended to pay off an interest-only mortgage at the end of its term, but in many cases it was not clearly explained that this was not a guarantee and there may be a shortfall at the end of the term (which for many was the result).
- More general substandard (relative to expectations) returns on investment, such as many years of zero (or close to) annual bonuses in a low-interest rate environment.
- Lack of transparency in the benefits and management of the products.

With-profits products with lower levels of participation are becoming more common in the UK for those insurers actively selling with-profits business, for example unitised products with a smoothing mechanism for payouts but no explicit guarantees or bonus structure. However, these products are not discussed further here as they are not typically in the scope of runoff providers, where the focus is on closed blocks of older style with-profits business.

In the UK, there has been a steady decline in the number of with-profits insurers owing to acquisitions of either with-profits insurers in their entirety, or their with-profits blocks where with-profits is no longer key to the selling insurer's strategy. There has also been significant activity in consolidating with-profits funds within insurers, and this is a trend that is expected to continue as many insurers focus on simplification, harmonisation and modernisation.

The largest example of a runoff provider in the UK is the Phoenix Group (Phoenix), which is one of the largest life and pensions consolidators in Europe. However, it should be noted that Phoenix (like many runoff providers in the UK) is not solely a consolidator. Its presence as a runoff provider is only for one portion of its business strategy, which includes growing organically through its open business[13] as well as through mergers and acquisitions.

Some of Phoenix's recent activity in respect of acquisition and integration includes:

- The acquisition of the UK closed-book business of Sun Life Financial in 2023, including one with-profits fund. As well as Phoenix's typical motivations for acquisition (increased customer base, cost and capital synergies), this facilitated a new long-term strategic asset management partnership with Sun Life.
- The acquisition of ReAssure Group from Swiss Re in 2020, including four with-profits funds. ReAssure Group had previously acquired the mature savings business (including with-profits policies) of Legal & General earlier in 2020.
- The acquisition of Standard Life Assurance from Standard Life Aberdeen in 2018, including four with-profits funds. As well as Phoenix's typical motivations, this allowed for diversification of product offerings to expand Phoenix's new business capabilities in the retirement market.
- The acquisition of Abbey Life from Deutsche Bank in 2016, including two with-profits funds.
- The intragroup transfer of Standard Life and Phoenix Life Assurance Limited policies into Phoenix Life Limited by insurance business transfer, which completed in 2023. This brought together the businesses of four legal entities, comprising about 8 million policies and about GBP 200 billion of assets into a single entity, and included the transfer of eight with-profits funds into Phoenix Life Limited. This transfer was undertaken to simplify the organisational structure of Phoenix, as well as to release significant capital (about GBP 400 million) through consolidation of the nonprofit funds (as the with-profits funds are ring-fenced, there was no capital release in the with-profits funds).
- The migration of Phoenix customers to Diligenta's administration platform. This included the migration of about 700,000 policies in 2023, with a total of 1.2 million policies migrated out of the total project scope of 2 million policies.
- Over the 2021-2023 period, investing in the development of an in-house asset management team, whose day job is to optimise Phoenix's assets and liabilities, and enhance shareholder returns.

13. In its 2023 results announcement (see https://www.thephoenixgroup.com/media/vahepiay/phoenix-group-annual-report-and-accounts-2023.pdf), Phoenix stated that, given the significant market opportunities available, it has consciously chosen to invest heavily in order to accelerate its organic growth.

Phoenix currently has over 20 with-profits funds, and another element of its business strategy (aside from growth) is to optimise its in-force business. Phoenix subcontracts the administration and servicing of its policies to outsource service providers and is currently in the process of migrating and harmonising this administration.

Royal London Mutual Insurance Society Limited (Royal London) has also been active in terms of acquisition and harmonisation activity for with-profits business. Royal London is the largest mutual life insurance and pensions company in the UK. As a mutual, there are no shareholders with whom to share profits, and so all profits are for the benefit of policyholders.

Some of Royal London's recent activity in respect of acquisition and integration includes:

- The consolidation of six of its closed with-profits funds into its open fund during 2021 and 2022 by various legal mechanisms. This included distributing the surplus in the closed with-profits funds to the with-profits policies in those funds and transferring most of the risks of managing those policies to the open fund policyholders. This type of consolidation can reduce governance and operating costs for with-profits funds significantly.
- The acquisition of Police Mutual in 2020, including a block of with-profits policies. These policies were transferred directly into Royal London's open with-profits fund as part of the insurance business transfer in order to simplify the organisational structure.
- The acquisition of the Co-operative Insurance Society's life insurance and asset management businesses in 2013, including one with-profits fund. This with-profits fund is large and so was not consolidated as part of the consolidation activity in the 2021-2022 period.

In addition to these examples, there have been many recent de-risking, harmonisation and simplification activities in the UK, including:

- Removal of nonprofits business from with-profits funds. Many insurers have carried out this activity, as the different risk profiles of the with-profits business and the nonprofit business (particularly longevity risk for blocks of annuities) make managing distribution of surplus to with-profits policies challenging. Extracting the nonprofit policies from the with-profits funds ensures the nonprofit business is not a drain on the resources of the with-profits fund.
- Conversion of guarantees such as guaranteed annuity rates and guaranteed bonuses.
- Conversion of with-profits policies to nonprofit or unit-linked.

2.4 IMPACT OF ACQUISITIONS AND INTEGRATION ACTIVITY IN THE UK

Assessing the impact of acquisitions and integration on profit-sharing in the UK is challenging, owing to the inherent complexity of with-profits business. For instance, one source of assessment may be trends in declared bonuses for particular classes of business or cohorts. However, declared bonuses are not always published at a granular level, and where they are it is not typical for historical rates to also be available to assess trends. Furthermore, bonus rates result from a complex interplay of multiple profit and loss sources (with investment returns likely the predominant factor), as well as wider management of the fund over time with regards to guarantees, smoothing and intergenerational fairness. Changes in bonus rates will not give an indication of solely cost savings from acquisitions and integrations.

