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CLIENT MEMORANDUM

NAIC to Consider Private Equity Investments in Life and Annuity Insurers

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The National Association of Insurance Commissioners (NAIC) has scheduled a conference call on May 23 to address the increased interest by private equity funds and hedge fund managers in life insurers, particularly those focused on annuity products.

The NAIC's Financial Analysis Working Group (FAWG), which coordinates multi-state action with respect to troubled insurers and identifies industry trends, has noted the interest of private equity and hedge funds in managing life and annuity investment assets, either through the acquisition of life insurers or the reinsurance of life and annuity risks. FAWG's expressed concern is that the prudence required to manage life insurance and annuity assets for the benefit of policyholders is "inconsistent with the business model of private equity firms and therefore creates inherent risks." FAWG recommends the formation of a new working group charged with the task of developing tools that would authorize insurance regulators to monitor and mitigate risks presented by private equity and hedge fund acquisition and management of life and annuity assets.

Because FAWG is not designed to develop public policy, it has recommended that the NAIC's Financial Condition (E) Committee form a working group to address this issue. In its referral, FAWG has identified possible best practices, as well as potential changes to state laws and regulations incorporating such practices based on NAIC models. Such recommendations focus on (i) the acquisition of control (Form A) process and (ii) insurance regulators' financial examination practices for life insurers.

FAWG's proposed best practices include requiring acquirers, as part of the Form A process, to demonstrate that policyholders are fundamentally more secure under the proposed acquisition, and to provide details on their investment strategy with respect to the target insurer and the insurance group. FAWG proposes that regulators use tools including

- engaging an investment banker to determine if the investment strategy and related affiliate agreements are appropriate giving specific consideration to equity firm fees and arrangements with broker dealers;
- obtaining pro forma results under specific stress scenarios;
- requiring the acquirer to enter into a capital maintenance agreement supporting the net worth of the target operations;
- requiring more information regarding cash flows and reserves as well as insurer reserve methodologies;
- limiting the investment strategy used with respect to any assets held in trust to ensure they meet asset liability matching and any state insurance law requirements;
- obtaining specific commitments from the acquirer regarding state insurance laws and regulations; and
- obtaining information from the acquirer regarding investment returns necessary to meet investor demands and plans to obtain such returns through its insurance company investment.

In addition, FAWG recommends that insurance regulators consider using an investment specialist to carry out ongoing financial analysis of the insurer and its affiliates, including annual targeted examinations to ensure that the insurer's investment strategy provides a prudent approach to investing policyholder funds. Further, FAWG recommends coordination with international regulators, detailed review of the investment portfolio of the insurer and its affiliates, ongoing stress tests and a review of agreements with affiliates and non-affiliates related to fee agreements and reinsurance arrangements. Examinations of private equity-owned reinsurers that assume annuity risks from U.S. regulated insurers are also recommended as a best practice.

Amendments to specific state laws such as the Credit for Reinsurance Model Law, state investment laws and Risk-Based Capital formulas are also suggested.

For private equity firms, hedge funds and life insurance industry participants, it will be important to monitor these developments at the NAIC. Although still preliminary, the actions at the NAIC may result in substantial regulatory changes related to private equity firms and hedge funds managing the assets of life insurance companies.

If you have any questions regarding this memorandum, please contact Leah Campbell (212 728-8217, lcampbell@willkie.com), Allison J. Tam (212 728-8282, atam@willkie.com) or the Willkie attorney with whom you regularly work.

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