SPOTLIGHT ON INNOVATION *in the* TRANSACTION INSURANCE MARKET

Advisen executive interview: Dennis Kearns, QBE

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Interest in Transaction Insurance is reaching fever pitch. What are the drivers of growth and how far can the market go?

QBE North America's Dennis Kearns told Advisen that the future lies in offering exceptional service, and understanding complex exposures such as cyber, tax and healthcare.

Dennis Kearns is the leader of QBE North America's Transactional Liability and Financial Institutions practices. Dennis has 20 years of insurance industry experience in product development, underwriting and claims focusing on the management and professional liability sectors.

In 2014, Dennis launched QBE's Transactional Liability practice and led QBE's entry into the Representations & Warranties and Tax Insurance space.

The Transaction Insurance industry is growing at a fast pace: what do you see as the main drivers of this growth?

Since 2011, the Transaction Insurance market has grown around 200 percent, which is very healthy. The market currently stands at more than $1 billion in premiums worldwide and $30 billion in limits. A number of factors have played strongly into that growth.

Firstly, in late 2011 and through 2012, we started to see more confidence in M&A transactions as the economy rebounded from the financial crisis. Companies were more receptive to M&A, which fed into recognition of the utility of Transaction Insurance products.

Secondly, Representations and Warranties (R&W) insurance has become recognized as a cost effective deal-facilitation vehicle, offering parties solutions for completing a transaction, often where they have reached an impasse in closing a deal. Through the use of R&W insurance, a buyer is able to reduce its credit risk on the seller by having the insurer provide indemnity for any unanticipated breaches of the representations and warranties. In turn, the R&W insurance gives a seller a cleaner exit, with a reduction or complete elimination of any escrow, enabling the seller to distribute more profits from the transaction to its investors in a shorter time frame.

Thirdly, two main buyer groups have driven take-up rates on insurance in this market, private equity (PE) firms and law firms. PE firms are a natural buyer of the R&W product. As a seller, these firms have a strong incentive to sell quickly and cleanly, to release cash back to their shareholders. Similarly, as a buyer, PE firms favor turning to a well-capitalized insurer for indemnification and recovery directly from the policy in the event of a loss, rather than having the seller retain liability for payment of loss in the event of a breach.

M&A law firms, acting on behalf of buyers and sellers, strongly influence the Transaction Insurance buying decision. Accordingly, at QBE, we ensure we are interacting with PE firms, their law firm influencers and their broker advisers to better understand the needs of these buyers and the opportunities they present for us to enhance the transaction insurance solutions we can offer.

"DOUBLE-DIGIT GROWTH IN PREMIUMS IN THE US HAS INCREASED THE NUMBER OF CARRIERS ATTRACTED TO THIS CLASS OF BUSINESS."

Fourthly, with more policies being sold, the supply-side of Transaction Insurance products has grown. Double-digit growth in premiums in the US has increased the number of carriers attracted to this class of business. Indeed, we are seeing about three new entrants to the market each year, which helps to drive product innovation and price competiveness. QBE entered the market conservatively, setting up a business plan in the latter part of 2014 and underwriting our first transaction in the first half of 2015. Since then, we have experienced strong growth, particularly in 2016, where we have more than doubled our policy count of 2015. That said, the Transaction Insurance market is still small, relative to other lines of business. There are around 15 regular markets in the US for Transaction Insurance products, compared to more than 60 markets offering D&O insurance, for example.

Fifthly, Transaction Insurance products have become more affordable. As insurance carriers have sharpened their underwriting acumen and understanding of the risks, and as the quality of the risks presented has improved, rates have dropped nearly 30 percent for transactions in certain classes of business. The increased cost-effectiveness of the pricing, particularly after the 2009 financial crisis, has made the product more economically viable for parties involved in an M&A transaction.

Lastly, the ultimate driver for growth will be the experience of claims being paid. The true testament to the utility of any insurance product is how it responds when there is a claim. Thus, more claims brings more opportunity for insurer differentiation at the time when it matters most!

"RATES HAVE DROPPED NEARLY 30 PERCENT FOR TRANSACTIONS IN CERTAIN CLASSES OF BUSINESS."

At QBE, our in-house claims group is staffed with highly skilled and experienced lawyers. Our ability to process and pay claims in a smooth and efficient manner – proving that the product responds – is the best route to sustainable growth in this market. Moreover, we continue to work with our customers and their advisers, including our broker partners, to better understand their needs and develop policy language that better addresses the insurance risks these parties face, so that the coverage provided in the event of a claim presents a meaningful risk management solution.

How big can the Transaction Insurance market get?

R&W insurance has been offered since 1998, and we estimate that it is used on around 18 percent of US private M&A deals. That low level of infiltration offers a significant opportunity for growth in the market—even if economy slows and the volume of M&A deals declines. Therefore, while the double-digit growth rates experienced over the last three years may not be sustainable over the next three to five years, deals will still be done, and insurance will continue remaining a cost effective deal-facilitation solution that can grow in popularity.

"SUSTAINABLE LONG-TERM GROWTH COMES FROM PARTNERSHIP WITH OUR CUSTOMERS, THEIR BROKERS AND THEIR ADVISORS."