In addition, per-policy expenses are not disclosed, making it difficult to determine the direct impact of any cost savings for an acquired block of business, or the acquiring insurer's existing with-profits business. Expense agreements between shareholders and with-profits funds add another layer of complexity to any analysis that could be carried out.

In theory, there should be clear cost benefits for with-profits policies transitioning from a smaller company to a runoff provider like Phoenix. For example, in the case of Sun Life UK:

- Sun Life UK's business was administered by an outsourced administration provider (Diligenta) before Phoenix acquired it. Consequently, it is uncertain whether the acquisition and integration will have materially impacted these costs, though Phoenix's larger scale may mean it has access to more favourable administration rates with Diligenta.

- Although Sun Life UK took steps to reduce overheads, such as outsourcing its regular valuations, the reduction in policy counts over time likely led to increased per-policy costs as fixed overhead costs had to be shared between a smaller number of policies. Therefore, it is plausible that with-profits policies experienced reduced overhead costs after moving to Phoenix, given its much larger size.

Looking wider than the with-profits business, in Phoenix's 2023 results announcement[14] it noted that it will invest about GBP 500 million in its migration, transformation and cost efficiency programmes over the 2024-2026 period to optimise its in-force book. These programmes are intended to deliver cost efficiencies at scale as Phoenix brings together all of its businesses onto a single group-wide operating mode. This is expected to support about GBP 250 million of annual cost savings by the end of 2026. Although the results announcement is framed in terms of shareholder benefits, it may be expected that some of these efficiencies will flow through to the with-profits policyholders through reduced charges on their policies, although this will depend on any expense agreements in place with shareholders.

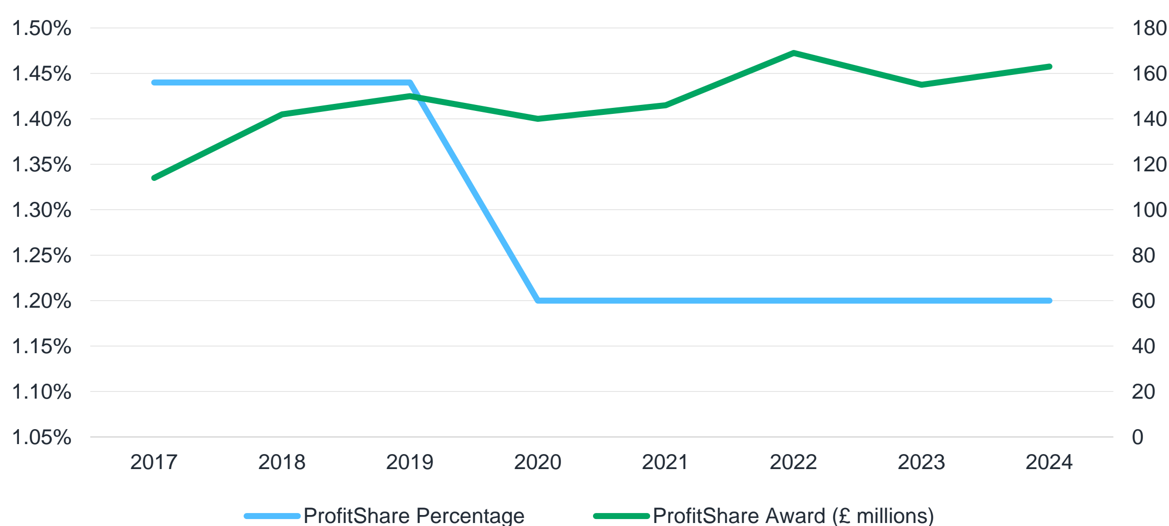
Turning to Royal London, similar challenges exist for determining the exact impact of the acquisition and integration activities. However, as there are no shareholders, Royal London's public results more directly show benefits for its with-profits policyholders. The profits it makes are reinvested in the business to improve its offerings and service for customers, returned to eligible customers via ProfitShare (explained below) and used to support charitable and social impact activities.

Royal London introduced its ProfitShare scheme in 2016, designed to share profits with its customers by adding bonuses to their policies (over and above the bonuses through "regular" operation of with-profits policies). As of April 2024, there were over 2 million eligible customers with life and pensions policies with Royal London.

The graph in Figure 14 shows the trend in ProfitShare annual allocations since it was introduced:

- The blue line shows the ProfitShare percentage for those with-profits customers with the highest participation in ProfitShare. Eligible with-profits policies contracted in 2022 or later receive one-quarter of this percentage, and eligible unit-linked customers receive one-eighth of this percentage.
- The green line shows the aggregate amount of ProfitShare awarded each year in pound millions.

FIGURE 14: PROFITSHARE TRENDS IN ANNUAL ALLOCATIONS



As can be seen from Figure 14, ProfitShare has been reasonably consistent in terms of aggregate amount. The decrease in ProfitShare percentage in 2020 was attributed to the economic outlook indicating that a low interest environment would continue for some time.

14. Phoenix. Helping People Secure a Life of Possibilities: Annual Report and Accounts 2023. Retrieved 6 December 2024 from https://www.thephoenixgroup.com/media/vahepiay/phoenix-group-annual-report-and-accounts-2023.pdf.

