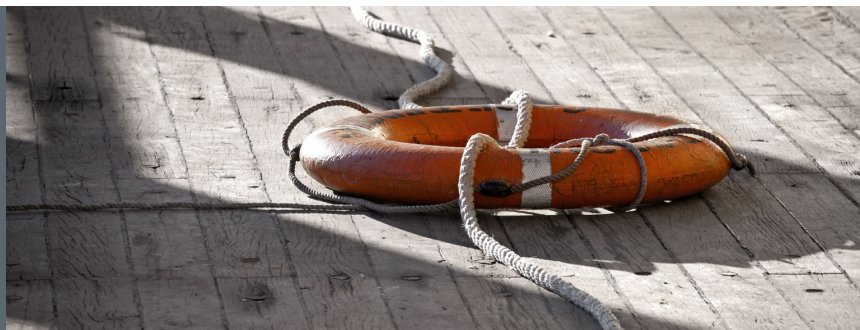


in the news

Insurance



January 2014

Protecting Viable Private Equity Investment in the Insurance Sector

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The complexity of the insurance sector no longer causes many private equity firms to shy away from insurance industry entities as acquisition targets in carrying out a private equity firm’s investment strategies. However, PE firms getting in on the action should be aware of present and evolving regulatory requirements imposed on insurance company investments. The National Association of Insurance Commissioners’ “Private Equity Issues (E) Working Group” has recently proposed for comment enhanced regulatory scrutiny of private equity investment in the insurance sector, of which PE firms considering merger and acquisition activity in this market should be aware. Insurers interested in the opportunity for capital investment by PE firms should also be aware of the Working Group’s proposals. The comment period expires January 30, 2014.

M&A Activity in the Insurance Industry

Activity in insurance industry M&A was robust in 2011 and 2012. PE firms alone made over 100 acquisitions in this sector in those years.¹ While insurance M&A activity in 2013 did not continue that active pace, market followers project a significant increase in insurance sector M&A in 2014.² This

¹ From “Top 10 Issues for Insurance M&A in 2013, Time for mergers and acquisitions to take off?” Deloitte analysis of FactSet Mergers data, 2012.

² “Insurance M&A Trends That May Lead to ‘Perfect Storm’ in 2014,” available at www.insurancejournal.com/news/national/2014/01/09/316503.htm.



appears to be due to a perceived increasing demand in insurance sector investments by PE firms, particularly in insurance broker acquisitions, but also in life insurance and property & casualty insurance companies. A motivating factor for PE investment in insurance brokers is the favorable impact the brokers' compensation structure delivers to its cash flows and balance sheet risk. PE firms are also motivated by the opportunity to apply their "value-added" experience in financial management and risk assessment, recruiting talent, restructuring/streamlining and – particularly - asset management expertise to an attractive insurance sector target, as a component of the firms' investment strategies. In many cases, PE investment provides much needed capital for the insurance target, either to meet regulatory requirements or for the pursuit of a growth strategy.

Developments in the M&A Regulatory Environment

The regulatory requirements imposed on insurance companies and insurance company holding systems can make insurance sector investment challenging even when an acquiring firm understands the regulatory regime imposed on such transactions and the subsequent insurance holding company system that is created. At a minimum, regulatory requirements extend the timeline for closing transactions constituting an insurance company's change of control due to the approval requirements of the insurer's state of domicile.

Regulations applicable to the insurance sector continue to evolve. The Solvency Modernization Initiative and the National Association of Insurance Commissioners' adoption of principles-based reserving by life insurance companies have begun a new era of risk-based supervision for the industry.

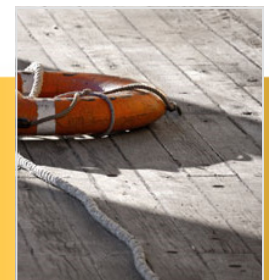
Risk-based monitoring has been recently enhanced further with many states' adoption of the NAIC's model regulatory reporting requirements related to risks posed by non-regulated entities, such as PE acquirers, in an insurance holding company system. Among these will be an "enterprise risk report" (Form F), which will be submitted by those

insurers subject to the requirement with their annual registration statement (Form B). The Form F reporting requirement will be effective in May 2015.

NAIC Private Equity Issues (E) Working Group

Recently, the NAIC's Private Equity Issues (E) Working Group has proposed additional scrutiny on transactions involving PE investment in the insurance sector (primarily with respect to investment in life insurers). The proposed "best practices" result from concern that the business model of private equity investment- to achieve a positive return on its investment - may not be aligned with the interests of policyholders. Annuitants, beneficiaries and other policyholders require a long-term view to meet policyholder benefits that may be at odds with a PE firm's investment and exit strategies. By contrast, firms in the industry have commented that the interests of private equity investors and policyholders typically are aligned. The success of the insurer is vital to the PE firm's investment and the policyholders' protection.

