Issues in insurance company mergers & acquisitions

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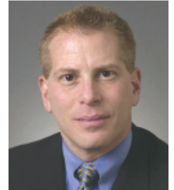
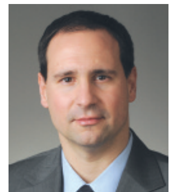
The completion of a successful merger or acquisition involving insurance companies requires careful planning and specialised skill sets to deal with the many important ways insurance companies differ from other entities. Insurance companies face a unique set of regulations, have special accounting rules, maintain liabilities that may be difficult to value. These challenges require in-depth knowledge of the business of insurance prior to attempting any acquisition. This article summarises the primary concerns that may arise in connection with the acquisition of an insurance company or lines of insurance business.[1]





Valuation

Valuation of the target insurance company or line of business is the first step in any potential acquisition. This requires an understanding of the many variables involved, including future revenue stream (such as premiums, fees, charges, and investment income), actuarially estimated future liabilities for policy benefits (including the related adjustment and litigation costs and the required amount of regulatory reserves), investments and hedging portfolio, asset liability matching strategies, distribution platforms and costs, technology and system capabilities, and regulatory requirements and restrictions.

Intrinsic values

Intrinsic value will be based on the profitability of the insurance products offered, which requires the determination of the sufficiency of premium and investment income to cover future liabilities for benefits and related costs. Intrinsic value will depend upon the ability of the business to generate future revenue. The ability to generate new business is primarily a function of the insurer's distribution chain. Distribution is most often accomplished through either independent brokers or dedicated agents, but it may also be conducted through other financial institutions such as banks and financial advisers. Valuing the performance of distribution channels is difficult, as it depends on projected future performance of multiple agents and dealers.

Future producer performance may be affected by any merger or acquisition transaction that disrupts the relationship between the insurer and its distribution channels. Maintaining distribution networks for property and casualty insurance is especially important due to the short-term nature of the products. Most property and casualty insurance policies have a term of one year and are renewed annually, and therefore any disruption in distribution could lead to an immediate decline in renewals. As part of the transaction terms, acquirers may require the seller to assist in the transition of the distribution relationships to the acquirer.

Acquirers must analyse the business's future obligations. Life insurance policies may be very straightforward or have complex formulas for the determination of the benefits owed to such insured. Formulas may be based on returns in various markets or include minimum payments based upon the values of such markets during the life of the policy. Future obligations of property and casualty policies may be more difficult to ascertain. Insurers not only maintain reserves for reported claims, but also for claims the insurer believes to have been incurred but that have not yet been reported. Such claims are uncertain, and actual losses may diverge from the reserves established by the insurer. The acquirer's actuaries can examine the assumptions used by the target insurer and estimate the reserves independently.

The servicing of the business is also important to any valuation process. Servicing requires, among other things, continued contact with insureds to collect premiums and process claims. Except in rare circumstances, administration is ultimately handled by the acquirer. Under certain circumstances, there is a period of time (which may be up to two years) in which the seller provides transition services for the business. This may be done in the situation where the acquirer does not maintain the type of software or other intellectual property needed to run the business. Also, with respect to the sale of a line of business, the seller may provide transition services because the acquirer may not be licensed to sell the types of products included in the target block of business.

Statutory liabilities

Insurance companies in the US are regulated on a state by state basis and are required to account for their business based on statutory accounting principles rather than generally accepted accounting principles. Statutory accounting principles are generally more conservative than generally accepted accounting principles, as statutory accounting principles focus on the solvency of the insurer. These principles and the applicable regulations require the maintenance of reserves by an insurer for the potential liabilities due under policies. Insurers must also maintain reserves related to realised gains from interest rate movements and changes to asset valuations based on the types of assets supporting the business. A larger amount of total reserves maintained with respect to the business may create a drag on the capital of the business and decrease its value.

Litigation and adjustment risks

Insurance companies are frequent targets of litigation, including class action litigation, most often claims that an insurance product's terms differed from representations made by producers or the insurer regarding such products or that the insurer's administration of the insurance product differed from that represented in the policy form or the related marketing materials. A potential acquirer must consider the state of ongoing litigation and the potential for future litigation. The acquirer should also examine the vulnerability of the target to future claims. This examination should focus on products that are currently, or recently have been, subject to litigation or products that have not been subject to litigation but may be in the future. In addition, an acquirer should review the target's complaint logs, as they may reveal trends that could lead to material litigation.