3. Italy

3.1 OVERVIEW OF THE ITALIAN MARKET

Life revalorised insurance stands as the product with the highest collected premiums among life insurance companies in Italy. In 2023, Class I premiums amounted to EUR 66.2 billion, reflecting a 9.2% growth and increasing their share of total premiums from 64.3% in 2022 to 72.6%. A significant portion of Class I products are individual policies linked to segregated funds (SFs), with whole life policies being the most popular, accounting for 54% of 2023 premiums.

Between 2021 and 2023, Italy's Institute for the Supervision of Insurance (IVASS) conducted a sample analysis on "insurance-based" investment products (IBIPs) and found that the composition of these products remained almost stable during this period. However, the total number of products offered increased from 542 in the fourth quarter of 2022 to 634 in the same period in 2023.

FIGURE 15: TOTAL PRODUCTS OFFERED, Q4 2023

	2023 Q4
Product number	634
% 'Revalorised'	39%
% unit-linked	29%
% multi-class	32%

Nearly all unit-linked and multi-class products offer more than one investment option, while almost all "revalorized" products are associated with a segregated fund. Single premium products dominate the IBIP market, accounting for 77.9%, whereas periodic premium products are less common, making up 22.0%.

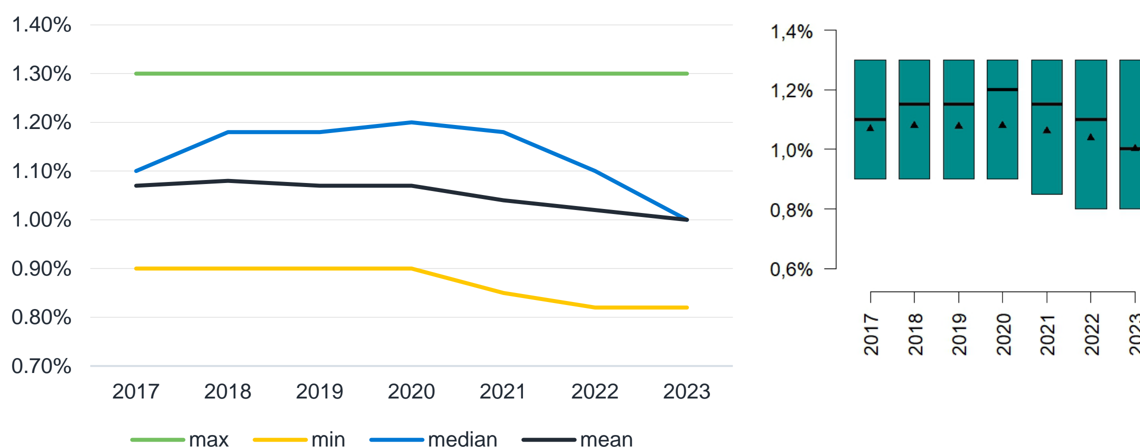
Unit-linked and multi-class products are primarily distributed through the banking channel, whereas revalorised policies are mainly offered through traditional channels. Foreign companies exclusively sell unit-linked products in the domestic market. The duration of contracts predominantly features whole-life forms across all three segments.

In 2023, profit-sharing calculations for life revalorised products were primarily conducted in two ways:

1. For most products, a management fee (averaging around 1%) is deducted from the annual gross rate of return.
2. In some cases, companies directly apply a profit-sharing rate to the gross return of the segregated fund, varying between 80% and 99% (the higher values are for corporate policies with substantial premiums).

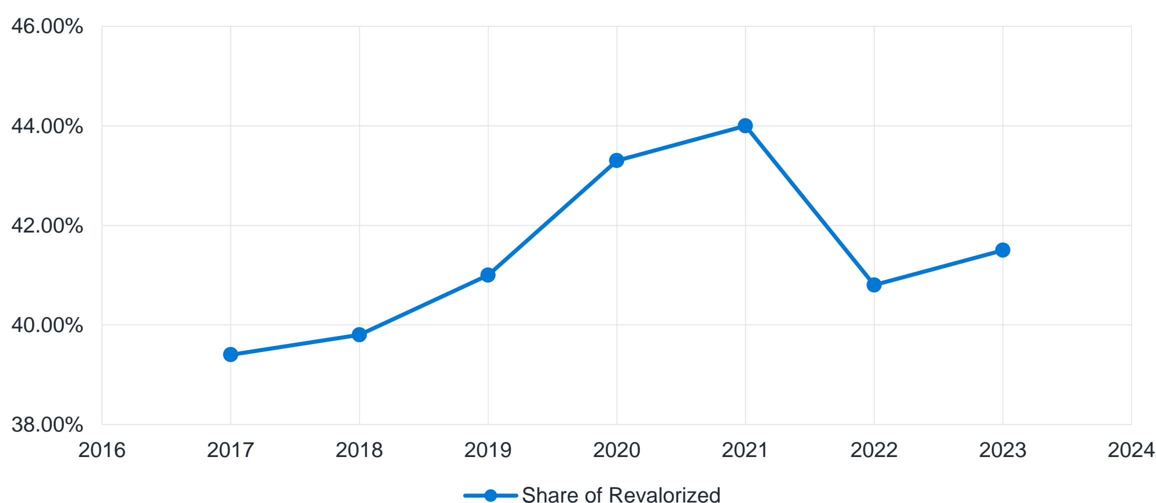
The management fee retained by companies has, on average, decreased between 2017 and 2023, while the variability between companies (interquartile difference) of the management fee rate has increased since 2021. The graph in Figure 16 illustrates the distribution of the management fee for revalorised tariffs, excluding multi-class tariffs.

FIGURE 16: MANAGEMENT FEE FOR REVALORISED TARIFFS



The proportion of tariffs with death-only guarantees has shown growth since 2017, with a more recent decline since 2021.