While the purpose of the Working Group's proposals is directed at mitigating and monitoring potential risks presented by private equity and fund managers' investment in life insurers, the proposals are not limited to PE investment in life insurers. As a result, it is unclear whether any proposed model regulations or best practices ultimately





would apply to any change of control of an insurer or would be limited to those resulting from PE investment. Although the proposals are explicit to PE investors, history would support a broader application as witnessed by the widely accepted governance best practices arising from the Sarbanes Oxley Act of 2002.

Nevertheless, the Working Group's suggestions presently are directed toward PE investments and would provide new or enhanced regulatory authority to regulators presented with change of control transactions by PE firms. They would also assert additional best practices related to such investments for inclusion in the Financial Condition Examiners Handbook and the Financial Analysis Handbook utilized for reporting under the Statutory Accounting Principles applicable in lieu of GAAP in the insurance sector.

At least one PE firm has commented that some of the Working Group's proposals are already within the purview of state insurance departments, some, if adopted, should be broadly applied. Some are not feasible or unfair and some require subjective assessments that should be the purview of the insurer's management and board of directors.

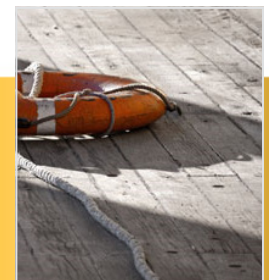
The Working Group's proposals include suggestions for changes to the Form A change of control application for approval of PE acquisitions of insurer's and enhanced annual examination authority of the insurer and its affiliates following a PE firm's investment.

The Working Group's Proposals Subject to Comment

The following provides a brief outline of the Working Group's proposed "possible best practices" applicable to PE investment in the insurance sector. The full text of the proposals can be found at www.naic.org/documents/committees_e_private_equity_wg_related_memo_fawg. Comments are due to Dan Daveline, NAIC Assistant Director-Financial Regulatory Services, by January 30, 2014.

Change in Control Form A Considerations

- Requiring the acquiring entity to demonstrate that the policyholder is fundamentally more secure with the proposed acquisition of control, including details of investment strategy of both the insurer and the entire group and consideration of the following:
 - Determination by an investment banker or other specialist of whether the investment strategy and related affiliated agreements (including private equity firm fees and fee structure) are appropriate for the backing of annuity contracts.
 - Providing pro forma results for the insurer under certain stress scenarios.
 - Requesting more specifics regarding cash flows and reserves.
 - If specifics of cash flows and reserves are obtained, actuarial evaluation of sufficiency of insurer's process for cash flow testing/modeling and process for settling reserves and calculation of charges for risk-based capital associates with products where the risks are material.
 - Providing information on investment returns necessary to meet investor demands and related investment strategies.





- Requiring a capital maintenance agreement upon the acquiring entity.
- Requiring conditions imposed on the acquiring entity for Form A approval, including:
 - Limiting investment strategy
 - Statement of PE firm to ensure members' compliance with insurance laws of domiciliary state
 - Statement that PE firm actions will not cause insurer to be out of compliance with laws of domiciliary state
- Coordination among regulators
- Review of investment portfolio of insurer and affiliates, including asset match to insurance liabilities
- Annual stress testing of insurer and insurance holding company group, including investments and policyholder liabilities
- Review investment management and other affiliated/non-affiliated agreements, including private equity firm fees and fee structure, intercompany transactions and reinsurance agreements

Annual Examination of Insurer and Affiliates

- Purpose of annual examination would be to ensure that the investment strategy provides a prudent approach for investing policyholder funds.

Non-Affiliate Examinations

- Authority to perform targeted examinations on non-affiliated insurers where the direct writer has ceded a material portion of their annuity risk to the private equity-controlled insurer.

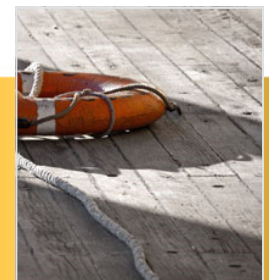
For More Information

For strategic and specific advice or assistance in commenting on the Working Group's proposals, managing the regulatory process for an acquisition within the insurance industry or complying with any of the regulatory requirements imposed by domiciliary state insurance departments, please contact:

- **Robert B. Sullivan** | 816.360.4151 | rsullivan@polsinelli.com
- **Kelly S. Sullivan** | 816.360.4278 | ksullivan@polsinelli.com

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