The sales practices of insurers and their agents are subject to regular market conduct examinations by regulators in states where they distribute products. An insurer may face substantial regulatory penalties for its failure to comply with the required practices of each jurisdiction. A potential acquirer should examine the results of past regulatory investigations to determine if the insurer has properly complied with product and marketing regulations. An acquirer should also examine current practices for compliance with applicable regulations and determine the status of any ongoing examinations. This investigation may reveal internal control weaknesses that could result in future claims that will affect the value of the target insurer.

Finally, acquirers should examine the amount of loss adjustment expenses incurred by a target insurer to understand the efficiency of the adjustment process. Historic loss adjustment expenses as compared to settlement amounts are an important factor in estimating the expected expenses involved in future claims.

Other valuation issues

Intellectual property is often important to the operations of an insurer for the servicing of contracts and the maintenance of relationships. An acquirer should examine the property rights of the insurer in any intellectual property that is material to the business of the target insurer. This should include a review of any contracts for the provision of intellectual property or related services to ensure that the rights to use such intellectual property can be maintained by the acquirer following the acquisition, and to determine any termination fees related to such contracts.

Insurance holding companies are often well-diversified financial companies that may include banks, mutual funds, investment advisers, insurance agencies, and securities broker-dealers, and as with most operating companies, they will own properties including real estate, and have multiple employment and environmental issues. The assets and liabilities associated with these activities will also need to be valued. The acquirer should consult with experts familiar with the various businesses and with counsel familiar with issues arising from these businesses to determine their value.

Acquisition types

The first step in any merger or acquisition is to decide which assets the acquirer desires to purchase. A merger with or acquisition of a stock insurance company will be, subject to regulatory filings and approvals. An acquirer may form a subsidiary to merge with an insurance holding company or with an insurer, or the acquirer may purchase an insurance company from an insurance holding company. However, if the assets to be purchased consist of a block of insurance policies without a purchase of or merger with the entire company, a traditional asset purchase transaction will not suffice, and the acquirer must utilise reinsurance. Also, as discussed below, special issues arise in the context of acquisitions of mutual insurance companies.

Coinsurance transactions

The direct obligations of an insurer cannot be transferred to the acquirer without the consent of the insureds. Obtaining consents from a multitude of insureds is not often feasible, and therefore acquirers often acquire interests in blocks of insurance policies through indemnity coinsurance. In indemnity coinsurance, an acquirer reinsures a specified percentage of the relevant block of policies. Through this arrangement, the selling insurer remains primarily liable to the insureds but transfers some or all of the premiums received from the policyholders and the

obligations for policyholder benefits to the acquirer. The purchase price is paid to the seller in the form of a ceding commission under the coinsurance agreement, and the acquirer generally pays a continuing servicing cost to the seller in the form of a periodic expense allowance. In the event that the block of business involves life insurance separate accounts, the transaction may be structured as modified coinsurance. In this structure, the assets and reserves remain with the seller and the performance of the business is borne by the acquirer through periodic net settlement payments between the parties.

Reserves for reinsurance

In a reinsurance arrangement, the seller will generally require that the transaction enable it to take credit for the reinsurance provided, allowing it to release the reserves related to the block of policies. Such reserves should instead be maintained by the acquirer. In some instances, most often where the selling insurer requires credit protection from the acquirer, the selling insurer may require that the reserves be maintained by the acquirer but the related assets be held by the insurer or placed in a collateral trust. Alternatively, the insurer may require that the acquirer transfer the assets to the insurer (in the form of a funds withheld account) or a collateral trust upon the occurrence of certain credit events of the acquirer.