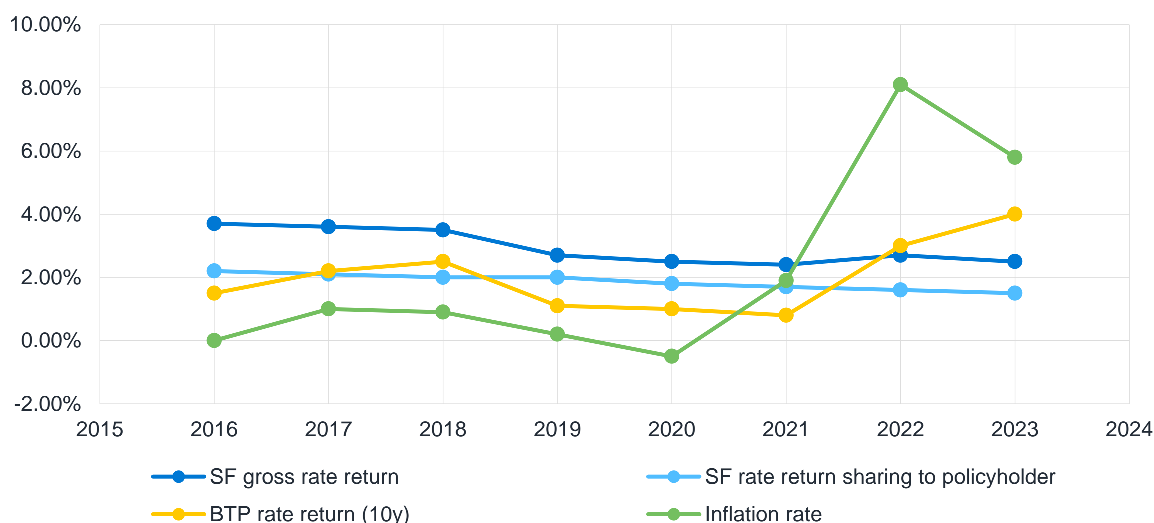
FIGURE 17: SHARE OF REVALORISED TARIFFS WITH GUARANTEE ONLY IN CASE OF DEATH



Segregated funds are utilised by insurance companies to determine the gross rate of return attributed to the insurance benefits of revalorised policies, which encompass almost all Class I and V products. This rate is calculated by dividing the financial result of the period (typically one year) by the average asset value of the period (accounted at book value). The financial result includes earned financial income, trading and issue discounts and realised capital gains, net of realised capital losses.

In 2023, the average rate of return observed was 2.6%, consistent with the 2.5% observed in 2022. For the second consecutive year, the return on segregated funds was lower than both the 10-year BTP rate and the inflation rate. BTPs, or Buoni del Tesoro Poliennali, are a form of financing that investors offer to the Italian government. This financing allows the government to support its activities, which may include healthcare, education and infrastructure development. The average net rate of return to policyholders was around 1.5%, underscoring a gap when compared to returns on investments in BTPs or other bond instruments. However, it is important to note that in previous years the situation was reversed, with segregated fund returns higher than market rates due to a significant amount of unrealised gains.

FIGURE 18: COMPARISON OF AVERAGE RETURN OF SEGREGATED FUNDS, BTP RATE OF RETURN AND INFLATION



3.2 FINANCIAL GUARANTEES

In 2022, the trend of selling products with a 0% guaranteed rate (minimum rate of return), which are the most popular, continued to grow. Reserves for policies with a 0% rate guarantee accounted for 61.4% of the total, up from 58.3% in 2021. The incidence of annual consolidation guarantees (cliquet) decreased from 38.6% to 37.6%, while the share of maturity rate of return guarantees (best-of) increased from 12.2% to 14.5%. Additionally, the amount of reserves for contracts that recognise a periodic coupon rose from 1.4% to 2.0%. These figures are based on the latest available IVASS report for 2022. However, there is a nascent trend of placing products with guarantees slightly above 0%.

Revalorised products integrate several components: insurance guarantees linked to human life, guaranteed minimum return or return of invested capital and the possibility for policyholders to participate in extra returns linked to the financial performance of the segregated fund. A segregated fund is an investment portfolio managed separately from other assets held by the company. The return on these investments, determined by specific accounting rules, is used to revalue policyholders' benefits. The final outcome of the management activity is a gross rate of return, certified by an external auditing firm.

Recently marketed products typically offer 0% guarantees. However, some products launched in recent months have guaranteed rates just above 0%. In the historical portfolios of companies, within older segregated funds, there are still contracts with guaranteed rates of 3% to 4%. Each year, the fund earns a varying return depending on the assets held. The net rate of return is the portion of the gross rate of return allocated to the revaluation of contractual benefits, based on various technical methods described in the contract documents. Benefits are revalued according to the returns obtained by the segregated fund, subject to a minimum value that is generally the greater of the minimum guaranteed rate or the net return.

Revalorised insurance products are essentially structured contracts that combine several types of financial instruments. For Italy, we focus on the option to participate in the performance of the segregated fund and its interaction with the guaranteed minimum. Two main types of options are observed in market practice: the cliquet option, which is no longer applied to newly issued products, and the best-of option, which is similar to a European-style option. The functionality of a policy management system regarding an out-of-use option such as the cliquet option is a particularly relevant issue when dealing with runoff portfolios.

3.2.1 Cliquet option

Cliquet is the traditional guarantee offered on revalorised insurance contracts. Each year, the annual return is the greater of the guaranteed minimum and the SF return net of profit-sharing. This is a consolidated guarantee and there is no allowance for negative returns.

The cliquet option allows the policyholder to lock in the return earned at one point in time, strengthening it at a later date.