At QBE, we believe that sustainable long-term growth comes from partnership with our customers, their brokers and their advisors. We want to be a true deal partner throughout the transaction process – from initial deal negotiation right through to settlement of claims. The more we can demonstrate that full service potential, the more sustainable our growth will be.

How is the market responding to new risks? Where is the innovation coming from?

As we noted earlier, Transaction Insurance is designed to facilitate deals. Within R&W insurance, we do that by assisting the parties in removing or mitigating potential obstacles to deal closure through the use of creative insurance solutions. Known circumstances are usually excluded from R&W insurance. However, in a number of deals, the presence of a particular exposure is known or suspected, but the gravity of the risk presented by such exposure is unknown. This is the classic "known unknown," such as ongoing litigation or potential tag along litigation, environment contamination or tax liability. As the Transaction Insurance market matures and underwriting acumen and expertise continue to develop, we should see a greater willingness on the part of the market participants to provide separate solutions for these "known unknowns." This is particularly likely with existing litigation and environmental and tax liability, where the liability posed by such exposures can be conceptualized, but the gravity of such exposures remains unknown. The ability to remove these potentially problematic exposures and create a separate cover not only keeps the cost of an R&W policy affordable, but presents the parties to a transaction with new and creative solutions for critical exposures that in the past have stymied deals.

"[QBE] WILL BE LAUNCHING A PRIMARY TAX INSURANCE PRODUCT IN THE FOURTH QUARTER OF 2016."

The utility of tax liability insurance, whether as an offshoot of an M&A transaction or a standalone transaction insurance solution, has been increasingly recognized in the past couple of years, and will continue to present growth opportunities for insurers in the Transaction Insurance market. We are starting to see more carriers offer tax insurance solutions, QBE included, as we will be launching a primary tax insurance product in the fourth quarter of 2016. Tax insurance products protect against tax losses stemming from liability arising out of challenge to the tax treatment of a current or historical transaction or investment or failure to receive certain tax credits.

Another emerging risk that the Transaction Insurance market continues to examine is healthcare. This is a growing economic sector that offers a substantial growth opportunity for insurers. This sector is particularly challenging because of the potentially significant regulatory and governmental compliance exposures. Accordingly, the Transaction Insurance market is actively exploring how to provide affordable insurance solutions to healthcare M&A transactions, including the regulatory and governmental compliance exposures. The success of such endeavors will likely hinge on the ability to clearly define the extent of the potential for regulatory/governmental liability. New and innovative approaches being explored in the market include conducting a comprehensive pre-loss audit of a healthcare provider's practices involving Medicare/Medicaid billing and governmental audit procedures. To the extent such pre-loss activity can be comprehensive but still affordable from a cost benefit analysis, the more likely you will see insurers willing to consider such tools and ultimately offer more comprehensive insurance products to this vital sector of our economy.

What about cyber exposure?

Cyber exposure has an impact across many lines of business – including Transaction Insurance. The seller in M&A deals will make representations as to the level of their cyber exposure, and the buyers will need to contemplate the extent to which they are being asked to assume liability for such exposures following the close of a transaction. Thus, the Transaction Insurance market is currently looking at how to account for this cyber exposure, which is particularly prevalent in companies that hold personally identifiable information from credit card transactions, operate with cloud-based technologies or hold healthcare or personal financial records/details of patients/customers.

Does it affect R&W pricing? Is it a standalone product? Does it coincide with other specific cyber policies or D&O? These are some of the questions we are actively addressing at QBE. QBE writes standalone cyber policies and D&O

cover, and my team is in constant dialogue with those underwriters to dovetail our coverages and manage potential risk aggregation concerns.

As the cyber market continues to develop and underwriters become more comfortable with the cyber exposures in an R&W policy, you will see insurers become more amenable to offering more tailored cover solutions for these exposures.

"...THE TRANSACTION INSURANCE MARKET IS CURRENTLY LOOKING AT HOW TO ACCOUNT FOR [THIS] CYBER EXPOSURE..."

How can the market make the R&W product more relevant?

The R&W product has been offered for 18 years now, so one can say it is relatively mature. From here, the market focus must be on making the product a truly efficient component of the transaction solution. Service levels are key.

The Transaction Insurance market must continue to work in lock-step with deal parties to offer a seamless response time to the deal. Insurance must never be considered as an obstacle to the deal process, but must operate in 'deal time' to meet deadlines set by the deal parties. At QBE, we have hired and continue to hire the best attorneys who understand the environment and are accustomed to working within those parameters.

How is this achieved? Continued commitment to innovative products and exemplary service. The right product and the way in which you service that product are your market differentiators.

"THE RIGHT PRODUCT AND THE WAY IN WHICH YOU SERVICE THAT PRODUCT ARE YOUR MARKET DIFFERENTIATORS."

At QBE, we remain committed to offering a fully tailored, customized product to the buyer. We offer a short, easy-to-read template policy to our customers, which then is tailored to fit their deals. Lastly, the ability to attract repeat buyers in this market is crucial, and therefore service levels and flexibility must remain paramount. QBE actively courts the repeat buyer, giving them assurances that the last transaction they did with QBE forms the basis of the next transaction, and that their QBE policy and service will continue to evolve with the evolution of their businesses.