In a reinsurance arrangement, if the seller is a US domiciled insurer and the acquirer is not or does not meet the regulatory requirements of the domiciliary state of the seller, the seller may not be able to eliminate its reserving requirements for the business solely based on the reinsurance arrangement. To receive adequate credit for the reinsurance when the acquirer is an offshore company, the acquirer must establish collateral sufficient to support the reserves in a form that is available to the seller if the purchaser does not pay its obligations under the reinsurance as they become due. The requirements for receiving credit for reinsurance differ for each state but generally allow collaterlisation through assets held in trust for the seller or the issuance of a letter of credit for the benefit of the seller. Credit for reinsurance trusts are subject to the immediate withdrawal by the seller for use to pay benefits under the policies reinsured to the acquirer. Assets maintained in the trust by the acquirer generally must conform to the investment restrictions of the relevant state. Income

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on these assets may be removed by the acquirer at any time but market value increases in the trust assets may only be withdrawn by the acquirer with the consent of the seller and only to the extent that the market value is greater than 102% of the required reserve. Letters of credit must be issued by a qualifying US financial institution, be evergreen, with a period of at least one year, and funds must be available immediately upon demand. These collateral techniques ensure payment of claims to the seller but impose costs on the acquirer in the form of asset restrictions or letter of credit fees.

Mutual insurance company acquisitions

In the case of mutual insurance companies, the company is owned by its policyholders, rather than stockholders. Policyholders in a mutual insurance company receive a right to participate in the profits of the company through their insurance policies. Mutuality is achieved in two forms: mutuals and mutual holding companies. A mutual insurance company serves as both the main insurer and the holding company, while a mutual holding company is a holding company owned by the policyholders that own stock insurance companies. Subsidiary stock companies of a mutual holding company may be purchased, but in order to purchase a mutual insurance company the target company generally must demutualise prior to the acquisition or merge with another mutual insurance company. Demutualisation involves the conversion of participating portions of policies into stock in a holding company and typically the offering of newly issued stock. This process requires approval of the regulator of the target company to develop a fair price and other protections for the insureds. However, the offer process may be avoided through a sponsored demutualisation where the acquirer participates in the demutualisation and purchases the shares. Alternatively, the mutual company could convert to a mutual holding company in which outside investors may acquire a minority equity stake in the intermediate holding company.

Administrative and transition services

Because of the highly specialised nature of the insurance business, any acquirer will also want to ensure that the proper personnel are retained following the sale of the business. An acquirer should review employment and other contracts to ensure that key employees, brokers, agents, reinsurance contracts, and intellectual property can be retained. In the sale of a business line, the acquirer may want the ability to write new policies in the name of the insurer. This may occur where the acquirer is not licensed for a specific line of business in all jurisdictions where the seller operates. In that case, new business would be written by the seller and would be reinsured by the acquirer. The insurer and acquirer will negotiate indemnity and licensing agreements for use of the insurer's name in marketing and any liability that may arise due to selling practices.

Sellers and acquirers often agree to transition services that maintain services during the transfer of the company and provides for the acquirer to instruct certain seller employees on servicing of the business. This servicing often includes contact with insureds and accounting for the business, and it should be performed in a manner that maintains the business in a similar fashion as when owned by the seller. It is important that the seller and acquirer negotiate the standard under which the business will be serviced, the cost for such services, and any indemnity that will be provided. The acquirer should also ensure that the services would continue for the desired timeframe necessary for it to fully integrate the operations of the business.

Regulatory filings

Prior to the finalisation of any merger or acquisition involving an insurance company, both parties should ensure that insurance filing and approval requirements are met. Generally, a sale of an insurance company or the sale of a significant block of business must be approved by its applicable regulators. These filings are made by the acquirer in the case of a merger and by the seller in the case of an asset sale. If a transaction involves an insurance holding company, applicable filings may be required in all the domiciliary states of subsidiary insurers. Regulators are required to approve such a sale and will review the transaction to determine that adequate protections are provided to insureds. Approval may also be required by regulators in jurisdictions where the insurer is licensed, not only jurisdictions where the insurer is domiciled. For example, some states, including California, require a filing for bulk sales of insurance policies for companies that write business in their state.

Acquiring an insurance company requires careful consideration at each step. The seller and buyer must navigate numerous structural, legal, and regulatory concerns to successfully complete the sale transaction.

Notes:

[1] This article does not address certain issues common to merger or acquisition transactions generally such as securities law, tax law, and fiduciary duty considerations

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