General formula:

$$C_t = C_0 \times \prod_{k=1}^{t-1} [1 + max\,(\frac{\gamma i_k - \delta - \beta}{1+\beta}, MGR)]$$

$\gamma = profit\ sharing\ \%$

$i_k = SF\ gross\ return$

$\delta = managment\ fee\ \%$

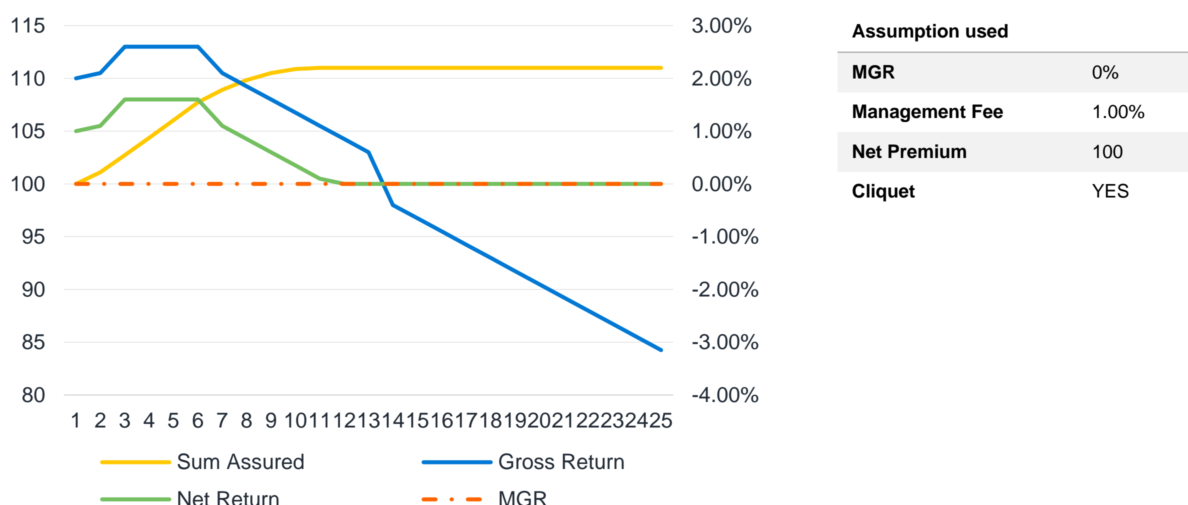
$\beta = technical\ rate\ \%$

$MGR = minimum\ guarantee\ \%$

This is an example of the cliquet guarantee in a context where SF rates initially increase and then decrease until they are less than the management fee (1%).

As can be seen from the graph in Figure 19, the net return to which the policyholder is entitled can never be less than the MGR.

FIGURE 19: EXAMPLE OF CLIQUET GUARANTEE



Assumption used	
MGR	0%
Management Fee	1.00%
Net Premium	100
Cliquet	YES

3.2.2 Best-of option

With this guarantee, the return to the policyholder is the greater of the return on the segregated fund net of profit sharing and the MGR. The main difference between this type of guarantee and cliquet is that, in this case, the comparison is not made annually but only at specific events (death and/or surrender and/or maturity), so returns below the guaranteed minimum are possible (negative returns are not usually allowed, but sometimes they can be).

General formula:

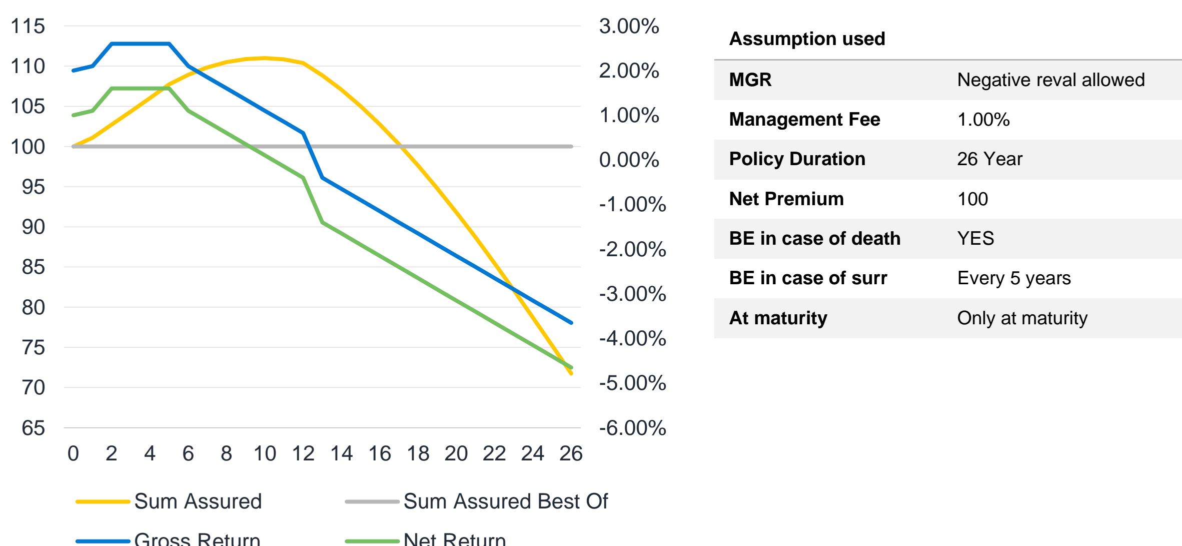
$$C_t = C_0 \times \max\left[\prod_{k=1}^{t-1}(1+\rho_k); (1+MGR)^{t-1}\right]$$

$$\rho_k = \frac{\max\left(\gamma i_k - \delta - \beta, 0\right)}{(1+\beta)}$$

At maturity or the window: Similar to the best-of option, but the warranty verification occurs at policy maturity or during specific windows (e.g., after a certain number of years). This example demonstrates how the best-of guarantee operates in situations involving the cliquet option, such as in cases of death, redemption or maturity.

In this context, the "event" guarantee clearly shows its role in adjusting for the minimum guaranteed sums insured. Various studies indicate that these products are less "expensive" than cliquet options in terms of the time value of options and guarantees (TVOG) and the solvency capital required.

FIGURE 20: EXAMPLE OF BEST-OF GUARANTEE



Assumption used	
MGR	Negative reval allowed
Management Fee	1.00%
Policy Duration	26 Year
Net Premium	100
BE in case of death	YES
BE in case of surr	Every 5 years
At maturity	Only at maturity

FIGURE 21: DEATH BENEFIT

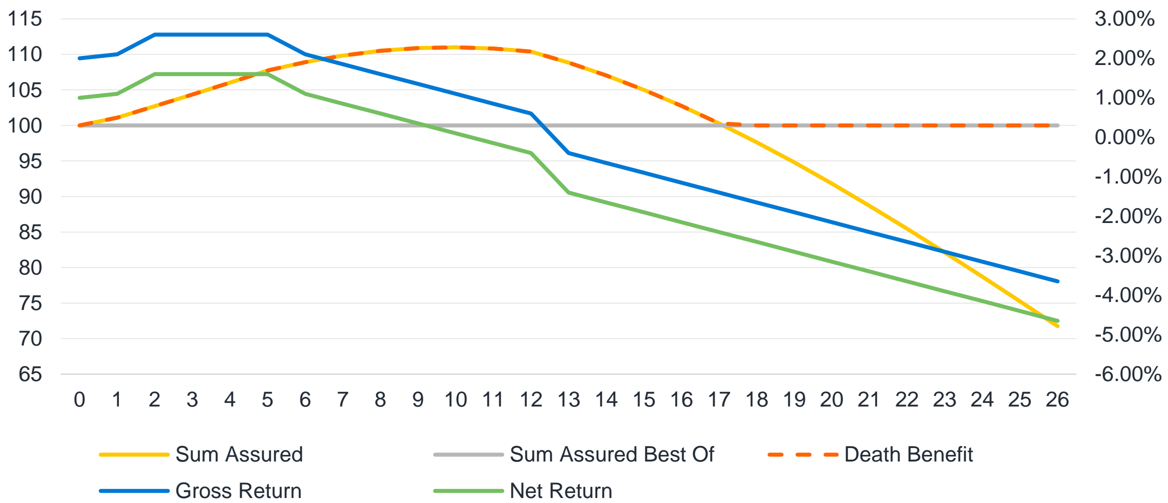


FIGURE 22: SURRENDER BENEFIT – 5-YR WINDOW

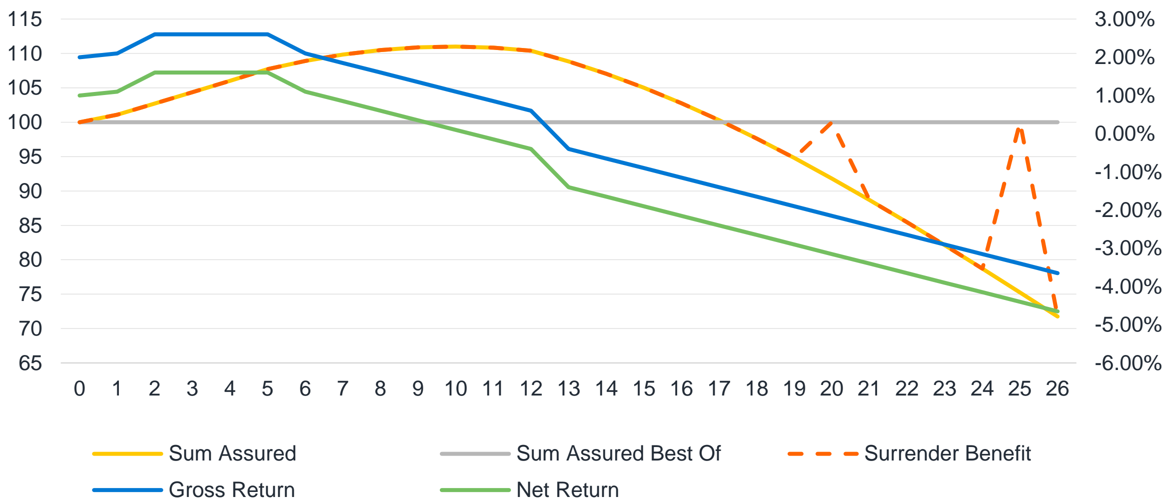
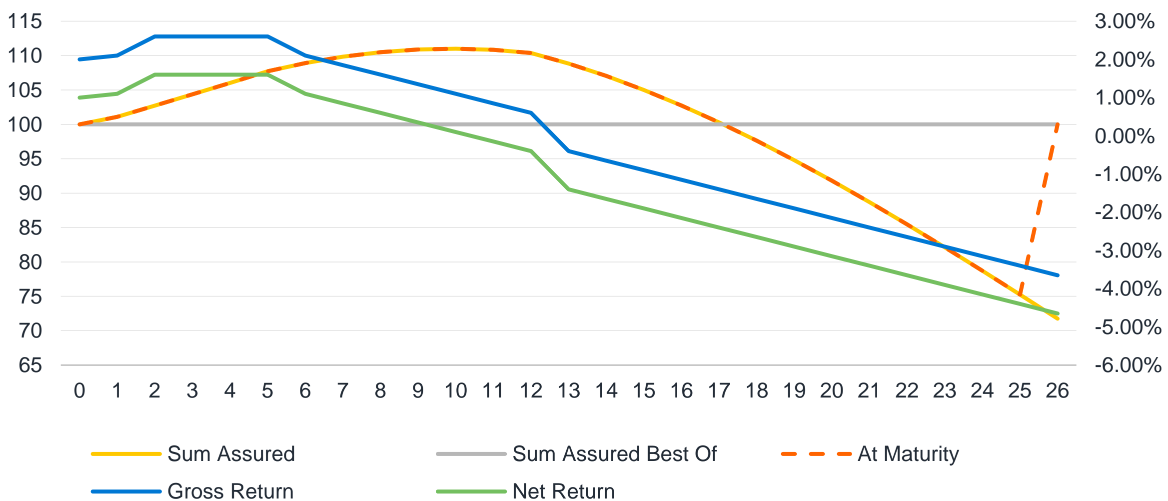


FIGURE 23: ONLY AT MATURITY



3.3 MARKET ANALYSIS OF M&A ON PROFIT-SHARING

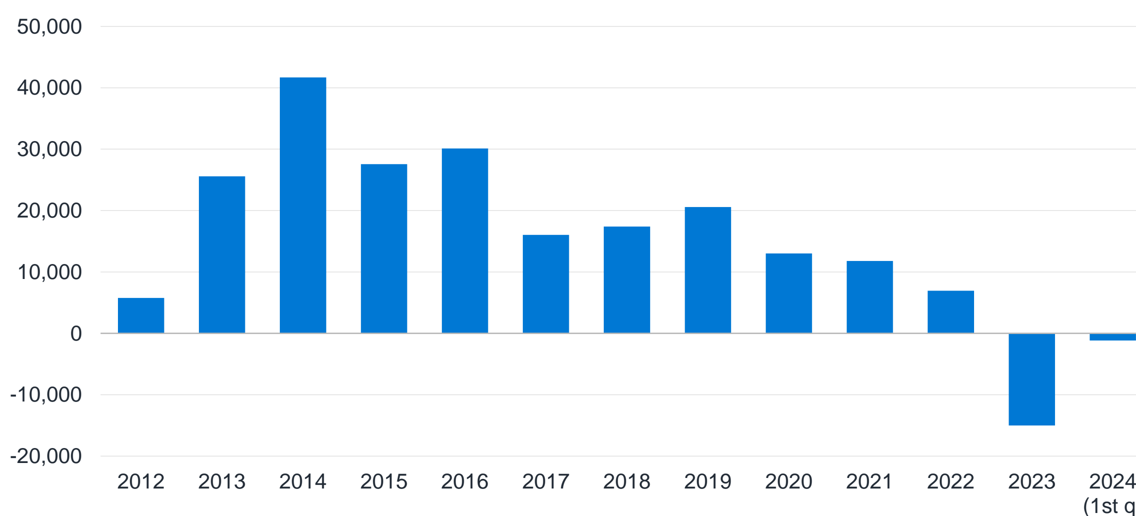
In Italy, there are no companies specifically dedicated to runoff portfolio management. Although several insurance companies have explored the idea of creating such platforms, possibly through partnerships, no concrete initiatives have been established so far.

Mergers and acquisitions (M&A) and migration processes are inherently complex and time-consuming. Transition periods can extend over a year, during which the previous owner continues to manage the divested portfolios on behalf of the acquiring company. During this time, only routine activities are performed, limiting the new company's ability to implement strategic management changes.

Furthermore, profit-sharing in Italy is linked exclusively to the results of segregated funds (SFs) and does not benefit from the overall company results. This makes profit-sharing relatively unaffected by the synergistic optimisations that might arise from acquisitions or mergers. Cost management synergies at the company level have minimal impact on the cost dynamics of the SF. Although a merger of SFs might offer some advantages, it is generally limited because such transactions often involve runoff portfolios with little potential for improvement. Additionally, regulators impose several restrictions on these transactions, approving mergers only occasionally to protect the interests of policyholders invested in the segregated funds involved.

Understanding this phenomenon requires contextualising it within the current Italian market. The year 2023 has been challenging for SFs. Rising interest rates have led to increasing unrealised capital losses, reducing SF returns and, consequently, profit-sharing. This has also resulted in a significant increase in surrenders and a reduction in associated premium income from a reduced policy base, exposing SFs to negative cash flows and a duration mismatch between assets and liabilities. The graph in Figure 24 shows the trend in net inflows of revalorised products under SF from 2012 through the first quarter of 2024. In 2023, the net inflow was EUR 14,996 million, and the first quarter of 2024 recorded a decrease of EUR 1,168 million compared to the same quarter of the previous year.

FIGURE 24: ITALY SF – NET INFLOWS (2012 TO Q1 2024)



Source: Associazione Nazionale fra le Imprese Assicuratrici (ANIA).

Given the technical premises regarding the operation of profit-sharing in segregated funds (SFs) and the current macroeconomic context, we can summarise that the three main levers available to acquiring companies for enhancing management returns and, consequently, profit-sharing are:

- Surrender control
- New business
- Strategic asset allocation

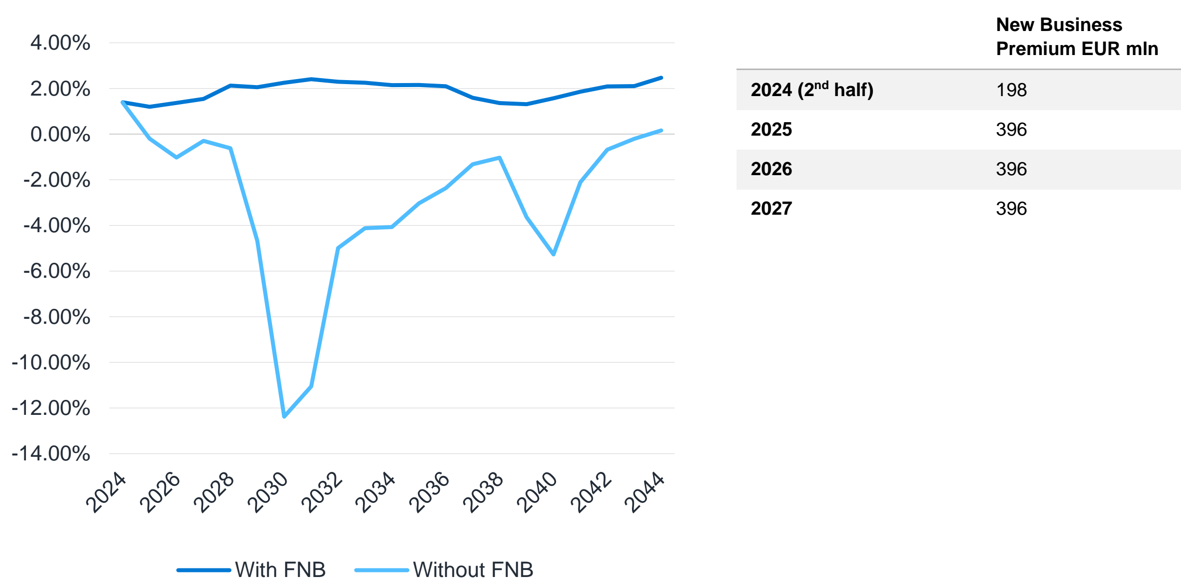
The effectiveness of the first two levers is heightened when the company has greater control over its distribution network, such as through its own agents or within a bancassurance business model. The third lever, strategic asset allocation, can optimise managerial returns by aligning with the company's risk appetite framework and synergising with the dynamics of passive portfolios (surrenders and maturities). This continuous rebalancing can mitigate the duration mismatch between assets and liabilities, leading to more significant managerial performance benefits.

In 2023, there were M&A transactions involving companies primarily consisting of revalorised products with profit-sharing. Milliman Italy has been closely monitoring these activities and continues to work through the transition and migration phases. Currently, some companies involved in recent M&A transactions are evaluating and defining business plans focussed on launching new products to support SF returns for portfolios most affected by rising rates and increased surrenders.

These new products aim to initially cover negative net inflows, thereby reducing the realisation of capital losses. In the longer term, they will support SF returns by investing new premiums in higher-yielding assets. Additionally, these new products may include guaranteed minimum clauses above 0%.

The graph in Figure 25 (based on Milliman internal data) shows the effects of new production on managerial returns and, consequently, on the profit-sharing recognised to policyholders. This analysis is based on the premium income estimates provided in the accompanying table.

FIGURE 25: SF RETURN (GROSS) – PORTFOLIO ALPHA



	New Business Premium EUR mln
2024 (2nd half)	198
2025	396
2026	396
2027	396

Does M&A and migration increase profit-sharing to policyholders?

In this report, we have meticulously examined the effects of mergers and acquisitions (M&A) and portfolio migrations on the profit-sharing mechanisms of runoff insurance providers in Germany, the UK and Italy. Our findings provide nuanced insights into whether these activities benefit both insurers and policyholders across different regulatory and market environments.

In Germany, the case studies of Proxalto and ARAG LV highlight the mixed outcomes of M&A and portfolio migrations. Proxalto has demonstrated significant growth in its provision for premium refund (RfB) and capital returns, outperforming its peers and suggesting that effective management post-migration can indeed yield positive results for both the insurer and policyholders. Conversely, while ARAG LV has not excelled to the same degree, it still shows stable performance and gradual improvement, indicating that M&A activities do not necessarily harm policyholder interests and can lead to incremental gains.

In the UK, the situation is more complex due to the unique structure of with-profits funds and the discretionary nature of their management. Major players like the Phoenix Group and Royal London have leveraged M&A (and subsequent harmonisation) to optimise their in-force business, streamline operations and potentially reduce costs. The direct benefits to policyholders (or to a particular group of policyholders) are less easily measurable due to the intricate interplay of investment returns, expense agreements, smoothing and bonus-setting approach, though the harmonisation usually also benefits the policyholders. While there is potential for cost savings and improved profit-sharing, the outcomes heavily depend on the specific management strategies employed by the acquiring insurers.

In Italy, the lack of dedicated runoff management companies and the challenges posed by rising interest rates on segregated funds (SFs) present a different scenario. Here, the effectiveness of M&A and portfolio migrations is tied to strategic levers such as surrender control, new business acquisition and strategic asset allocation. These strategies can help mitigate negative net inflows and enhance SF returns, ultimately benefiting both insurers and policyholders. The introduction of new products with guaranteed minimum clauses above 0% is a promising development aimed at stabilising returns and improving profit-sharing outcomes.

In conclusion, while M&A and portfolio migrations have the potential to be beneficial for both insurers and policyholders, the extent of these benefits varies across different markets and regulatory environments. Success hinges on effective management, strategic alignment and the ability to adapt to market conditions. Continuous monitoring and strategies adapting to changing economic and competitive environments are essential to ensure that these activities translate into tangible benefits, safeguarding the interests of both insurers and policyholders.

Contributors

The authors would like to take this opportunity to thank all contributors who provided us with input from the various regions of Europe. Of course, the goal is to involve Milliman offices in further analyses or projects across national borders, as the umbrella organisation Milliman combines both system understanding of the software that may be offered and in-depth knowledge of local market and regulatory characteristics.

International input was received from Daniele Zinicola, Giorgia Rotunno, Jennifer van der Ree, and Diya Pittie.

Peer review was conducted by Prannoy Chaudhury, New York, USA, Principal.

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